TAX REFORM ACT OF 1969

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HEARINGS

BEFORE THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

NINETY-FIRST CONGRESS

FIRST SESSION

ON

H.R. 13270

TO REFORM THE INCOME TAX LAWS

PART 2 OF 7 PARTS

SEPTEMBER 11 AND 12, 1969

GENERAL OUTLINE OF ORAL AND WRITTEN TESTIMONY IN PART 2:

Deferred Compensation
General
Multiple Corporations
Single Persons
Tax-Exempt Organizations

Printed for the use of the Committee on Finance

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Subject:
- Deferred compensation:
  - Oral testimony, pp. 1025-1033
- General:
  - Oral testimony, pp. 913-1025
  - Written testimony, pp. 1193-1671
- Multiple corporations:
  - Oral testimony, pp. 1162-1189
  - Written testimony, 1189-1192
- Single persons:
  - Oral testimony, pp. 1039-1062
- Tax-exempt organizations:
  - Oral testimony, pp. 1063-1162
  - Written testimony, pp. 1673-1776

CONTENTS

PART 2

Witnesses

	Page
Adams, Denvel D., national adjutant, Disabled American Veterans, accompanied by: Raymond Neal, national commander; Charles L. Huber, national director of legislation; and Donald C. Alexander, counsel	1157
Prepared statement	1159
American Business Press, Robert E. McKenna, chairman, Washington Legal Committee and president, Chilton Co., accompanied by: Paul Conrad, general counsel, National Newspaper Association; and Robert Saltzstein, general counsel, American Business Press	1100
Prepared statement of Robert McKenna	1119
Prepared statement of Paul Conrad	1123
American Machine Tool Distributors Association, Joel Barlow, counsel	
Prepared statement	961
American Textile Manufacturers Institute, J. T. Higgins, chairman, tax committee	1017
Prepared statement	1020
Association for Advanced Life Underwriting, James B. Irvine, Jr., president, accompanied by: Gerald H. Sherman, counsel	1025
Prepared statement	1029
Barlow, Joel, counsel, National Machine Tool Builders Association, American Machine Tool Distributors Association, and National Tool, Die & Precision Machine Association	961
Prepared statement	968
Botwinick, Benjamin, an independent CPA, representing the Metropolitan Taxicab Board of Trade, Inc., New York City	1185
Caplin, Mortimer, M., National Tax Equality Association	1063
Prepared statement	1092
Club Managers Association of America, Jack P. Janetatos, attorney	1152
Disabled American Veterans, Denvel D. Adams, national adjutant	1157
Prepared statement	1159
Edwards, Richard Walton, Jr., Washington, D.C.	1055
Prepared statement	1059
Furness, Betty, National Committee on Tax Justice, accompanied by: Woodrow Ginsburg; and Philip Stern	913
Prepared statement of Hon. Paul Douglas, chairman, National Committee on Tax Justice	915
Higgins, J. T., chairman, Tax Committee, American Textile Manufacturers Institute	1017
Prepared statement	1020
Imperial Council of the Ancient Arabic Order of the Nobles of the Mystic Shrine for North America, Edwin Steers, general counsel, accompanied by: J. Worth Baker, imperial potentate; George Saunders, imperial recorder; Paul E. Ibach, assistant general counsel; and Robert Mountain, C.P.A.	1133
Prepared statement of Paul E. Ibach	1139

Irvine, James B., Jr., president, Association for Advanced Life Underwriting, accompanied by: Page
Gerald H. Sherman, counsel ... 1025
Prepared statement ... 1029
Ja tatos, Jack P., attorney, National Club Association and Club Managers Association of America, accompanied by:
Kenneth Emerson, executive director, National Club Association;
E. Guenter Skole, chairman, Governmental Affairs Committee, Club Managers Association; and
Walter A. Slowinski, counsel ... 1152
Jolley, Rev. Homer R., president, Loyola University ... 1099
Prepared statement ... 1104
Kachlein, George F., Jr., executive vice president, American Automobile Association accompanied by:
Joseph E. McAndrews, tax counsel; and
Arthur I. Cooper, assistant treasurer ... 1142
Prepared statement ... 1145
Kust, Leonard E., vice president and general tax counsel, Westinghouse Electric Corp ... 1033
Prepared statement ... 1035
Lehrfeld, William J., tax counsel, National Fraternal Congress of America ... 1125
Prepared statement ... 1126
Loyola University, Rev. Homer R. Jolley, president ... 1099
Prepared statement ... 1104
Machinery & Allied Products Institute, Charles W. Stewart, president ... 978
Prepared statement ... 981
Mapco, Inc., Robert E. Thomas, president ... 1174
Prepared statement ... 1179
McKenna, Robert A., president, Chilton Co., chairman, Washington Legal Committee of the American Business Press; accompanied by:
Paul Conrad, general counsel, National Newspaper Association; and
Robert Saltzstein, general counsel, American Business Press ... 1109
Prepared statement of Robert McKenna ... 1119
Prepared statement of Paul Conrad ... 1123
Metropolitan Taxicab Board of Trade, Inc., Empire State Cab Association, Inc., and the International Taxicab Association, Benjamin Botwinick, CPA ... 1185
Mikva, Hon. Abner J., a U.S. Representative in Congress from the State of Illinois ... 959
National Club Association, Jack P. Janetatos, attorney ... 1152
National Committee on Tax Justice, Betty Furness, accompanied by:
Woodrow Ginsburg; and
Philip Stern ... 915
Prepared statement of Hon. Paul Douglas, chairman, National Committee on Tax Justice ... 917
National Fraternal Congress of America, William J. Lehrfeld, tax counsel ... 1125
Prepared statement ... 1126
National Machine Tool Builders Association, Joel Barlow, counsel ... 961
Prepared statement ... 968
National Retail Merchants Association. Walter Pozen, counsel ... 1170
Prepared statement ... 1172
National Small Business Association, Robert E. Thomas ... 1174
Prepared statement ... 1179
National Tax Equality Association, Mortimer M. Caplin ... 1063
Prepared statement ... 1092
National Tool, Die & Precision Machining Association, Joel Barlow, counsel ... 961
Prepared statement ... 968
Parents Without Partners, Mrs. Caryl Terry ... 1039
Prepared statement ... 1040
Pozen, Walter, counsel, National Retail Merchants Association ... 1170
Prepared statement ... 1172
Riddell, James W., tax counsel, Volume Footwear Retailers of America ... 1162
Prepared statement ... 1164
Rural Small Town-Small City Coalition, Philip H. Willkie ... 955
Prepared statement ... 956
Saulnier, Raymond J, professor of economics, Barnard College, Columbia University ... 1008

	Page
Shinder, Miss Dorothy, director, War Singles (Not War Widows), and president, Single Persons Tax Reform	1042
Prepared statement	1048
Steers, Edwin, general counsel, Imperial Council of the Ancient Arabic Order of the Nobles of the Mystic Shrine for North America; accompanied by:	
J. Worth Baker, imperial potentate;	
George Saunders, imperial recorder;	
Paul E. Ibach, assistant general counsel; and	
Robert Mountain, CPA	1133
Prepared statement of Paul Ibach	1139
Stern, Philip, National Committee on Tax Justice	917
Prepared statement	951
Stewart, Charles W., president, Machinery & Allied Products Institute	978
Prepared statement	981
Terry, Mrs. Caryl, representing Parents Without Partners, Inc	1039
Prepared statement	1040
Thomas, Robert E., president, Mapco, Inc	1174
Prepared statement	1179
Volume Footwear Retailers of America, James W. Riddell, tax counsel	1162
Prepared statement	1164
War Singles (Not War Widows), Miss Dorothy Shinder, director	1042
Prepared statement	1048
Westinghouse Electric Corp., Leonard E. Kust, vice president and general tax counsel	1033
Prepared statement	1035
Willkie, Philip H., Rural Small Town-Small City Coalition	955
Prepared statement	956

Communications

Adelman, Robert P., director of taxation, Celanese Corp	1370
Alpha Gamma Rho Fraternity, letter to the chairman	1697
Aluminum Co. of America, letter with attachments of E. A. Vaughn, vice president and controller, to the chairman	1258
American Association of Petroleum Geologists, letter with attachments of Kenneth H. Crandall, president, to the chairman	1687
American Chemical Society, letter with attachments of Wallace R. Brode, president, to the chairman	1680
American Dental Association, letter of I. Lawrence Kerr, D.D.S., chairman, council on legislation, to the chairman	1729
American Life Convention and Life Insurance Association of America, William B. Harman, Jr., general counsel, Americal Life Convention, and Kenneth L. Kimble, vice president and general counsel, Life Insurance Association of America:	
Statement	1263
Letter to the chairman	1269
American Medical Association, letter with attachments of Ernest B. Howard, M.D., to the chairman	1715
American Paper Institute, statement with attachments of Edwin A. Locke, Jr., president	1280
American Public Gas association, letter with attachments of Robert H. King, president, to the chairman	1386
American Retail Federation, statement submitted by Eugene Adams Keeney, president	1237
American Society of Civil Engineers, letter of William H. Wisely, executive secretary, to the committee	1774
Americans Veterans Committee, letter with attachments of June A. Willenz, executive director, to the chairman	1352
Arent, Fox, Kintner, Plotkin & Kahn, letter with attachment of Edwin L. Kahn, to the chairman	1724
Arnold, Arthur M., director of taxation and governmental affairs, Empire State Chamber of Commerce, statement	1232
Association of the Bar of the City of New York, letter with attachments of Robert J. McDonald, chairman, committee on taxation, to the chairman	1578
Barker, John M., vice president-taxes, General Mills, Inc., statement	1249
Beirne, Joseph A., president, Communications Workers of America, letter with attachments to the chairman	1240

Page

Beloit College, Beloit, Wis., letter with attachments of Miller Upton, president, to the chairman 1349
Boy Scouts of America, letter with attachments of Irving Feist, president, to the committee 1698
Bowling Proprietors Association of America, letter of Robert E. Kline, Jr., to the chairman 1728
Brady, Frank A., Jr., statement of the Committee on Taxation of the New York Chamber of Commerce 1308
Braislin, Gordon S., Dime Savings Bank of Brooklyn, letter to the chairman 1375
Brann, Lester W., Jr., executive vice president, Illinois State Chamber of Commerce 1246
Brode, Wallace R., president, American Chemical Society, letter with attachments to the chairman 1680
Campbell, Woods, Bagley, McNeer & Herdon, attorneys and counselors at law, letter of Luther E. Woods, to the chairman 1359
Can Manufacturers Institute, Inc., letters with attachments of Waldo B. Lyden, chairman, tax committee, to the chairman 1275, 1277
Caplin, Mortimer M., letter to Hon. Abraham Ribicoff, a U.S. Senator from the State of Connecticut 1087
Cavers, David F., Council on Law-Related Studies, letter to the chairman 1683
Celanese Corp., letter of Robert P. Adelman, director of taxation, to the chairman 1370
Center for Information on America, Inc., statement submitted by Townsend Scudder, president 1770
Century Townhouses, letter with attachments of William Graeper, to Hon. Wendell Wyatt, a U.S. Representative from the State of Oregon 1711
Chicago Association of Commerce and Industry, letter of Edward J. Harney, chairman, Federal Revenue and Expenditures Committee, to the chairman 1376
Children's Aid Society, letter of Morgan Dix Wheelock, chairman, to the chairman 1774
Chrysler Corp., letter of Brian T. O'Keefe, assistant comptroller, to the committee 1314
Clements, Jamie H., staff attorney, Scott & White Clinic, letter with attachments to the chairman 1692
Columbia University, New York, N.Y., letters of C. Lowell Garriss, professor of economics, to the committee 1261
Communications Workers of America, letter with attachments of Joseph A. Beirne, president, to the chairman 1240
Council on Law-Related Studies, letter of David F. Cavers, to the chairman 1683
Crandall, Kenneth J., president, American Association of Petroleum Geologists, letter with attachments to the chairman 1687
Curley, John E., director of taxes, Whirlpool Corp., letter to the chairman 1253
Davis, Charles O., Jr., executive secretary of the executive committee, statement of the National Conference of State Legislative Leaders 1698
Dime Savings Bank of Brooklyn, letter of Gordon S. Braislin, to the chairman 1375
Dole, Hon. Robert J., a U.S. Senator from the State of Kansas 1222
Elks, submitted by Frank Hise, grand exalted ruler and Franklin J. Fitzpatrick, grand secretary, statement of 1713
Empire State Chamber of Commerce, statement of Arthur M. Arnold, director of taxation and governmental affairs 1232
Erie County Plastics Corp., Corry, Pa., letter of P. C. Roche, president, to the chairman 1336
Feist, Irving, president, Boy Scouts of America, letter with attachments to the committee 1698
Financial Executives Institute, letter of E. A. Vaughn, chairman, committee on taxation, to the chairman 1378
Florida State University, statement of Charles E. Rockwood, department of economics 1336
Foerst, Elmer, letter to the chairman 1697
Foregger, Richard, M.D., statement 1255
General Mills, Inc., statement of John M. Barker, vice president—Taxes 1249
Glass Container Industry Research Corp., statement of 1709
Goff, Stewart A., letter to the committee 1709
Graeper, William, Century Townhouses, letter with attachments to Hon. Wendell Wyatt, a U.S. Representative from the State of Oregon 1711

Page

Gruening, Ernest, letter to the chairman 1710
Hancock, A. Van W., president, State Communities Aid Association, statement of 1719
Harman, William B., Jr., general counsel, American Life Convention, and Kenneth L. Kimble, vice president and general counsel, Life Insurance Association of America:
Statement 1263
Letter to the chairman 1269
Harney, Edward J., chairman, Federal Revenue and Expenditures Committee, Chicago Association of Commerce and Industry, letter to the chairman 1376
Harriss, C. Lowell, professor of economics, Columbia University, New York, N.Y., letters to the committee 1261, 1262
Hise, Frank, grand exalted ruler, Elks, statement of 1713
Holstien, J. A., Kitchen Equipment Fabricating Co., letter to the chairman 1718
Howard, Ernest B., M.D., American Medical Association, letter with attachments to the chairman 1715
Hyster Co., letter of Ernest G. Swigert, to the chairman 1772
Iacobucci, Velio, Upper Darby, Pa., letter to the chairman 1721
Illinois State Bar Association, letter with attachments of Joseph Z. Sudow, chairman, Section on Federal Taxation, to the committee 1657
Illinois State Chamber of Commerce, statement submitted by Lester W. Brann, Jr., executive vice president 1246
Institute for the Study of Economics Systems, statements of Louis O. Kelso and Norman G. Kurland 1391
International Ladies' Garment Workers' Union, letter of Louis Stullberg, president, to the chairman 1341
International Longshoremen's & Warehousemen's Union, letter and statement of Albert Lannon, Washington representative, to the chairman 1297
International Reading Association, letter of Ralph C. Staiger, executive secretary-treasurer, to the chairman 1771
Jardine, Emile R., C.P.A., Stockton, Calif., letter to the committee 1274
Jenkins, Thomas M., statement of 1721
Johnson, Grayson, letter to the chairman 1723
Kahn, Edwin L., Arent, Fox, Kintner, Plotkin & Kahn, letter with attachments to the chairman 1724
Kaplan, Livingston, Goodwin, Berkowitz & Selvin, letter of Murray S. Weber, to the committee 1360
Keeney, Eugene Adams, president, American Retail Federation, statement 1237
Keitel, George W., director of budget, United Church Board for World Ministries, statement of 1725
Kelso, Louis O., Institute for the Study of Economic Systems, statement of 1391
Kerr, I. Lawrence, D.D.S., chairman, Council on Legislation, American Dental Association, letter to the chairman 1729
Kimble, Kenneth L., vice president and general counsel, Life Insurance Association of America, and William B. Harman, Jr., general counsel, American Life Convention:
Statement 1263
Letter to the chairman 1269
King, Robert H., president, American Public Gas Association, letter with attachments to the chairman 1386
Kitchen Equipment Fabricating Co., letter of J. A. Holstein, to the chairman 1718
Kline, Robert E., Jr., attorney, Bowling Proprietors Association of America, letter to the chairman 1728
Kurland, Norman G., Institute for the Study of Economic Systems, statement of 1391
Lacobucci, Velio, letter to the chairman 1721
Lannon, Albert, Washington representative, Longshoremen's & Warehousemen's Union, letter and statement to the chairman 1297
Larson, Dr. Martin A., board of policy member, Liberty Lobby, Washington, D.C., statement 1286
Lehrfeld, William J., letter to the chairman 1131
Liberty Amendment Committee of the U.S.A., Los Angeles, Calif., statement of Willis E. Stone 1341

	Page
Liberty Lobby, statement of Dr. Martin A. Larson, board of policy member	1286
Life Insurance Association of America and American Life Convention, Kenneth L. Kimble, vice president and general counsel, Life Insurance Association of America, and William B. Harman, Jr., general counsel, American Life Council:	
Statement	1263
Letter to the chairman	1269
Lightfoot, Mrs. Ursula A., letter to the chairman	1730
Locke, Edwin A., president, American Paper Institute, statement with attachments	1283
Loflin, Z. L., president, National Interfraternity Conference, Inc., letter to the chairman	1732
Lumley, John M., assistant executive secretary for legislation and Federal relations, statement of National Education Association	1294
Lyden, Waldo B., chairman, Tax Committee, Can Manufacturers Institute, Inc., letters with attachments to the chairman	1275, 1277
Madonna Home, Inc., letter of William A. Sonderegger, acting administrator, letter to the chairman	1772
Mahon, Don, national executive secretary, National Federation of Independent Unions, letter to the chairman	1389
Master, Moses, C.P.A., statement	1189
McDonald, Robert J., chairman, Committee on Taxation, Association of the Bar of the City of New York, letter with attachments to the chairman	1578
McCormack, Donald R., executive secretary-treasurer, Stringhold Inc., letter with attachments to the committee	1741
McDonnell, Pierce S., Esq., Warrenton, Va., and Cleveland Heights, Ohio, statement	1300
McFarlane, William D., Washington, D.C., statement	1301
McGee, Robert J., statement of New England Journal of Medicine	1746
Meehan, John P., statement of National Association of Life Underwriters	1666
Moss, Robert V., Jr., president, United Church of Christ, statement	1304
Muskie, Hon. Edmund S., a U.S. Senator from the State of Maine, statement	1195
National Association of Evangelicals, statement of Floyd Robertson, assistant general director	1331
National Association of Life Underwriters, statement submitted by John P. Meehan	1666
National Conference of State Legislative Leaders, submitted by Charles O. Davis, Jr., executive secretary of the executive committee, statement of	1698
National Constructors Association, statement submitted by Thomas J. Ryan, chairman, tax committee	1332
National Education Association, statement submitted by John M. Lumley, assistant executive secretary for legislation and Federal relations	1294
National Federation of Independent Unions, letter of Don Mahon, national executive secretary, to the chairman	1389
National Interfraternity Conference, Inc., letter with attachments of Z. L. Loflin, president, to the chairman	1732
National Newspaper Association, statement	1123
National Retail Furniture Association, letters of M. E. Weatherby, Jr., chairman, tax committee, to the chairman	1191, 1192
Nelson, Hon. Gaylord, a U.S. Senator from the State of Wisconsin, statement	1200
New England Journal of Medicine, statement submitted by Robert J. McGee	1746
New York Chamber of Commerce Committee on Taxation, statement submitted by Frank A. Brady, Jr	1308
New York State Bar Association, Special Committee on Exempt Organizations, statement	1753
New York State Bar Association, Committee on Employee Benefits, V. Henry Rothschild II, chairman, statement	1529
O'Keefe, Brian T., assistant comptroller, Chrysler Corp., letter to the committee	1314
O'Meara, the Right Reverend Edward T., national director, Society for the Propagation of the Faith	1749
Pancake, Robert Allen, letter to the chairman	1751

	Page
Philadelphia Bar Association, letter with attachments of Joseph W. Price III, to the committee	1314
Price, Hon. Bob, a U.S. Representative from the State of Texas, statement	1227
Price, Joseph W., III, Philadelphia Bar Association, letter with attachments to the committee	1314
Reuther, Walter P., president, United Automobile, Aerospace, and Agricultural Implement Workers of America (UAW), statement of	1506
Robertson, Floyd, assistant general director, National Association of Evangelicals, statement	1331
Roche, P. C., president, Erie County Plastics Corp., Corry, Pa., letter to the chairman	1336
Rockwood, Charles E., Department of Economics, Florida State University, statement	1336
Rothschild, V. Henry, II, chairman, Committee on Employee Benefits, New York State Bar Association, statement of	1529
Ryan, Thomas J., chairman, Tax Committee, National Constructors Association, statement	1332
Scott & White Clinic, letter with attachments of Jamie H. Clements, staff attorney, to the chairman	1692
Scudder, Townsend, president, Center for Information on America, Inc., statement of	1770
Sisters of Mercy of the Union in the United States of America, statement by Sister Mary Regina Cunningham, R.S.M., Superior General, Sisters of Mercy of the Union, Bethesda, Md	1675
Small, Ella May, letter to Hon. Clinton P. Anderson, a U.S. Senator from the State of New Mexico	1340
Society for the Propagation of the Faith, submitted by the Right Reverend Edward T. O'Meara, national director, statement of	1749
Sonderegger, William A., acting administrator, Madonna Home, Inc., letter to the chairman	1772
Southern States Industrial Council, letter of W. L. Thornton, president, to the chairman	1773
Staiger, Ralph C., executive secretary-treasurer, International Reading Association, letter to the chairman	1771
State Communities Aid Association, submitted by A. Van W. Hancock, president, statement of	1719
Stone, Willis E., national chairman, Liberty Amendment Committee of the U.S.A., Los Angeles, Calif., statement	1341
Stronghold, Inc., letter with attachments of Donald R. McCormack, executive secretary-treasurer, to the committee	1741
Stulberg, Louis, president, International Ladies' Garment Workers' Union, letter to the chairman	1341
Sudow, Joseph Z., chairman, Section on Federal Taxation, Illinois State Bar Association, letter with attachments to the committee	1657
Swigert, Ernest G., Hyster Co., letter to the chairman	1772
Swim, Dudley, of Carmel, Calif., statement of	1663
Thornton, W. L., president, Southern States Industrial Council, letter to the chairman	1773
Trenerry, Walter N., attorney, St. Paul, Minn., statement	1344
United Auto Workers, statement of Walter P. Reuther	1506
United Church Board for World Ministeries, statement of George W. Keitel	1725
United Church of Christ, statement submitted by Robert V. Moss, Jr., president	1304
Upton, Miller, president, Beloit College, Beloit, Wis., letter with attachments to the chairman	1349
Vaughn, E. A.:	
Financial Executives Institute, letter to the chairman	1378
Aluminum Company of America, letter with attachments, to the chairman	1258
Weatherby, M. E., Jr., chairman, Tax Committee, National Retail Furniture Association, letter to the chairman	1191
Weber, Murray S., Kaplan, Livingston, Goodwin, Berkowitz & Selvin, letter to the committee	1360
Weinberg, J. C., Weinberg, Ward & Beam, public accountants, letter with attachments to the chairman	1357
Weissmann, Ronald F., Cincinnati, Ohio, statement	1356
Wertheimer, Robert G., Babson College, Babson Park, Mass., statement of	1366

Page

Whirlpool Corp., letter of John E. Curley, director of taxes, to the chairman ---- 1253
Willenz, June A., executive director, American Veterans Committee, letter with attachments to the chairman ---- 1352
Wisely, William H., executive secretary, American Society of Civil Engineers, letter to the committee ---- 1774
Wheelock, Morgan Dix, chairman, the Children's Aid Society, letter to the chairman ---- 1774
Woods, Luther E., Campbell, Woods, Bagley, McNeer & Herdon, attorneys and counselors at law, letter to the chairman ---- 1359

Additional Information

Articles:
- "The Great Capital Gains Trial," chapter from the book entitled "The Great Treasury Raid," by Philip Stern ---- 922
- "Underdepreciation from Inflation," by George Terborgh ---- 999
- "Tax Reform: Adding Hodgepodge to Hodgepodge," from the Wall Street Journal ---- 1004
- "The Time for Lower, Fairer Taxes is Now!", from the Reader's Digest ---- 1069
- "Inventor Tries New Approach," from the Elizabeth, N.J., Daily Journal ---- 1254

Power of Congress To Tax Cooperatives, study prepared by the staffs of the Treasury and Joint Committee on Internal Revenue Taxation, April 1951 ---- 1075
Thirty largest farmer cooperatives ---- 1086

Appendix A

Written testimony received by the committee of a general nature ---- 1193

Appendix B

Written testimony received by the committee expressing an interest in the subject of tax-exempt organizations ---- 1673

TAX REFORM ACT OF 1969

THURSDAY, SEPTEMBER 11, 1969

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 Herman E. Talmadge, presiding.

Present: Senators Long, Anderson, Gore, Talmadge, Hartke Fulbright, Harris, Byrd, Jr., of Virginia, and Williams of Delaware.

Senator TALMADGE (presiding). The hearing will come to order.

This morning we will hear the first public witnesses testify at these tax reform hearings. Before we are through over 300 witnesses will be heard.

The witness list today was originally scheduled to be heard on Monday of this week. Because of the death of Senator Dirksen of Illinois, a beloved member of this committee, the committee did not meet on Monday, Tuesday, or Wednesday. Tomorrow we will be back on the regular schedule of hearings announced on September 3.

The 3 days of hearings on private foundations originally scheduled for Tuesday, Wednesday, and Thursday of this week have been rescheduled for Monday, Tuesday, and Wednesday, October 6, 7, and 8, respectively.

Witnesses appearing today will speak largely on the bill in general. We do have witnesses who will address themselves primarily to the tax treatment of single persons.

Our first witness this morning was scheduled to be the Honorable Paul Douglas. Senator Douglas served with great honor and distinction in the Senate as a member of the Committee on Finance. Unfortunately, illness prevents Senator Douglas from being with us today and in his stead his statement will be presented by Miss Betty Furness. Miss Furness served the Nation with high honor as President Johnson's Adviser on Consumer Affairs.

Miss Furness, you are recognized.

STATEMENT OF MISS BETTY FURNESS, ON BEHALF OF NATIONAL COMMITTEE ON TAX JUSTICE; ACCOMPANIED BY WOODROW GINSBURG AND PHILIP STERN

Miss FURNESS. Good morning, Mr. Chairman. Thank you.

I would like to report that although we are——

Miss SHINDER. Pardon me for intruding. Mr. Chairman and members of the Committee on Finance and the lady to my right, I protest the fact——

Senator TALMADGE. You will be heard in regular order.

Miss SHINDER (continuing). I have not been put—the lady does not yield, sir. I protest——

Senator TALMADGE. You will please take your seat. You will be heard in your regular order as scheduled as a witness.

Miss SHINDER. I protest the fact that there is not a full committee of the Senate Finance Committee——

Senator TALMADGE. The committee will come to order and you will please assist the lady in retaining a seat, please.

Miss SHINDER. Thank you, sir, but I do protest. Thank you.

Senator TALMADGE. Miss Furness, I am sorry about the interruption. You may proceed.

Miss FURNESS. So am I, Mr. Chairman.

We regret that former Senator Douglas was not able to be here today, but I know you will be pleased to know that his health is coming along very nicely. He is recovering and he did ask me if I would present his testimony.

Senator TALMADGE. We are delighted to hear that he is making a good recovery.

Miss FURNESS. Thank you; I knew that you would be. You may question what I am doing on a Committee for Tax Justice. It would be a good question. When Senator Douglas asked me to serve on this committee, we all recognize that I am not a tax expert, but I think within the last couple of years I have beocme an expert on the consumer, and I am a little afraid that with all the talk of tax reform this year there is a possibility that the consumer's voice may not be heard quite as loudly as the voices who plead for tax preference for special interests. Obviously, we know that we are all consumers, but as of this moment, I am especially concerned for the consumer whose dollar is being increasingly spent for necessities. As we are all consumers, so are we all victims of inflation, but there is a tremendous number of consumers who are feeling this squeeze, I think very tightly, because a loaf of bread and a pound of meat cost the same whether it is bought by a low-income consumer or a high-income consumer.

I believe very strongly that every American is willing to pay his fair share of taxes, but I hope that you gentlemen—and I am confident that you will—will give special consideration to those who do not have an official lobby, and we are counting on you to rectify the imbalance so that each American will pay only his fair share of taxes.

I would like to introduce today two gentlemen who have accompanied me here, or who I am accompanying: Mr. Woodrow Ginsburg is a member of the Technical Committee of the National Committee on Tax Justice, and Mr. Philip Stern, who has written a book called "The Great Treasury Raid." Due to the fact that you are hearing so many witnesses, I am not going to read Senator Douglas' testimony. It has been placed into the record, or perhaps I should officially request——

Senator TALMADGE. Without objection, it will be inserted in the record.

Miss FURNESS. Thank you very much, Mr. Chairman. If there are any questions from you or Mr. Williams, I am sure that Mr. Ginsburg would be more than happy to answer them from a technical viewpoint.

Senator TALMADGE. Senator Williams, any questions?

Senator WILLIAMS. No questions.

Senator TALMADGE. Do you have any further testimony?

Miss FURNESS. I do not, but I would like to present Mr. Philip Stern, who does have further testimony.

(Mr. Douglas' prepared statement referred to previously follows:)

STATEMENT OF HON. PAUL H. DOUGLAS, CHAIRMAN, THE NATIONAL COMMITTEE ON TAX JUSTICE

Mr. Chairman and members of the Finance Committee, I should like to thank you for giving me the privilege of appearing before you in behalf of speedy and significant tax reform. We have discussed these matters together in the past as friends around the conference table. They are more important this year than ever, for public interest and indignation seems to be at an all time high, consequently, this may be the year for a successful conclusion to the long struggle for tax justice or, if not that, for a significant beginning. My former Senate colleagues and friends in the House of Representatives tell me that there is intense public interest in tax reform. Mail protesting the injustices in our tax system is reportedly higher than ever. The debate in the House of Representatives on the Tax Reform Act before you clearly indicated that the vast majority of Congress wants tax reform now; the Administration has promised it. To assure that this opportunity is not passed over, in May and June of this year I asked a number of eminent citizens, prominent in their fields of endeavor, to band together as The National Committee on Tax Justice. All of the committee members share my feeling that tax reform is an immediate necessity. We have furnished you with a full list of our committee members. Included among these members are experts on the injustices in the present tax system.

The members of The National Committee on Tax Justice endorsed a five-point tax reform package that would provide equity to taxpayers, relieve the tax burden on low and middle income families and provide new funds for the Federal government. To achieve tax justice we have urged Congress to enact the following reforms:

1. Eliminate preferential treatment of all capital gains.
2. Eliminate special deductions for depletion of oil and other minerals beyond the cost of the mineral property and for the expensing of exploration and development costs.
3. Provide federal assistance to state and local bond issues instead of allowing a tax exemption on their interest.
4. Withhold taxes on interest and dividends at the source as is now done for wages and salaries.
5. Provide tax relief for low and middle income families by providing a minimum standard deduction of $1,100 for all families.

It was estimated that this program would provide $7 to $10 billion more in Federal revenues while relieving 38 million low and middle income families of $2.5 billion in tax liabilities.

Congress was also asked to give prompt attention to the ending of other unwarranted tax favors such as accelerated depreciation on buildings, the multiple surtax exemptions on corporations and the unlimited charitable deduction. The tax laws should also be revised to avoid encouraging the formation of conglomerates.

This reform program is a moderate one and has a broad-based acceptance.

The "Tax Reform Act of 1969" passed by the House of Representatives is an important initial step towards fulfilling the goals of the committee. True reform will require even bolder steps.

Careful scrutiny of the act reveals that the rich continue to receive favored treatment. Tax reform monies are to be used to reimburse persons with large incomes among whom those who presently gain most from tax preferences are found.

A third of the "goodies" provided relief to taxpayers will go to less than 10% of the nation's taxpayers—those with adjusted gross incomes of more than $15,000. The $3.1 billion tax relief package for this small minority of taxpayers is almost 2½ times the $1.3 billion to be recouped by tax reform from them. Over half of the $4.5 billion in general rate reductions goes to this exclusive class. The new lower maximum tax on earned incomes gives $100 million in relief to

the less than ½ of 1% who have adjusted gross incomes of over $50,000. Although welcome relief is indeed given to low and middle income families, it is obvious that the wealthy will benefit most from what should be labeled a "readjustment" rather than a reform.

The measure passed by the House adopted The National Committee on Tax Justice goal of a minimum standard deduction of $1,100 for all families. In 1971 this will benefit over 38 million taxpayers and take off the tax rolls six million poor people. The raising of the standard deduction to 15% with a $2,200 maximum and the rate decrease in the lowest five tax percentages will help working families earning $7,000 to $13,000 a year. More than half of the tax reduction, however, will eventually go to those persons in higher income brackets who comprise less than ¼ of the taxpayers. There is no tax justice when money gained from tax reform is used to reduce the rates of those who benefited most from tax inequities. This is especially deplorable when it creates a deficit and would reduce the funds available for much needed federal programs. More money is desperately needed for education, slum clearance and programs to improve our environment. The lost revenue will instead go to individual citizens who are best able and should pay their fair share of these programs. The Senate should closely examine this unfair redistribution of the tax burden. This re-examination should take place in the context of the re-ordering of priorities inherent in the House bill. By 1972 there will be a revenue loss of $4 billion that will fall into the pockets of less than ¼ of our taxpayers.

This will occur while there is a pressing need for expanding federal and state programs.

The bill is advertised as a tax reform measure but more than half of the revenue gain—$3 billion—comes from a repeal of the investment tax credit. This halfway legislation falls way short of fully plugging all tax loopholes. Elimination of most tax preferences should bring a revenue gain of over $12 billion—a sufficient sum to ease the burden of the low and middle income wage earner and provide some funds for the country's needs.

The House measure ignores unrealized gains transferred by gift or death—a loophole that costs the United States Treasury over $2 billion annually. The National Committee on Tax Justice called for the elimination of the preferential treatment of all capital gains including unrealized gains transferred by gift or death with some provision for averaging over a period of years. The adoption of this proposal would yield an annual revenue gain of $6 to $9 billion. The repeal of the alternative capital gains tax of 25% and the provisions in the minimum tax and allocation of deductions only begin to reduce this unwarranted preference.

The excess oil depletion allowance was reduced from 27½% to 20%. Depletion allowances for other minerals were correspondingly reduced. This action only reduces the unwarranted $1.6 billion subsidy by a quarter and is not a true reform measure. There is no logic to sustain this wasteful practice that produces only 9 cents worth of additional mineral resources for every federal dollar expended. The bill curbs the so-called carved-out and ABC production payments that made it possible for the mineral resources industry to further avoid income taxes. This commendable action will bring an estimated revenue gain of $200 million.

Left untouched were the present tax preferences accorded to the oil industry alone that permit oil operators to deduct in the year paid out most of their costs of exploration for/and development of oil wells—a $300 million subsidy. These costs are comparable to capital outlays which in other industries have to be deducted over a period of years.

The income gained by excess depletion allowances and expensing of exploration and developmental costs are not subject to the minimum tax provisions of the bill, another special concession to the oil industry lobbying effort. The minimum tax itself is an indirect approach to tax preferences. The provision provides that those with considerable means who have escaped taxation pay some tax. The basic inequities of the tax code still remain.

The section on state and local bonds providing for an option of a federal subsidy on taxable issues will confuse the bond market and not dispense with the preference. Tax-exempt interest on state and local bonds should be eliminated. A guaranteed adequate subsidy to the cities would eliminate the need for tax-exempt state and municipal bonds.

The bill does not provide for withholding taxes on interest and dividends at the source, a goal of The National Committee on Tax Justice. This allows nearly $4 billion of dividend and interest income to go untaxed annually.

The bill now before the Senate also falls short in fully plugging the loophole accorded to the real estate industry to deduct depreciation from income faster than the depreciation actually occurs. This preference for real estate operations should be ended. Its need can only be supported in the field of low income housing.

The reform measures in the bill will have to be tightened to cure the present injustices in our tax system that:

allow 381 affluent Americans to enjoy incomes of more than $100,000 without paying a penny of income tax;

make it possible for one super-rich American to enjoy more than $20 million of income in one year without paying a cent in taxes;

allow another super-affluent citizen to enjoy more than $1,500,000 of income without even having to file a tax return;

impose the same effective tax rate on those earning over $200,000 as persons earning between $15,000 and $20,000.

The plain fact is that most Americans—those with incomes of less than $15,000—more than 90% of the taxpayers—shoulder most of the burden of the income tax rates we all see in the tax tables on our tax return. Ironically, though, the higher a person's income and the better able he is to bear tax burdens without sacrificing the necessities of life, the more escape hatches open up to him through which he can avoid paying his fair share of taxes.

Those escape routes, those tax favors, impose a dual hardship on the less well-to-do in America. For not only are they called upon to pay more than their fair share of the tax burden; they are also asked to sit by and do without public programs and services for which they have the greatest need—programs dealing with poverty and the decay of our cities and schools and the pollution of the air and water—supposedly because the government cannot "afford" such programs. For, of course, if the government were collecting the billions of dollars that are currently being siphoned off through gaping tax loopholes, there would be funds for the rebuilding of our slums and schools, for the purifying of the environment and many other programs which are now suffering financial asphyxiation.

The American people know that essential public programs must be paid for; they only ask that their share of that payment be just; that every individual be taxed according to his ability to bear the burden of taxation; and that no one be asked to bear more than his fair share of that burden because of special tax favors accorded others.

We believe that people with approximately equal net incomes should pay approximately equal taxes. I do not see how this principle of horizontal equity can be opposed by any sensible person. That is what we are trying to obtain. The reforms we advocate would move us much closer to that goal.

The Ways and Means Committee and the House of Representatives have made a beginning in the "Tax Reform Act of 1969." The Senate is in an opportune position to complete the task to provide equity for the taxpayer and recoup funds lost through existing loopholes so that Congress will be able to make some progress on the dire social needs of our country. I know the Senate will take up the challenge and fully meet the growing demand for *real* tax reform.

Senator TALMADGE. Mr. Stern, you are recognized at this time.

STATEMENT OF PHILIP STERN, NATIONAL COMMITTEE ON TAX JUSTICE

Mr. STERN. Thank you, sir. Mr. Chairman, I have a statement that I would like to ask be inserted in the record.

Senator TALMADGE. Without objection, the statement will be inserted in full after you present your summary.

Mr. STERN. To economize your time, I would like to summarize it as briefly as I can, sir.

Senator TALMADGE. Thank you.

Mr. STERN. I appear here to urge you to end a feature of the tax system that I consider outrageously unfair to you Senators and to your colleagues in the Senate and House.

The matter can be put fairly simply: You Senators now receive an annual salary of $42,500. And having had the honor to work for Senator Paul Douglas for 2 years, I know how you work prodigiously hard for that. Now, assuming for simplicity's sake, that you have three dependents and take the standard deduction, you stand to be in the 45-percent tax bracket.

Now, it is no secret to Senator Long, your chairman, and perhaps other members of this committee, that I am blessed with considerable wealth. And a significant portion of my income comes in the form of capital gains for which by and large I exert little or no personal effort. I invest in company X or Y and having done that I just sit back and let somebody else do the work.

For example, a number of years ago I had the great good fortune to invest in the Xerox Co. Having done so I just sat back while Mr. Linowitz and his colleagues made Xerox grow and prosper. And when it did, I reaped the benefits—and I paid no more than a 25-percent tax.

Now, what a situation this is; you having worked enormously hard to earn your salaries pay 45 percent and I having done little or nothing to get my capital gains paid only 25 percent.

I consider that a disgrace. I think it is disgracefully unfair to you, and if I were in your position I wouldn't stand for it. And I am here today to urge you to end this outrage against yourselves and to end the artificial distinction between ordinary income and capital gains and tax the two on the same basis.

Now, that proposal carries three important provisos. First, that you provide for so-called constructive realization of gains at death. Second, that you include some mechanism for averaging gains accrued over a period of years. And third, that after and to the extent that you have done the above, that you significantly lower the top bracket income tax rate.

In my opinion, that single action of taxing capital gains as ordinary income would eliminate the greatest single cause of both inequity and complexity in the American tax system.

That may sound like an extravagant statement but I think I can document it.

First let me take up the matter of equity. I think the matter is most dramatically summed up with this astounding fact, that the topmost income group in the country, those whose incomes exceed $5 million a year, pay just half as much tax, half as much tax proportionately as do those with just one-tenth as much income. Now, how can that be in a system of graduated income taxes, supposedly, going up to 70 percent? The answer is that among those superrich people with incomes of $5 million or more, two-thirds of their income is in so-called capital gains, not taxed at 70 percent or 50 percent, but taxed at no higher than 25 percent, the same top bracket rate that is paid by a married couple with a taxable income of $12,000.

Clearly the preferential capital gains tax throws the principle of ability to pay right out the window. It makes a mockery of the graduated income tax rate.

Now, the special capital gains rate is of enormous benefit to the superrich. It saves a man with a million-dollar income $228,000 a year, or, to put that in ordinary language, it gives him added take-home pay of more than $4,000 a week.

But, of course, to talk of the capital gains tax as a 25-percent tax is only telling part of the story. For those who are patient enough, by which I really mean wealthy enough, to hold on to their appreciated properties until death, as you know, the capital gains tax is not 25 percent; it is zero. I don't think I need to explain to you gentlemen why that is.

The prodigious total of $11.5 billion goes wholly untaxed every year. Because of the failure to tax capital gains at death the annual revenue loss is $2.5 billion. This brings me to the one very important point about the special taxation of capital gains; namely, the enormous revenue loss that is involved, now estimated at $8.5 billion a year, far more than we are talking about when we talk about extending the surtax.

Another point. The preferential tax treatment of capital gains is a major reason behind the fact that there are 255 multimillionaires in this country who paid no tax whatever in 1967, as pointed out to you by former Secretary Barr.

Now, the reason for that is something that most people don't realize; namely, that half of all capital gains are wholly discarded and ignored for tax purposes, and most people don't realize how this fact cuts in half the amount of income that has to be offset by other kinds of key deductions in order to achieve this blissful state of total taxlessness. But as one example in the recent Treasury Department reform studies shows, that feature enables one man to enjoy a total income of $1.3 million in a year, almost all of it in capital gains, and still pay a tax of just $383. That is three one-hundredths of 1 percent of his total income. I wonder how many members of this committee achieved paying that small——

Senator WILLIAMS. Can I ask a question at that point?

Mr. STERN. Yes, sir.

Senator WILLIAMS. Just how could a fellow—any individual have a million and a quarter capital gains and pay only $383 tax, unless his income was in some other category?

Mr. STERN. Unless his income was——

Senator WILLIAMS. If he had a million and a quarter capital gains at 25 percent, his tax would be higher than that.

Mr. STERN. No, sir. I am glad you asked that question because it illustrates precisely the point.

Senator WILLIAMS. That is what I am asking for. What exemptions do you have?

Mr. STERN. This gentleman had about a million three in total income. A million two of that was in capital gains. Of the million two, $600,000 was just tossed aside completely excluded from any tax computation. That left him with a taxable income of roughly $600,000.

Senator WILLIAMS. That is correct.

Mr. STERN. So this gentleman went out and borrowed about $10 million and he had interest charges of $587,000, all of them deductible, every penny of it.

Senator WILLIAMS. That's the reason I asked it. There had to be an offsetting expense. Of course this bill deals with that.

Mr. STERN. Yes, sir. The point I am making is if his million two had been in ordinary income, all of it would have been includable and he would have had to have found a million two in deductions

to get to this low tax state. But the fact that half of them were excluded right off the bat cut in half the amount of money that he had to find offsetting deductions for.

Now, I said earlier that the special taxation of capital gains adds to the inequity of the tax system and to the complexity of it, and also to the pressures to which you Senators are subject. Naturally, people are extremely anxious to transform their high-taxed ordinary income into low-taxed capital gains and so they invent elaborate mechanisms such as collapsible corporations and spinoffs and personal holding companies and stock options, et cetera, to achieve it.

Now, to counter tax abuse in that area, you gentlemen have to write extraordinarily complex provisions into the tax code. For example, section 341 dealing with the collapsible corporation includes 3,000 words added to the tax code. Also, this creates tremendous pressures on you. I am sure you all remember the iron ore industry wanting to have iron ore royalties accorded the same special capital gains treatment that coal royalties enjoyed, and I am asking; why subject yourselves to these pressures? I implore you to make life easier for yourselves by ending the artificial distinction that creates those pressures. Think of the number of tax avoidance avenues that would be closed or would fall into disuse if you took this one step. Fast depreciation on buildings, airplanes, railroad cars, and the like, corporate stock options, so-called farm losses, the favorable tax treatment for timber and other things would all fall into disuse because they all depend on the special capital gains rate for their tax advantage.

Whole sections, whole subchapters of the tax code could be eliminated. Supchapter P, for example, dealing with the contribution of appreciated porperty to partnerships could be wholly eliminated if you eliminated this distinction.

And if it would be of interest to you, I would like to submit later for the record a list of the provisions that I think could be stricken from the tax code if you took this step.

My question is, why take on these various pressure groups one by one? Why not have it all over and done with in a single step?

Now, I hope that no one will invoke the image of defenseless widows and orphans who would be ruined by an increase in the capital gains tax, for the facts are these and I think they are important to each of you.

The first is that only one taxpayer in 12 reports any capital gains at all. Eleven out of 12 have none. So we are really talking about affecting only a small proportion of the population.

In the under 5,000 group, only one taxpayer in 20 reports any capital gains, and these account for just 2 percent of this group's income.

By contrast, in the over a million, over $1 million income group, nine out of 10 have capital gains, and those account typically for three-fourths of this group's income. Third, and this to me is the astounding fact, those with incomes of $10,000 or less make up four-fifths of the population but get only one-fifth of the capital gains. Astoundingly enough, the same proportion of capital gains, namely about a fifth, goes to those fortunate few with incomes over $200,000. One in 5,000 taxpayers get one-fifth of all the capital gains.

My final point concerns the distortion of values and the diversion of talent and energy caused by special taxation of capital gains.

Think of the effort and talent that goes into trying to transform ordinary income into capital gains by financial alchemy, because that's what it amounts to. Couldn't that energy be better used in minimizing profits and minimizing prices?

Also, consider the kind of values that are expressed in what amounts to a penalty to earned income, on income earned through personal initiative, ingenuity and effort, for it is the man who makes his money by the dint of his own brawn or his own wit—doctors, lawyers, engineers, yes, and U.S. Senators—who are the most hard pressed and hard hit by the American tax system and the most penalized. It seems to me that penalizing earned income is hardly consonant with the moral precepts that we teach in our schools and churches and is hardly consonant with what's made this country what it is.

I know that it is not protocol to end a statement of this sort by posing a question to the committee, but may I presume to conclude by begging the members of the committee to explain to me the answers to two simple questions. One, why should the work of money be so vastly favored over the work of men? And secondly, and most importantly, why is a dollar of capital gains income different from a dollar of earned income when it comes to buying food or shoes or a yacht or for paying taxes? Will somebody explain the answer to that question to me?

That concludes my statement, Mr. Chairman. I would like to ask permission, if I may, to insert in the record at this point the text of the chapter from my book that deals with capital gains.

Senator Anderson. Without objection, that will be done.

(The chapter follows. Testimony continues on p. 949.)

5

The Great Capital Gains Trial*

(The scene is a packed U.S. courtroom. The occasion: the trial of People v. The Capital Gains Tax. *The jurors—(twelve regulars and four alternates)—have been chosen, and the opposing lawyers are scheduled to make their opening statements. The noise in the courtroom subsides as the Judge enters.)*

CLERK: Oyez, oyez, oyez! All persons having business before this honorable court are admonished to draw near and give their attention, for the court is now sitting. God save the United States and this honorable court.

JUDGE: Be seated, please. The jury having been duly selected,

* The capital gains tax has here been placed on hypothetical trial simply as a means of simplifying and dramatizing the arguments, pro and con. Readers who happen to be trial attorneys are asked to indulge the obvious deviations from regular courtroom procedure, especially the freedom accorded the jury to question counsel and to debate issues in open court. At the conclusion of the trial, the author appears, thinly disguised as the Foreman of the Jury.

we may now proceed with the case of *People v. The Capital Gains Tax.*

This case is, of course, most unusual. The Defendant, the Capital Gains Tax, stands accused of two contradictory offenses. On the one hand, the People contend that because the tax is so *low*, it is guilty of injecting unfairness and complexity into the American tax system. On the other, the Investors, in a separate brief, maintain that because the tax is so *high*, it is hampering the free flow of American capital. Apparently, the Defendant can do no right.

Counsel for the People, you may proceed with your opening statement.

PEOPLE'S COUNSEL: Thank you, your honor.

Ladies and gentlemen of the jury, his honor, with his usual succinctness, has ably stated the People's case. Our charge is two-fold: first, that the Defendant, the Capital Gains Tax, is perhaps the greatest source of unfairness in the American tax system; and second, that it is the most significant single cause of tax complexity.

To understand these charges, picture, if you will, a dam in a river—high water behind it, low water in front. As you know, the high water exerts steady pressure against the dam as it seeks the level of the lower water.

Our tax system is not unlike that. On the high side of the tax dam lies what the tax laws call "Ordinary Income"—the wages and salaries all of us earn, as well as any interest or dividends we might receive. This Ordinary Income is subject to the regular income tax rates that run as high as 91 percent.

On the low side of the dam are so-called "Capital Gains" —the profit you make when you sell a share of stock or, say, a piece of land, for more than you paid for it. The profits on property you've owned six months or more don't come under the regular tax rates. They get a special rate that is never more than 25 percent*—far less, obviously, than the top in-

* It can be less. See Glossary.

come tax rate of 91 percent. The tax bill passed by the House of Representatives in 1963 provides an even lower rate—21 percent—on most property you've held more than two years.

The pressure on the dam results from the difference between the rates. Everybody in the upper brackets would naturally like to pay less taxes—and they're constantly badgering Congress and the courts to have this or that kind of income classified—and taxed—as a "capital gain." After years of pressure, the dam has deteriorated quite a bit so that today the distinction between so-called "ordinary income" and "capital gains" sometimes doesn't make much sense.

In order to illustrate this point to you ladies and gentlemen of the jury, I have prepared signs describing certain ordinary income and capital gains situations, which I have placed side by side on easels in front of you, for easy comparison.

Ordinary Income Situation No. 1	*Capital Gains Situation No. 1*
You are a novelist. You have written a widely-acclaimed, best-selling novel. You have just sold your novel to the movies for $300,000. You pay a tax of $223,640. You get to keep $76,360.	You are an inventor. You have invented a new pretzel bender. You have just sold your invention to a pretzel company for $300,000. You pay a tax of $75,000. You get to keep $225,000.

FOREMAN OF THE JURY: You mean to say, Counsel, that the inventor gets to keep nearly three times what the novelist keeps?

PEOPLE'S COUNSEL: That's right.

FOREMAN OF THE JURY: But why? What's the difference between them? They've both used their brains to create something of value. Why should one pay three times as much tax as the other?

PEOPLE'S COUNSEL: Because Congress says so.

FOREMAN OF THE JURY: What do you mean?

PEOPLE'S COUNSEL: In 1950 Congress simply decreed, in effect, that the proceeds of an invention can be classified as capital gains, whereas the proceeds from a "literary, musical or artistic composition" must be classified as ordinary income.

FOREMAN OF THE JURY: It doesn't make sense. Did Congress give any reason for all this?

PEOPLE'S COUNSEL: They just said it was desirable to "foster" the work of inventors. Let's look at the second pair of signs.

Ordinary Income Situation No. 2 (pre-1964)	*Capital Gains Situation No. 2 (pre-1964)*
You are a businessman, in the 75% tax bracket.	You are a businessman, in the 75% tax bracket.
You own an interest in *iron* mines.	You own an interest in *coal* mines.
You receive $20,000 of iron ore royalties.	You receive $20,000 of coal royalties.
You pay tax of $15,000.	You pay tax of $5,000.
You get to keep $5,000.	You get to keep $15,000.

ENGINEER JURYMAN: I don't understand. Isn't a dollar of iron ore royalty exactly the same as a dollar of coal royalty?

PEOPLE'S COUNSEL: That's what the iron ore people kept telling Congress. Congress gave capital gains treatment to coal royalties, they said, why not iron ore? So in 1963, the House voted to give iron ore royalties the special rate, too—even though it admitted there was no real "capital gain" involved.

ENGINEER JURYMAN: But why was Congress so generous to coal royalties in the first place?

PEOPLE'S COUNSEL: The coal royalty owners claimed they were in a bind because their contracts forgot to take into account the rising price of coal. Congress concluded this was a hardship situation and simply decreed that coal royalties should be

taxed as capital gains—even though there clearly isn't any "capital asset" involved, and even though other kinds of royalties are taxed as ordinary income.

ENGINEER JURYMAN: It's a kind of "legislative alchemy," isn't it? You take a dollar that comes from a coal royalty or selling an invention: one day it's ordinary income and then, Presto! Congress transforms it into a capital gain. It's the same dollar, from the same source, earned in the same manner—but it's suddenly taxed differently!

JUDGE: Counsel, may we proceed to the next signs, please?

Ordinary Income Situation No. 3	*Capital Gains Situation No. 3*
You are an apple farmer, with a top tax rate of 50%.	You are a Christmas tree farmer, with a top tax rate of 50%.
You make a $4,000 profit on the apples you have grown.	You make a $4,000 profit on the Christmas trees you've raised.
You pay a tax of $2,000.	You pay a tax of $1,000.
You get to keep $2,000.	You get to keep $3,000.

LABOR-LEADER JURYMAN: Christmas trees! You mean there's something special in the tax law for Christmas trees?

PEOPLE'S COUNSEL: I quote, sir, from Section 631(a) of the Internal Revenue Code which states that the capital gains treatment for timber specifically extends to "evergreen trees which are more than 6 years old at the time severed from the roots and are sold for ornamental purposes." In plain English, this means Christmas trees.

LABOR-LEADER JURYMAN: But why? Why Christmas trees?

PEOPLE'S COUNSEL: Well, when Congress gave capital gains treatment to certain tree sales—another case of legislative alchemy, by the way—Christmas trees were ruled ineligible. When there were complaints of discrimination, Congress wrote Christmas trees into the law.

The next pair of signs illustrate a far more basic point:

Ordinary Income Situation No. 4	*Capital Gains Situation No. 4*
You are a lawyer.	You are a corporation vice-president.
Your top income tax bracket is 62%.	Your top income tax bracket is 62%.
By working extra-long hours on a big case, you earn an extra $30,000.	For your extra-hours work and superlative job performance, your company has given you the right to buy company stock at a favored price. You buy the stock and later sell it for a $30,000 profit.
On your added $30,000, you pay a tax of $19,380.	On your added $30,000, you pay a tax of $7,500.
You get to keep $10,620.	You get to keep $22,500.

LAWYER JURYMAN:* Counsel, that one really hits home with me. No matter how hard I work, or how big a practice I build up, everything I earn from my practice is ordinary income, and Uncle Sam ends up with most of it.

LABOR-LEADER JURYMAN: What's wrong with that? Your fees are no different from my weekly paycheck. It's all ordinary income, isn't it?

LAWYER JURYMAN: That's right, and if the rule applied to everybody, I wouldn't kick. But these stock options† are nothing but salary bonuses—and what gets me is seeing some of my own clients getting twice the income I do, but paying a lot less in taxes—just because they happen to work for a corporation. I read about one lawyer who quit Wall Street and went to work as general counsel of Ford, and it wasn't long before he had nearly half a million dollars worth of these stock options. He certainly couldn't have done that on Wall Street.

ENGINEER JURYMAN: Nearly everybody on this jury is in the

* The presence of a lawyer on the jury is a literary license, since ordinarily attorneys may not serve as jurors.

† Discussed more fully on pp. 181-190.

same boat. All we have to sell is our services—and the more successful we are, the rougher our taxes are.

PEOPLE'S COUNSEL: You gentlemen have made my point for me. Why, I hope you will all ask yourselves, should people be taxed differently on their earnings just because of their profession?

Next pair of signs, please.

Ordinary Income Situation No. 5	*Capital Gains Situation No. 5*
You are a junior executive, single, with a taxable income of $14,000.	You are a junior tycoon, single, with a taxable income of $200,000.
Your hard work has earned you a $1,000 raise in your yearly salary.	Your broker has sold one of your stocks for a $1,000 profit.
Your top income tax bracket is 47%; your extra $1,000 of salary is taxed at 47%.	Your top income tax bracket is 91% but your $1,000 stock profit is taxed at 25%.
On your added $1,000 you pay a tax of $470.	On your added $1,000 you pay a tax of $250.
You get to keep $530.	You get to keep $750.

LABOR-LEADER JURYMAN: How can that be? Why this junior tycoon, or whatever you call him, has—let's see—about fourteen times as much income as this junior executive, but he pays about half as much tax on his extra $1,000.

PEOPLE'S COUNSEL: Absolutely correct.

LABOR-LEADER JURYMAN: But our tax system is supposed to be based on "ability to pay"—with people with bigger incomes paying *higher* taxes, not lower.

PEOPLE'S COUNSEL: Sir, you are perspicacious, discerning, and astute. As you have perceived, the capital gains tax and the principle of "ability of pay" have nothing whatever to do with each other. In fact, the junior tycoon might have had *fifty or a hundred* times the income of the junior executive and still paid less taxes on the extra thousand.

LABOR-LEADER JURYMAN: You know, I've always read about this capital gains tax, but I don't think I've ever met anybody who's been able to use it.

PEOPLE'S COUNSEL: That's not surprising, when you consider that if this jury happened to be a typical cross-section of American taxpayers, chances are that only *one* of you would have listed a capital gain on your tax return.

DOCTOR JURYMAN: One out of sixteen? That's only about 6 percent, Counsel.

PEOPLE'S COUNSEL: That's correct, sir. Out of sixty-one million tax returns filed in 1960, less than four million listed any capital gains.

But that's only part of the story. Even among the lucky four million, the gains were heavily bunched in the upper brackets—so much so that of the four million, the top 2/10 of 1 percent get more than a third of all of the capital gains. This chart will show you what I mean.

Those with incomes of:	*Comprise only this % of all taxpayers:*	*But get this % of all capital gains:*
$200,000 and over	96/10,000 of 1%	16%
$100,000 and over	4/100 of 1%	24%
$50,000 and over	2/10 of 1%	35%
$10,000 and over	8.7%	69%

JUDGE: Counsel, may we move on to your next signs, please?

Ordinary Income Situation No. 6

You are a businessman in the 75% tax bracket.

You buy a 20-acre tract in the suburbs.

Being a go-getter, you subdivide your property and build houses on it.

Capital Gains Situation No. 6

You are a businessman in the 75% tax bracket.

You buy a 20-acre tract in the suburbs.

You do nothing with your land; you just let it sit.

Ordinary Income Situation No. 6

You sell the lots and houses and make a $100,000 profit.
Your tax is more than three-fourths of your profit ($81,000).*
You get to keep $19,000.

Capital Gains Situation No. 6

You sell the land and make a $50,000 profit.
Your tax is just one-fourth of your profit ($12,500).
You get to keep $37,500.

ENGINEER JURYMAN: Let me be sure I understand, Counsel. Do you mean the "go-getter," as you put it, who does something with his land, makes twice the profit—and yet ends up with half as much take-home money?

PEOPLE'S COUNSEL: That's correct.

ENGINEER JURYMAN: But doesn't that amount to penalizing initiative and rewarding inaction?

PEOPLE'S COUNSEL: That's the way it seems to work out—although I'm sure Congress didn't intend such a result. Nonetheless, more than two pages of the tax law are devoted to warning taxpayers how little they must do with a piece of land if they want to be sure of getting the special capital gains tax rate.

Let's move on.

Ordinary Income Situation No. 7

You are a baseball player.
For 10 years you have been working your way up through the minor and major leagues.
You have just been voted Most Valuable Player in your league.
You sign a contract for $100,000 for the next season.

Capital Gains Situation No. 7

You are a drug store manager.
For 10 years you have owned 50 acres of unused land, left you by your father.
A company has just decided to build a huge factory right next to your property.
You sell your land to a developer for a $100,000 profit.

* The added $100,000, on top of your regular income, throws you into the 81 percent bracket.

Ordinary Income Situation No. 7	*Capital Gains Situation No. 7*
You will pay a tax of $45,576.	You pay a tax of $25,000.
You'll get to keep $54,424.	You get to keep $75,000.
P.S. The following year, due to a serious injury, you are forced to retire, and your income drops back to $8,000.	P.S. The following year, your income is back down to your $8,000 salary.

LABOR-LEADER JURYMAN: How do you like that? This drug store fellow gets $100,000 dumped in his lap—doesn't lift a finger to earn it—but pays about half as much tax as that guy who worked his heart out for that MVP award.

DOCTOR JURYMAN: Counsel, would you explain to us the significance of the P.S. at the bottom of each poster? I know you put it there for a purpose.

PEOPLE'S COUNSEL: Gladly, sir. As I know Defense Counsel will explain,* one of the main reasons behind the special capital gains rate is the so-called "bunched"-income problem. That is, a person like the drug store manager, suddenly getting $100,000 in one year, will pay more taxes than another person *getting the same amount of money*, but spread evenly over, say, ten years. You'll be hearing more about the pros and cons of this later. My point here is that the "bunched"-income problem is not unique to capital gains. Movie stars, athletes, writers, composers share it, too, but they don't get any special 25 percent rate on their income.

JUDGE: Counsel, you seem to have stunned the jury into rare silence. Proceed with your next illustration.

Ordinary Income Situation No. 8	*Capital Gains Situation No. 8*
You are a single lady, supporting your aged aunt.	You are a single lady, supporting your aged aunt.
Your taxable income is $6,000.	Your taxable income is $200,000.

* See p. 97.

Ordinary Income Situation No. 8	*Capital Gains Situation No. 8*
On May 1 you buy a share of Alleghany Stovepipe, for $40.	On May 1 you buy a share of Alleghany Stovepipe, for $40.
5 months and 29 days later—October 29—you sell the stock for $60 in order to meet an insurance premium payment.	Six months and one day later—November 2—you sell your stock for $60.
Your profit on the sale of the stock is taxed at your regular income tax rate of 30%.	Your profit on the sale of the stock is taxed at the special capital gain rate of 25%.

HOUSEWIFE JURYWOMAN: Why, that's perfectly outrageous! Why should that poor lady with the $6,000 income pay a higher tax than the other lady with more than thirty times as much income?

PEOPLE'S COUNSEL: Because, madam, the $6,000 lady is a "speculator" while the $200,000 lady is an "investor."

HOUSEWIFE: What do you mean, "speculator"?

PEOPLE'S COUNSEL: She sold her stock in less than six months—and that makes her a speculator, at least as far as the tax law is concerned.

HOUSEWIFE: How ridiculous! She sold that stock to keep her insurance from lapsing. She's no speculator.

PEOPLE'S COUNSEL: This, strangely enough, is one point on which the People and the Investors agree. We both feel it's ridiculous to distinguish speculators from investors by an artificial time cut-off. But there has always been a holding period requirement in the law. At first it was two years, but now it's been shortened to six months.*

I have one final—and crucial—point to make.

Up until now, you may have gotten the impression that the only way a person could cash in a capital gain was by paying a 25 percent capital gains tax. But that's not the case. *It can be done without paying any tax at all.*

* In 1963, President Kennedy proposed lengthening the holding period to one year, but Congress would have none of it.

DOCTOR JURYMAN: How can that be, Counsel?

PEOPLE'S COUNSEL: Because all the capital gains on property you hold when you die *escape tax entirely*. Suppose your grandfather gave you some General Motors stock. At the time he bought it and gave it to you, it was only worth $5,000, but over the years, what with stock splits and a rising stock market, it's come to be worth $105,000. Now if you sell it for that during your lifetime, you have a capital gain of $100,000 and you'd pay a $25,000 tax. *But if you leave that stock to your wife in your will, she can sell it for $105,000 and pay no capital gains tax at all.*

LABOR-LEADER JURYMAN: How come? The stock only cost $5,000. Why isn't the gain taxed?

PEOPLE'S COUNSEL: Because the law makes believe that after you die the "cost" of the stock is its value at your death. That is, according to the law, your wife's "cost" of the GM stock you leave her is $105,000, she sells it for $105,000—so there's no gain, and, of course, no tax.

LABOR-LEADER JURYMAN: You mean to say there's zero tax on all the gains that pass at death?

PEOPLE'S COUNSEL: That's a good way to put it.

LAWYER JURYMAN: That's not quite fair, though, Counsel. The $100,000 doesn't really pass tax-free, since there's an estate, or death, tax to pay on it.

PEOPLE'S COUNSEL: Not necessarily. $50,000 of it can pass tax-free to your wife automatically, and there's a $60,000 estate tax exemption, so there need not be any death tax.* But even if there were, there's still an enormous advantage to leaving capital gain property over leaving cash. Suppose all you can leave your wife is the cash you've managed to build up from your take-home pay. You've already paid an income tax on it —*and you pay a death tax besides.* Your neighbor, who leaves the General Motors stock, only pays the death tax, so he's way ahead.

* See Chapter 14.

LAWYER JURYMAN: But, Counsel, is it really as important as you make it out to be? After all, most of the gains must be left by just a few rich people, so the number of dollars that escape tax at death must be pretty small.

PEOPLE'S COUNSEL: Sir, I think you are in for a major surprise. Not one person I have ever asked about this has come anywhere near guessing the right answer. The fact is, though, that *from $12 billion to $13 billion escapes tax at death every year.*

By failing to tax these billions, the government is passing up *nearly $3 billion a year of revenue.*

ENGINEER JURYMAN: And how much revenue are we losing by not taxing capital gains the same as other income?

PEOPLE'S COUNSEL: Something over $2 billion. One tax expert figured out that if you taxed capital gains on a par with other income, you could afford to take the top tax rate down from 91 percent to 50 percent, and take two percentage points off of each tax rate below 50 percent—and still not lose any revenue. That top 50 percent rate ought to please all the people who moan about Uncle Sam being their "majority partner."

LABOR-LEADER JURYMAN: Yes, but what a sop to the rich—taking the top rate down to 50 percent.

PEOPLE'S COUNSEL: That's the way it looks at first glance—but let me ask you this: did you know that taxpayers with incomes of over $5 million pay taxes, on the average, of less than 25 percent?

LABOR-LEADER JURYMAN: That's impossible. Twenty-five percent—that's only a little more than the lowest-bracket rate. How can that be?

PEOPLE'S COUNSEL: Well, 70 percent of their incomes is taxed at the special 25 percent capital gains tax. That is, their average income is just under $9 million, but over $6 million of this is capital gains, and so it escapes the regular income rates. So you see, lowering the top rate to 50 percent, along with ending the special capital gains rate should certainly not be

looked on as a "sop to the rich." This chart I've prepared will show you how important capital gains are to the wealthy—and how little the lowly share in this tax favor:

	Percent of this income group having any capital gains	*Percent of this group's income that comes from capital gains*
Under $5,000	86%	2%
$10–25,000	4%	4%
$50–100,000	18%	18%
$1,000,000 and over	58%	64%

JUDGE: Counsel, you told the jury, initially, that you had a twofold indictment against the Capital Gains Tax, but you haven't covered the second part of your charge.

PEOPLE'S COUNSEL: Your honor and members of the jury, a justified complaint is frequently leveled at our tax laws and regulations that they are so complex as to be virtually incomprehensible—sometimes even to the experts. The People maintain that the special capital gains tax rate is the principal culprit—and we cite, as our authority, Mr. Stanley S. Surrey, top tax advisor to the Kennedy Administration and former Harvard law professor, who has said that capital gains are "the subject singly responsible for the largest amount of complexity" in the American tax laws.

The explanation for this lies in the image of the dam I cited earlier, with the high water pressing against it, seeking the lower level of the water below. Taxpayers on the high side of our two-level tax system exert a similar pressure as they seek the lower-level capital gains tax below the dam. They press upon the Treasury, Internal Revenue, the Congress and the courts in a never-ending battle to create new and more ingenious ways by which "ordinary income" can be alchemized into capital gains. They devise schemes with intriguing names like "collapsible corporations" and "corporation spin-offs."

Where does the complexity come in? Well, as an example,

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Congress' effort to prevent tax avoidance through the "collapsibles" ended up adding 3,000 words to the tax law itself, and the Treasury added 5,600 words to its own tax regulations —and even with that, "collapsibles" can still be put to great advantage in the real estate field.* "Spin-offs"† were slightly easier to control—it only took 1,000 words in the law and 4,000 words of added regulations to curb them.

Those, of course, are only two of the capital gains contrivances in the law. There are personal holding companies and stock options, real estate "tax shelters" and cattle raising,‡ timber and lump-sum pension settlements, and many others. Government officials estimate that roughly half of all tax cases in the courts involve the capital gains field.

Members of the jury, it would be difficult to measure or describe to you the effort, talent and ingenuity devoted to "working the capital gains angle." What a shame this talent isn't being channeled into minimizing costs and prices and maximizing profits.

President Kennedy asked Congress to undo some of the legislative alchemy it has performed in the past, and to end capital gains treatment for such things as cattle, timber, stock options, coal royalties and some others. Fine—but these are merely attacks on the symptoms, rather than the cause, which is our two-level tax system. (In fact, the *lower* capital gains tax in the 1963 tax bill passed by the House would *increase* the pressures for special capital gains treatment.) Even if Congress had closed up all the capital gains "loopholes" suggested by the President, new ones would, in time, spring up to take their place. For as long as the two-level system exists, these pressures will persist. Close up this major avenue of escape, and the pressures may not vanish, but they will subside substantially.

I submit, members of the jury, that we should put an end

* See pp. 150-151.
† See Glossary.
‡ Described in more detail on pp. 131-137, 181-190, 143-161, and 139-141 respectively.

to the preferred status that capital gains enjoy in our tax laws. We should tax all income at uniform rates, whether the income be from wages or the sale of stock, from novels or inventions. And we should end the zero tax on gains passing at death. These changes should, of course, be accompanied by a system of income-averaging* that would mitigate or solve the "bunched"-income problem.

If we take these steps, we can—and *must*—drastically lower the top tax rates, down to a 50 percent maximum.

I ask you, members of the jury, to envisage the dramatic benefits that would flow from such a reform.

It would make our tax system fairer: everyone would be taxed according to the same rate schedule, and according to his ability to pay.

It would restore sensible values to our society: no longer would the work of *money* be vastly favored over the work of *people.*

It would put an end to much of the pressure for special tax treatment, and would liberate much of the energy and talent now devoted to tax avoidance.

Finally, no more than 50 cents of any dollar would be taken by the tax collector.

I submit, your honor and members of the jury, that the abolition of the special capital gains tax rate is the single greatest tax reform this nation could undertake.

JUDGE: Counsel for the defense, you may proceed with your opening statement.

DEFENSE COUNSEL: Your honor, I am aghast at the radical proposal made by People's Counsel, which would, of course, shake the very foundations of our enterprise system. This country has had a separate capital gains rate ever since 1921, and so far as I know, Congress has never, in all those years, seriously questioned the principle of a separate rate.

* See Glossary.

JUDGE: Would you tell the jury what prompted Congress to enact the separate rate in 1921?

DEFENSE COUNSEL: Two considerations, your honor, which remain the principal reasons behind the special capital gains rate today.

The first is the manifest unfairness of taxing, *in a single* year, all the gains that may have accrued over a number of years, in, say, a share of stock or a piece of land. Clearly, to do so would push a taxpayer into an artifically high tax bracket. For instance, take a man who buys a piece of land, holds it for twenty years and sells it for a $100,000 profit. Now if this were to be taxed as if the gain had occurred evenly over the twenty years he held the property, this would mean just $5,000 of added income a year, which would probably affect his tax bracket very little. But if the entire $100,000 were taxed in the year he sells the land, he would suddenly be catapulted into the 75 percent or 89 percent bracket (depending on whether he's married or single), and the government would take most of his profit. As long as the tax rates get stiffer as a person's income goes up, this so-called "bunching" effect is going to be unfair.

JUDGE: What was the second main reason for the capital gains tax, Counsel?

DEFENSE COUNSEL: Congress felt that having to pay a tax on the sale of stocks and other properties was tending to make people hold on to them instead of selling them, and that capital was becoming too "frozen."

There is, members of the jury, a crucial difference between capital gains and ordinary income. Most of the income you receive—salaries, wages, interest, dividends and the like—involves no *choice* on your part. The income is paid to you, you're taxed on it, and that's that.

But with capital gains, you do have a choice. You can either sell a particular stock or bond or piece of land, and pay a capital gains tax, or you can hold on to the property and pay

no tax. It's this element of *choice* that creates a tax barrier to selling property—and it's this that justifies special tax treatment of capital gains. It's important to lower that barrier and make capital more mobile.

JUDGE: Perhaps, Counsel, a numerical example would illustrate what you mean by a "barrier."

DEFENSE COUNSEL: Well, suppose you have a share of stock you bought for $20. It's now selling for $100 and paying you a $3 dividend. Your broker suggests you sell. If you do, of course, you'll pay a $20 capital gains tax and have only $80 left to reinvest in a new security.

Now that may make you pretty reluctant to sell. Say, for instance, you're mainly interested in maintaining the $3 dividend you've been getting. If that's the case, you ought to turn down your broker's suggestion unless he can find you a stock with a 3.75 percent return—considerably higher than the 3 percent return your old stock paid. Remember, after paying the $20 tax, you'll only have $80 to put into a new stock and it takes a 3.75 percent return for an $80 stock to pay a $3 dividend.

On the other hand, if you're more interested in preserving your $100 of *capital*, it won't pay you to sell unless you can find a stock you're pretty sure will go up from $80 to $100 in the reasonably near future. At best, you'll be trading the *chance* that your new stock will go up, for the *certainty* of having to pay the $20 tax and having only $80 to reinvest.

So you see, the capital gains tax gives you every incentive to stay "locked in" to your existing investments, instead of switching to new ones. Of course, raising the tax, as People's Counsel proposes, would only intensify the locked-in effect.

So if People's Counsel, with his tender regard for the Treasury, is trying to increase revenues by raising the capital gains rate, he's going about it the wrong way, because raising the rate will simply make people hold on to their stocks in-

stead of selling and paying the tax, and the Treasury will raise less, not more, through the capital gains tax.

ENGINEER JURYMAN: Let me make sure of one point. You don't contend, do you, that the tax deters *new* capital from coming into the market? After all, a person pays no tax when he makes a new investment.

DEFENSE COUNSEL: That's correct.

ENGINEER JURYMAN: So your point is not that the tax "starves" industry from getting the volume of capital it needs, but merely that it deters people from switching the money they've already put into the market from one particular investment to another.

DEFENSE COUNSEL: Right again.

ENGINEER JURYMAN: Well, I don't understand what's so "bad" about people holding on to the stocks they have and what's so "good" about their switching from one stock to another.

DEFENSE COUNSEL: Well, "switching," as you call it, is the way capital finds its way out of the staid old conservative blue-chip stocks and into the pioneering, venturesome new companies. It's an essential ingredient to a dynamic and forward-moving economy.

Your honor, that is the essence of the two main arguments the Defense will offer.

People's Counsel, do you wish to rebut the points made by the Defense?

PEOPLE'S COUNSEL: Thank you, your honor. I shall try to take them up point by point.

First, Defense argues that we should not change the preferential capital gains rate because it has been in the law since 1921. But must we accept the notion that just because a provision has been in the tax laws for years, it is *ipso facto* virtuous, just and immutable? If so, we might as well end this trial and give up all thought of tax reform.

Besides, the special capital gains rate does not enjoy the

historical sanctity with which my adversary seeks to endow it. On the contrary, my supposedly "radical" proposal is, in reality, the soul of conservatism. It simply calls for reverting to what the Founding Fathers of our tax system wrote into the original 1913 income tax law. In fact, this "radical" plan of mine prevailed for a full nine years for individual taxpayers, and for nearly thirty years for corporations. Yet the country survived quite nicely.

DEFENSE COUNSEL: Ah, yes, but the 1913 law had a top tax rate of 7 percent. You can't compare that with the 91 percent rates we have today.

PEOPLE'S COUNSEL: True, but during the first nine years, the tax rates went as high as 77 percent—nearly as high as we have today.

DEFENSE COUNSEL: And soon after that, Congress saw the error of its original decision, and established a 12½ percent rate for individual taxpayer's capital gains.

PEOPLE'S COUNSEL: But for the most specious reasons. Take, first, the so-called "bunched"-income reason—as exquisite an exercise in illogic as the mind of man could invent. Now, I readily admit there *is* a "bunched"-income *problem* with capital gains. But as a *solution*, a flat preferential tax rate is the acme of absurdity.

First of all, the six-months' holding period makes a mockery of Defense's "bunched"-income argument. Suppose a man sells a stock for a profit after holding it just six months and a day. His gain all took place in one year and he is taxed in the same year. He has no "bunched"-income problem—yet he gets the same delicious 25 percent rate as the man who held his stock for twenty years.

ENGINEER JURYMAN: And what about corporations? I don't see why the "bunched"-income argument applies to them, since no matter how "bunched" their income is, its always taxed at their flat 52 percent rate. Why do *they* need a special rate?

PEOPLE'S COUNSEL: As to that, sir, I am as baffled as you. Now, if the capital gains rate were *really* what it is supposed to be—a device for averaging out the "ordinary income" rates—you'd expect it to go up and down as the regular income tax rates rise and fall. But it hasn't. For instance, in 1950, the income tax rates went up some 10 to 20 percent, to finance the Korean war, but the increase in the capital gains rate only amounted to about 4 percent.

ENGINEER JURYMAN: It would seem to me, Counsel, that to the extent there is a hardship from "bunched" income, it would be different in every case, depending on a person's income and tax bracket, the length of time he's held the property, the amount of the gain, and so on. How can a single flat rate, such as we have now, be an accurate and fair answer to the "bunched"-income problem in every case?

PEOPLE'S COUNSEL: It can't—and as a matter of fact, the present capital gains tax rate is so low that it more than offsets any "bunched"-income hardship and really gives most taxpayers a big windfall tax break. For example, take a person with a $25,000 taxable income who suddenly realizes a $50,000 capital gain on a stock he's held for twenty years. Taxing the entire $50,000 to him in the year he sells the stock makes him pay nearly 58 percent of it in taxes. If, however, you tax him as if he'd received the $50,000 evenly over the twenty years he owned the stock, he'd only have to pay 43 percent of it in taxes—but that would remove the "bunched"-income problem. But the existing capital gains tax goes far beyond that. Instead of paying 43 percent (which would be fair), he only has to pay 25 percent. In other words, he gets nearly *twice* the concession that equity requires. And, of course, the wealthier he is, the greater his windfall tax break, as the table in front of you clearly shows.

PEOPLE'S COUNSEL: Turning now to Defense Counsel's second argument—the so-called "locked-in" argument—my adversary has the right charge, but the wrong culprit. The existing system

THE "BUNCHED"-INCOME PROBLEM AND TWO SOLUTIONS
(Comparison of tax that has to be paid)

Income Level	*Problem*	*Two Solutions*	
	INCOME "BUNCHED"*	INCOME "UNBUNCHED"†	FLAT 25%‡ CAPITAL GAINS RATE
On a gain of $50,000			
$5,000	44.6%	22.0%	16.9%‡
$25,000	57.6	43.0	25.0
$100,000	77.4	75.0	25.0
$500,000	91.0	91.0	25.0
On a gain of $100,000			
$5,000	56.4%	23.6%	22.3%
$25,000	65.3	44.6	25.0
$100,000	81.0	75.0	25.0
$500,000	91.0	91.0	25.0

* Entire gain taxed all in one year.

† Gain spread evenly over 20 years (on the assumption the property has been held for that period)—i.e., tax is computed as if 1/20 of the gain had been taxed in each of 20 years.

‡ The rate can be lower than 25%, since a person is entitled to choose between having his gain taxed at 25% (the maximum), or at *half* his regular top-bracket rate. If this latter is less than 50%, it pays to choose the second method.

does have a locked-in effect, but the preferred capital gains tax rate is not to blame—in fact, it produces an opposite or anti-locked-in effect. No, the real culprit is the failure to tax capital gains at death.

FOREMAN OF THE JURY: Counsel, you covered too much ground in one breath. Could you explain *why* the failure to tax gains at death creates a locked-in effect?

PEOPLE'S COUNSEL: Because, as Defense Counsel has explained, the deterrent to selling comes from a person asking himself, "Shall I sell and pay a tax or hold on and pay no tax?"

But he's able to pose the question in this way only because if he holds on long enough—namely, until he dies—he will indeed "pay no tax." So of course there's an incentive to hold on rather than sell.

But if the rules were changed, and gains were taxed at death, as President Kennedy proposed in 1963, then a person would pose the question differently: "Shall I sell and pay the tax now or hold on *and pay the tax later?*" Either way, the tax would have to be paid; it would just be a matter of timing, so the incentive to hold on would be much less.

FOREMAN OF THE JURY: And why do you say that the existing capital gains tax encourages "switching"—an "anti-locked-in" effect, I think you called it?

PEOPLE'S COUNSEL: Well, put yourself in the shoes of a person in the 75 percent tax bracket. You have two choices: you can leave your money in AT&T stock, which fluctuates very little in price but pays a nice, steady dividend, on which you keep only 25 cents out of every dollar. Or you can sell your AT&T and put your money in a stock that stands a good chance of doubling in price in the next three years, *with you keeping 75 cents out of every dollar of profit, instead of 25 cents.* Which would you do? Wouldn't you be tempted to sell the AT&T and go for the stock profit?

ENGINEER JURYMAN: Your argument sounds logical in theory. But does it work out in actual practice?

PEOPLE'S COUNSEL: Three professors of the Harvard Business School made a nationwide survey of the habits and behavior of actual investors, and their findings were summarized as follows:

> Quite contrary to the indictment, the facts established by cross examination of investors show that it is precisely in drawing funds into new ventures and unseasoned securities that the capital gains tax at present rates exerts its strongest influences.

Actually, as far as over-all stock sales and purchases are concerned, *non*-tax reasons seem to be much more powerful than tax considerations. Take the years 1922 through 1933, for example. During that time, both the income tax and the capital gains tax rates were consistently at fairly low levels so that the supposed tax impediments my adversary has conjured up were at a minimum. Yet those years included both the fattest and the leanest in history in the volume of capital gains. The point is that economic conditions and market judgments are far more important than the level of taxes.

Also, a large proportion of stock buying and selling is done by colleges, pension funds, foundations, and insurance companies that are wholly or partially tax-exempt. For them, of course, taxes *couldn't* be a factor.

DOCTOR JURYMAN: Counsel, I am quite persuaded by what you say about the *present* tax system, but frankly I am concerned about what would happen to the economy if we were to tax capital gains the same as ordinary income—at rates as high as 50 or 65 percent.

For instance, you yourself have admitted that the present special capital gains rate has powerfully attracted investment into so-called venture or pioneering companies, where the risk is high and dividends may be years away. Where are those companies going to get capital under your proposal?

PEOPLE'S COUNSEL: Sir, Defense Counsel has sought to characterize the People's proposal as radical. Actually, it is based on the old-fashioned, laissez-faire, free enterprise principle that a free market is the best regulator, sifter and adjuster of economic forces.

The People believe that investors, given a free choice and free competition among companies for capital, will make sound decisions. Worthwhile ventures will get all the money they need. Since when did we need to subsidize risk-taking in America? After all, men invest—or even gamble—their personal energies and talents, even though they are taxed at the

regular income tax rates. Is money so much more precious than a man's own talent that its risks must be coddled?

Besides, stock issues play a relatively unimportant role in meeting corporations' capital needs. In 1962, for example, they furnished less than 4 percent of total corporate funds. Corporations get most of their capital either by borrowing or by plowing back their depreciation reserves and their profits.

My plan would also offer more liberal tax treatment of investment *losses* than is now allowed, which would provide considerable inducement to risk investment by top-bracket taxpayers.

JUDGE: I'm afraid we may be turning this trial into a seminar on economics. If neither side has anything further to submit to the jury at this time, this trial will stand adjourned for the day.

JUDGE: Mr. Foreman, has the jury concluded its deliberations?

FOREMAN OF THE JURY: Yes, your honor, and we are prepared to render our conclusions.

We start from a simple proposition: a dollar is a dollar, no matter how it was earned or where it came from. It will buy just as much in groceries, or shoes, mink coats or Cadillacs, whether it was made from a sale of stock or a sale of the sweat of a man's brow or the fruits of his brain. It will pay taxes just as well, too. The voice of Equity, therefore, calls clearly and eloquently for taxing *uniformly* "all income, *from whatever source derived*"—to use the words of the tax law itself.

The voices of Practicality and Simplicity speak, too. The voice of Practicality tells us that the pre-1964 top income tax rates of 90 and 91 percent not only stifled initiative, but also stimulated tax avoidance. Because such rates were intolerable, means were found to avoid them and very few were actually paying those rates. Much the same is true of the 70 percent rate approved by the House of Representatives in 1963. Taxing capital gains on a par with ordinary income, however,

would not only make it possible but, in our opinion, essential to do away with useless top rates, and bring the maximum rate down to 50 percent. That way, as People's counsel put it, Uncle Sam would no longer be anyone's majority partner—either in business or in every-day life.

At the same time, the voice of Simplicity tells us, a major avenue of tax avoidance would be closed. The incessant pressure for special tax treatment would be enormously lessened. Energies now devoted to minimizing taxes could be more constructively dedicated to minimizing costs and prices and maximizing profits, as People's Counsel put it.

We note the apprehension felt by many that the equal taxation of capital gains and ordinary income will dry up the wellsprings of capital and greatly reduce American risk-taking. But this viewpoint supposes the American economy to be so frail as to require a subsidy for risk-taking. We do not share such a view, and even if we felt a subsidy were required, we would certainly choose a device less clumsy and ill-directed than a blanket tax preference to *all* investment, safe as well as risky.

We have faith in the free enterprise system. We believe the free play of the market is the best regulator of economic forces—that investors, operating freely amid a free and open competition for capital, will produce the soundest economic and investment decisions. Institutions and investors will adjust themselves. Values will find a new—and sounder—level. As long as there are reasonable investment opportunities in America, there will be investors and capital to take advantage of them, with or without a tax subsidy. But if no such opportunities exist, no amount of tax preference will lure investors into the market.

We are well aware, your honor, that what we propose would be a sharp departure from the past. But we are persuaded by People's Counsel when he says that this would be "the single greatest tax reform this nation could undertake." And

as Justice Brandeis once said, "If we would guide by the light of reason, we must let our minds be bold."

The light of reason tells us that we can have a far simpler and far fairer tax system. The question is whether our minds are bold enough to make this a reality.

Senator ANDERSON. Senator Gore.

Senator GORE. If a preference is to be given to earned income, do you think it should be limited to the brackets above 50 percent?

Mr. STERN. If a preference is to be given to earned income—no, sir; I don't. It seems to me that what we are doing with the tax system as it is now is penalizing earned income across the board, including everybody who earns his income in a factory and has his tax withheld before he even sees it.

Senator GORE. Well, my question relates specifically to the provision in the bill which lowers the ceiling on earned income, so called, from 70 percent to 50 percent. It seems to me that if a preference is to be given to earned income, then all earned income is entitled to preference.

Mr. STERN. Well, sir, I think that the House bill is going about it from the wrong end. It is true that earned income, particularly in the top brackets, suffers a very high tax. But I think that the way to do this is to end the distinction between capital gains and ordinary income. And having done that, plus providing for constructive realization at death to close up that avenue of escape, then I would be all in favor of lowering the top-bracket rate for everybody substantially. It would depend——

Senator GORE. Well, I would disagree with you on that. Instead of a change in the rates, it seems to me that the tax reduction should be centered on raising the personal exemption for each taxpayer and dependent. This is where a tax reduction, where tax relief is direly needed. The man trying to rear and educate a family is the man who needs most sympathetic consideration, and particularly in the lower middle income brackets. Would you agree with that?

Mr. STERN. Yes, sir; I do, and I point out that if you eliminated the distinction between ordinary income and capital gains, the revenue gain would be in the neighborhood, at least its been estimated as high as $8.5 billion. Now, you could raise the personal exemptions a fair amount for $8.5 billion and come out with a balanced revenue.

Senator GORE. Well, this is so justified and it is so needed, I shall lose no opportunity at any day during the consideration of this bill to call attention to it. This I will press.

Thank you, Mr. Chairman.

Senator ANDERSON. Senator Talmadge.

Senator TALMADGE. No questions.

Senator WILLIAMS. Mr. Stern, you have raised some interesting questions, and as I understand it, your proposal would be that under the Revenue Code we treat all capital gains as though it were regular income in all instances.

Mr. STERN. Yes, sir, including an averaging mechanism so that if you earned, if your capital gains were accrued over a period of years, that would be averaged out so that it is not all bunched in 1 year.

Senator WILLIAMS. I understand. Now, would you make any exceptions to that rule or would you go right across the board?

Mr. STERN. No exceptions occur to me at the moment.

Senator WILLIAMS. No exceptions. One of the instances that has been called to our attention is when somebody that has a stock at a low price, forms a foundation and then donates that stock to the foundation. And say it costs them $10 and it is worth $200. They get a $200

tax exemption or credit. And then when the foundation sells that stock for the $200 or $500, whatever it may be, they don't pay capital gains. Now, do I understand that you would suggest that they be taxed at capital gains or how would you tax the donor?

Mr. STERN. I don't see any reason why either the tax deduction should not be limited to the original cost, or if you want to take the full tax deduction you have to pay the capital gains tax.

Senator WILLIAMS. Well, of course, we are eliminating capital gains in our thought. Now, would you suggest that these foundations when they dispose of this stock which they got at a cheap price, that they should pay tax on that, either the capital gains rate, whatever the law is, or regular income?

Mr. STERN. I think the donor ought to have to pay whatever gains tax is involved when he makes——

Senator WILLIAMS. At the regular rates?

Mr. STERN. Yes, sir.

Senator WILLIAMS. And if it costs him a hundred thousand dollars and it is worth $10 million and he gave it away, he should pay the regular tax on the difference between the $100,000 and the $10 million when he gives it to his foundation, is that your argument?

Mr. STERN. If he wants the full deduction, yes, sir. I don't see why he should have it both ways, to get a deduction as if he had sold it at a profit and still not have to pay the tax on that. That seems to me double dipping.

Senator WILLIAMS. Yes. Now, how would you handle the situation where we cannot retroactively impose the tax on the individuals? Some of these foundations have this. Would you tax them under your proposal now when they sell that stock which has already been donated in prior years and which has a substantial gain today and they decide to dispose of it?

Mr. STERN. As you say, sir, you get into real problems when you start taxing things retroactively——

Senator WILLIAMS. No, you couldn't tax it retroactively but we could tax them from this day forward and that is what I am asking you. I am not suggesting it. Are you suggesting—that all capital gains from now on be taxed as regular income with no exceptions, and does that include any exceptions or do you except foundations from that category?

Mr. STERN. Well, you gentlemen——

Senator WILLIAMS. You mentioned the foundations and I just want to get clear what you are recommending.

Mr. STERN. Yes, sir. You gentlemen exempt foundations from taxation.

Senator WILLIAMS. We exempt a lot of things but you are proposing we close those exemptions and I am asking——

Mr. STERN. No, sir. I appreciate the question because I am suggesting that for any entity subject to tax, that entity must pay the same tax on his or its capital gains as on his or its ordinary income.

Senator WILLIAMS. Well, the bill that is before us upon which you are testifying does propose to tax foundations on their investment income.

Mr. STERN. Yes, sir.

Senator WILLIAMS. Now, as I understand it, under your proposal investment income will also include capital gains.

Mr. STERN. Yes, sir; it would.

Senator WILLIAMS. So you are recommending that they be taxed on the straight sale of capital gains as far as foundations are concerned.

Mr. STERN. Yes, sir, although I have to say I am presiding over two foundations——

Senator WILLIAMS. I realize that and that is the reason I recognized you as an authority in this case.

Mr. STERN. Yes, sir.

Senator WILLIAMS. And I appreciated your testimony that you thought you should pay some tax in that foundation.

Mr. STERN. Anything that is taxed ought to pay tax on ordinary income and capital gains is what I am saying.

Senator WILLIAMS. And the stock that is in your foundations, when that stock is sold do you think it should be taxed as regular income the same as we tax other corporations and other individuals?

Mr. STERN. If you impose that tax on investment income, yes, sir; I do.

Senator WILLIAMS. Yes, sir. Thank you.

Mr. STERN. I would like to point out, sir, that capital gains and ordinary income were taxed on the same basis during the first 8 years of the American income tax system. So what I am proposing here is hardly radical. It is in a sense conservative. It is going back to what the founding fathers of the tax system originally enacted. And it existed, this equal taxation existed even though tax rates in that period went as high as 77 percent. So this is no radical new departure in American taxation.

Senator WILLIAMS. No further questions.

Senator ANDERSON. Senator Byrd.

Senator BYRD. No questions, Mr. Chairman.

Senator ANDERSON. Thank you very much for appearing here today.

Miss FURNESS. Thank you.

(Philip Stern's prepared statement follows:)

STATEMENT OF PHILIP M. STERN[1] BEFORE THE COMMITTEE ON FINANCE, U.S. SENATE, SEPTEMBER, 8, 1969

I appear here to urge you to end a feature of the tax system that I consider outrageously unfair to you gentlemen on this committee and to all your colleagues in the Senate and House.

This matter can be put simply: you Senators now receive an annual salary of $42,500 (and having had the honor to work for Senator Paul Douglas for two years, I know how hard you work to earn that salary). Assuming, for simplicity's sake, that you have three dependents and take the standard deduction, you have a taxable income of about $39,000 and pay a top-bracket tax rate of 45 percent.

Now it is no secret to your Chairman (and perhaps to other members of this committee) that I am blessed with considerable wealth. A significant portion of my income comes in the form of so-called "capital gains"—profits on the sale of stocks or other property.

Now compare the amount of work you and I do to earn property. By and large, those capital gains are the result of little or no effort on my part: I invest in Company X or Y and from then on I don't lift a finger. Some years ago, for example, I had the good fortune to invest in the Xerox Corporation. Having done so, I sat back while Mr. Sol Linowitz and his colleagues worked their heads off to make the Xerox company grow and prosper. And when they succeeded, I reaped the benefits—and paid no more than a 25 percent tax on the proceeds.

[1] Mr. Stern, a member of the National Committee on Tax Justice, is author of *The Great Treasury Raid*, a best-selling book on tax loopholes published in 1964.

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What a situation: you, having worked enormously hard, pay a 45 percent tax on your top dollars. I, having exerted no effort at all, pay no more than 25 percent.

I consider that grossly unfair; and if I were in your position. I would not stand for it. I urge you to put a prompt end to this outrage and to take an action that would, in a single stroke, eliminate the biggest single source of inequity and complexity in the American tax system. Specifically, I urge you to put an end to the artificial distinction between so-called ordinary income and capital gains and tax the two on the same basis.

That proposal carries three important provisos: first, that you provide for so-called "constructive realization" of capital gains at death so that the gain on appreciated properties held until death will no longer pass, in effect, tax-free; second, that you include some mechanism for the averaging of capital gains accrued over a period of years so that such gains, when realized in a single year, will not be unfairly subjected to the graduated income tax schedule; and third, after you have accomplished the above, that you significantly lower the top-bracket income tax rate.

It may sound extravagant to contend that to tax capital gains on the same basis as ordinary income would in a single stroke remove the greatest cause of inequity and complexity in the American tax system. But I can document that claim.

Take first the matter of equity, which is most dramatically summed up in this astounding fact:

The topmost income group in the United States—those whose incomes exceed $5 million per year—pay *just half as much tax, proportionately, as do those with one-tenth as much income.*[1]

To anyone looking at the tax table on page 11 of the income tax instructions, such a result must seem impossible. After all, those tax tables show tax rates rising, up to 70 percent, as income rises. How can the super-rich pay half as much tax, proportionately, as those with one-tenth as much income? The answer, of course, lies in the preferential capital gains tax, and in the fact that among the hyper-affluent people with incomes of more than $5 million, two-thirds of their total incomes are in the form of capital gains—not taxed at 70 percent or even 50 percent, but at no more than 25 percent—*the same top-bracket rate that is paid by a married couple with a taxable income of just $12,000.*

Clearly, then, the preferential capital gains tax throws the principle of ability to pay right out the window. It makes a mockery of the graduated income tax. A person can have an income of a million dollars, or five million, and receive another million (or five million) in capital gains, and still pay no more than a 25 percent tax on it.

This is of enormous benefit to the super-rich. The special capital gains rate saves the average person with a million-dollar income at least $228,000 a year.[2] To put that in the language of the man on the street, it gives those multi-millionaires added "take-home pay"—added spending money in their pockets—of more than *$4,000 a week.*

But, of course, that isn't the whole story. I have been talking of the capital gains tax as a 25 percent tax. But for literally billions of capital gains each year, it isn't 25 percent at all. It's zero. For those who are patient enough (by which I really mean wealthy enough) to hold on to their appreciated properties until death, the capital gains tax is zero. By way of illustration, when I die the Xerox stock I mentioned earlier will be passed on to my heirs at its value at my death. That is, shares I bought at $50 that rise, say, to $250 in my life will be treated, in my children's hands, as if they had been bought for $250 and all the gains that took place during my lifetime will be wiped out, for tax purposes. Each year, the astounding total of $11.5 billion wholly escapes capital gains tax in that manner. The annual revenue loss from that feature alone is estimated at $2 *billion*[3]. All told, the preferential tax treatment of capital gains, including both the living and the dead, costs the U.S. Treasury—i.e. costs those taxpayers who do not enjoy capital gains advantages—an estimated $8.5 billion annually.[3]

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[1] See Senate Finance Committee hearings on Revenue Act of 1963, p. 279, which shows median effective tax rate on amended gross income (including excluded capital gains) for the $5,000,000-and-over class to be 23.7 percent, while the comparable rate for those in the $500,000–$750,000 class is 53.0 percent.

[2] See 1969 U.S. Treasury "Tax Reform Studies and Proposals," p. 81, Table 5, especially a comparison of Columns (3) and (5).

[3] 1968 Report of the Secretary of the Treasury, p. 338.

The preferential tax treatment of capital gains is also a major reason behind the impressive fact brought out by former Secretary Barr that in 1967 255 Americans were able to enjoy incomes of more than $200,000 without paying a penny of income tax. No less than 381 American millionaires with incomes over $100,000 achieved total taxlessness that year.

How does the favored tax treatment of capital gains contribute to this total taxlessness of the rich? After all, you might say, the capital gains tax is 25 percent—how can it lead to *total* tax avoidance.

The answer lies in a popular misconception about the taxation of capital gains. Most people think of the capital gains tax as a simple 25 percent tax. But, of course, it is something quite different: 50 percent of all captial gains are wholly discarded, ignored, for tax purposes, and the remaining 50 percent is subject to a tax of no more than 50 percent. Now a 50 percent tax on half the gains does indeed amount to a 25 percent tax. But the total exclusion of that other 50 percent is of extreme utility in achieving the blissful state of total taxlessness—because it reduces by half the amount of income that has to be offset by other kinds of deductions.

An example will illustrate. Take the case of Mr. G, an actual taxpayer whose financial wizardry was set forth in a recent Treasury Department study.[1] Mr. G enjoyed a total economic income of $1,284,000 nearly all of which—$1,210,000—was in the form of capital gains. Half of those gains—about $605,000—was automatically tossed aside, placed wholly outside the reach of the tax collector, and ignored in computing his taxable income. This reduced by half the amount of income that Mr. G had to offset with other deductions. This he was able to do simply by borrowing about $10 million (which he may well have channeled into other tax-avoidance ventures), on which he paid interest—entirely tax deductible—of $587,000. This plus a few other deductions very nearly wiped out his otherwise taxable income, and on his total intake of $1.3 *million*, he ended up paying a total tax of just $383—three one-hundredths of one percent of his income. By contrast, as the Treasury Department study notes, the average single individual living at the poverty level pays nearly 7 percent of his income in taxes—twenty times as much, proportionately, as the multi-millionaire Mr. G. (I wonder how many members of this committee contrived to pay just three one-hundredths of one percent of their incomes in taxes last year.)

CAPITAL GAINS AND TAX COMPLEXITY

Let me turn now to the extent to which the favored tax treatment of capital gains adds to the complexity of the tax system—and, in so doing, adds enormously to the pressures to which you Senators are subjected.

The pressure is not difficult to understand. It is not unlike the force exerted on the wall of a dam in a river, with high-level water behind it, exerting tremendous pressure as it seeks the level of the lower water below the dam. The same is true of our tax system which artificially divides income into two kinds: so-called "ordinary income," subject to high taxes, up to 70 percent; and capital gains, the low-level income taxed at no more than 25 percent. Naturally, there is an immense desire on the part of those who earn the high-taxed kind of income to transform it somehow into low-taxed capital gains. Enormous amounts of talent and ingenuity are devoted to satisfying this desire, resulting, over the years, in such elaborate mechanisms as collapsible corporations, corporate spinoffs, personal holding companies, lump-sum pension settlements and the like.

To illustrate the great complexity this adds to the tax system—and the prodigious work to which it puts you gentlemen in order to prevent abuse of these devices—the curbing of unwarranted use of the so-called collapsible corporation required the addition of no less than 3,000 words to the tax code—you'll find it at Section 341—and the addition of nearly twice that amount of verbiage (5,600 words) to the tax regulations. I am advised that entire subchapters of the tax code could be eliminated if capital gains were taxed on the same basis as ordinary income. Won't you spare yourselves all the unnecessary labor you have put into the drafting of such intricate provisions of the tax law, by ending the artificial distinction that underlies them?

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[1] "Tax Reform Studies and Proposals," U.S. Treasury Department, Feb. 5, 1969, p. 92.

Then, of course, there are the various definitional quirks that plague taxpayers and translate themselves into pressures on you. I am sure you remember, perhaps with considerable pain, the wholly illogical distinction that formerly existed between the tax treatment of iron ore royalties and coal royalties—until the inevitable pressure from the iron ore industry persuaded you to accord them the same favorable capital gains treatment that coal royalty recipients had enjoyed. Why subject yourselves to such pressures? I implore you to make life easier for yourselves by abolishing the artificial distinction that brings about those pressures.

Think of the number of tax-avoidance provisions that would fall in one fell swoop if you adopt the step I am urging upon you today: corporate stock options; so-called farm "losses"; fast depreciation on buildings, railroad cars and airplanes; the favorable taxation of timber—all would fall into comparative disuse if you would but take the single step I recommend to you. If you want to effect substantial tax reform why take on each of those provisions—and their respective pressure groups—separately? Why not have it over and done with in a single action?

Now, lest any defenders of the preferred capital gains tax invoke the image of defenseless widows (or orphans) who would be mercilessly taxed if this tax preference were to end, let us be clear about who are the fortunate recipients of these lightly-taxed capital gains:

First of all, only one taxpayer in twelve enjoys any capital gains; eleven tax returns out of twelve show no capital gains whatever.

Second, in the under-$5,000 group, only one taxpayer in twenty receives any capital gains, which makes up less than two percent of that group's total income. By contrast, at the top of the economic pyramid, among those with incomes of $1,000,000 and over, nine taxpayers out of ten receive capital gains, and these account for nearly three-fourths of that group's total income.

Third, only one-fifth of all capital gains go to those with incomes of less than $10,000, even though they make up *four*-fifths of all taxpayers. Astoundingly, about the same proportion of all capital gains—slightly more than a fifth, in fact—goes to those fortunate few with incomes over $200,000—even though they constitute just two one-hundredths of one percent of all taxpayers, or the top one in five thousand.

So please, members of the committee, do not weep unduly for the widows and orphans; they would be almost wholly unaffected were you to adopt the reform I urge on you today.

Finally, there is the distortion of values and the enormous diversion of energy that results from the preferential capital gains tax. Think of the amount of energy and creative talent that is currently devoted to trying to transform "ordinary income" into more lightly-taxed capital gains through one or another form of financial or legislative alchemy. Surely there are more productive outlets for such energy and talent.

And consider, too, the kind of values implicit in this crucial feature of our tax system. It imposes, in effect, a penalty on earned income, on income earned through personal initiative, ingenuity and effort. It is the man who makes his money by dint of his own brain, wit or brawn—the doctors, the lawyers, engineeds, and actors and the like—who are the hardest hit by our tax system—a system that says, loud and clear, that the work of money is to be valued far more highly than the work of men.

That is far from the moral precepts we teach in our schools. It is far from the value system that makes our country what it is. I believe that basically each of you agrees. I urge you to end this false and distorted value system and return our tax structure to the parity between earned and unearned income that prevailed during the first eight years of our income tax system.

While it is not considered protocol to end a statement such as this with questions to the committee, may I presume to ask any member of this committee to explain to me the answers to these questions:

(1) Why should the work of money be so vastly favored over the work of men?

(2) Why should a lawyer or doctor or engineer—or United States Senator—pay more taxes on dollars he *works* to earn than an investor pays on dollars that others may earn for him?

(3) Most important, in what respect is a dollar of capital gains income different from a dollar of earned income when it comes to buying food or shoes—or yachts—or, for that matter, paying taxes?

Senator ANDERSON. Secretary Cohen.
Wilbur Cohen.
Senator WILLIAMS. Is Mr. Cohen here?
Philip Willkie.

STATEMENT OF PHILIP H. WILLKIE, RURAL SMALL TOWN-SMALL CITY COALITION, INC.

Mr. WILLKIE. Mr. Chairman, members of the committee, I am privileged and honored that you invited me here to testify today.

I believe that this bill as it was passed by the House in the form that it is presented to you is a bad piece of legislation. I think it's received a great deal of publicity, a great deal of very favorable publicity which it does not deserve. I think this bill if it is enacted into law, if the Senate passes it in the form before you now and the President signs it, will do America a great deal of—create a great many problems in this country. I think it curbs the creative instincts in man. I think it stymies men in building either for profit businesses or not for profit cooperatives or colleges or charitable or volunteer organizations. I think this piece of legislation will further add problems to the people of the middle and the lower middle classes who at this time are having a hard time making ends meet. I think it will further aggravate and hurt the racial crisis, the black ghetto, the minority crisis, and I think will further frustrate the young. I think this bill as it is written now will raise interest rates on mortgages. I think it will raise real estate taxes. I think it will raise utility rates. I think it will create unemployment. I think it is conceivable it might even create a crash in the stock market similar to what we knew in 1929. I think it hurts the safety of safe deposits. I think it will end the local control of public improvement financing. I think that it will greatly cripple or curb the activities of our colleges, of our independent education institutions, of our charitable organizations such as the united fund, USO, the heart and cancer, and various volunteer medical and health organizations, or if it doesn't do that, it will force all of them under the Department of Health, Education, and Welfare.

I think that it will cause a situation where a large part of our investment banking business will have to be done by some Government organization such as the Small Business Administration or the RFC. I think it will mean that most local public improvements will have to be financed by the Department of Housing and Urban Development, or they will not be financed at all.

I think the way the bill is written it is a bad piece of legislation. I think that it treats capital—I think it will cripple the use of capital in a system based on capitalism. And I think it does as much for the voluntary organization or the cooperative organization as it does for for-profit business. I don't think you can treat capital as income as the previous speaker mentioned it. I don't think that will work and keep a capitalistic system going. And I think you are going to see it in the real estate business. I think you are going to see a big slowdown in the real estate business. And I think the increase of the capital gains tax to 32.5 percent and treatment in the tax preferences is a great mistake in terms of the proper expansion so that we get the needed investment in the economy.

I hope that you gentlemen will give the bill your most serious consideration, that you will rewrite—if you are going to pass it out with a recommendation for it to pass, I hope you are going to rewrite large hunks of it. If it is in its present form, I hope you recommend that it not be passed.

Senator ANDERSON. Thank you for a vigorous statement. We appreciate it a whole lot.

Senator WILLIAMS. No questions.

Senator ANDERSON. Thank you very much. You have got a fine name.

Mr. WILLKIE. Thank you, sir.

(Mr. Willkie's prepared statement follows:)

STATEMENT OF PHILIP H. WILLKIE

Gentlemen, I appear before you today as a Rushville, Indiana, lawyer, the president and principal shareholder of the Rushville National Bank, and as the organizer and promoter of Rural Small Town-Small City Coalition, Inc., an organization which I incorporated on the 1st day of July, 1969, in association with Max Wright, secretary-treasurer of the Indiana State AFL–CIO, and Grover Hartman, executive secretary of the Indiana Council of Churches, for the purpose of promoting, publicizing and researching the economic, political, and social development of the rural small town-small city areas.

I appear here because I believe the present Tax Reform Bill as passed by the United States House of Representatives is against the public interest. I believe strongly that if the Senate passes this bill in the form that it was passed by the house and should the President sign it, great damage will be done to the country, our society, and the economy. It will do much to curb the creative instincts of men: those creative instincts which have done much to make this country what it is today.

In the effort to eliminate many so-called "loopholes" in the present tax structure, many valuable incentives to investment in areas essential to the national interest will be eliminated. In many cases, the most effective means of problem solving are through tax credits extended to the private sector. The proposed law threatens this concept in several areas.

I believe that the bill if enacted into law will stymy men and stop them from building and improving both for-profit businesses and not-for-profit organizations and institutions which have contributed so much to the common welfare. I believe this bill is the most socialistic ever seriously considered by the Congress of the United States.

This bill, if enacted in its present form will make it more difficult for the middle class, struggling now to make ends meet. It will add to the frustrations of the minorities, and it will indirectly contribute to the disillusionment of many of our young people.

I think the "reform" would raise real estate taxes, raise mortgages and interest payments, raise the purchase price of homes, cut-down housing and apartment projects, substantially slow if not stop the construction of all commercial shopping centers, office and factory buildings, and create widespread unemployment in the building trades, which will of necessity spread to other industries. Once a rise in unemployment begins, where does it stop? So called "reform" will increase the price of food, cause a further decline of the stock market, precipitating possibly a 1929 type crash, depress the price of older real estate, freeze both the real estate and securities market, cripple the municipal bond market, substantially end the local control of public improvement financing, raise all utility rates, electric, gas, water and telephone, hurt the safety of all deposits in commercial and mutual savings banks and savings and loan associations, making it practically impossible (or very difficult) for any man to expand or develop a business. It will further aggravate the dollar drain problem by causing capital to flee the country, creating a situation where most investment banking functions of necessity are done by government banking such as our SBA or RFC type arrangements.

The Tax Reform Bill if it becomes law in the form in which it was passed by the House will curtail the building of local public improvements such as schools, university dormitories, sewerage systems and fire stations, forcing them to borrow

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from federal agencies. Local control of the financing of public improvements will be ended. It will seriously hurt if not cripple all independent educational institutions such as schools and colleges, voluntary organizations like USO, the Salvation Army, United Fund, the Heart Fund and the Cancer Fund, hinder the cultural development of the country by hurting museums, symphony orchestras and theater groups, force all independent voluntary, educational, charitable and service organizations to either drastically reduce their functions or become wards of the Department of Health, Education and Welfare.

The bill places an unprecedented tax on the income of foundations. Most money that goes into foundations has been previously earned and taxes paid on it at the time it was earned so that for the first time in history charitable contributions to educational institutions and to churches and others will be taxed the second time. This is not only unfair but it will obviously reduce contributions by at least the amount of the tax. Also the stipulation in the new tax bill relating to foundations specifies that a foundation may not own more than 20% of the voting stock of a corporation. There are other stipulations which will make it necessary for a great many foundations to sell stock in companies that are small. Larger companies will probably have to put their stock on a public market in spite of the fact that the owners of the stock believe this is undesirable for the business. We would like to see both the tax and these new stipulations relating to foundations removed when the tax bill is finally passed.

In my opinion, the house version of the "reform" bill will seriously damage the cooperative and hurt the development of independent organizations. It will either lead to wide-spread bureaucratic and socialistic control of our economic, social, political and cultural life, or mean the drastic curtailment of many social services now provided by independent institutions. This bill has been highly publicized as a bill to soak the rich and help the poor and middle classes. I believe, the bill should it become the law, without major revision, will be a tax measure by which the wealthy wiggle out and the poor and middle classes get soaked.

Why do I believe that this bill will do all these drastic things? Because this bill as it is presently is an anti-capital bill. In its basic concept it breaks down the distinction between capital and income. It will make it difficult for any individual or group of individuals operating on either a for-profit or not-for-profit basis. This goes not only for individuals and corporations but also for colleges, charitable organizations and cooperatives to accumulate and use capital. Capital is the basic tool in the functioning of a free economic system. I do not believe, its effectiveness can be crippled as it is crippled in this bill without crippling the system. Specifically, the bill increases the capital gains tax at the top end of the spectrum from 25% to 32½%, and extends the holding period from six months to a year on the sale of all properties and securities. This can only have the effect of slowing and freezing markets and reducing incentives to build and develop businesses and real estate projects.

This substantial increase in taking long-term capital gains is not benefitted by the new 50% maximum rate to be applied to earned income. This is one of the extremely rare instances in which a law is made retroactive to cover gains made prior to the year in which the law was passed. An individual who has spent much of his lifetime as an executive of a company, having invested not only his efforts and know-how but a great deal of his personal funds in that company's stock, undoubtedly planned his future based upon the expected after-tax monies to be received upon the retirement of this stock. It appears to be against all previous IRS policy and certainly is not morally justifiable, to suddenly reduce the funds (in some cases a 15% reduction) that an individual needs upon retirement in order to fulfill his future plans. It would certainly seem to be more equitable to eliminate the alternative tax computation on any securities acquired after July 25, 1969.

If this would be unacceptable to Congress, perhaps it would be willing to allow the alternative tax computation to be used for that portion of any gain on the sale of securities represented by the appreciation in the securities up to July 25, 1969. As the proposed law now stands, Congress is, in effect, proposing to increase the tax rate on long-term capital gains, most of which occurred in prior years.

It should be noted that the bill contains a provision which would ban capital gain treatment for the taxable portion of a distribution from a qualified pension, profit-sharing or stock bonus plan made by the employer during plans years beginning *after 1969*. Thus, employer contributions made on behalf of an employee prior to 1970 will still get full capital gain treatment on lump sum

distributions. This prospective approach to new tax legislation exists throughout not only this law but all prior tax law changes. The retroactive feature of the elimination of the 25% maximum alternative tax would not seem to be in keeping with prior policy of both the IRS and Congress.

Both the increase in capital gains tax and the provisions in the new tax bill which will make it impossible to continue profit-sharing, bonus plans of one kind or another, are definite restrictions on incentive. In the U.S. we do have a capitalist system. It is a system based on private ownership of property, a system based on competitive rewards to those who compete best for serving the customer in a free market, and yet a system which has been freely open to ability, talent and creativeness wherever it has appeared. And what has been the result? A system which has brought greater benefits to more people than any other system in all history. The Russians have found it desirable even in their system to introduce more and more incentives for a better result for everyone. It seems strange that the United States is now enacting laws that will reduce or eliminate incentives.

The changes on the depreciation rules on real estate coupled with the increase in the capital gains tax, coupled with the interest limitations to $25,000 for each individual plus the income received from any project has to slow if not stop all kinds of real estate development and cause unemployment in the building trades. This will prevent the fulfillment of our national housing goals. A reliable source in the accounting field reports that one real estate investor "has halted a deal for the construction of 25,000 apartments because he does not choose to pay the proposed 32½% capital gains tax for the privilege of transferring his investment from (i.e., selling) land he has owned for 15 years."

At this time, Mr. Chairman and members of the committee, I would like to call your attention to the present housing condition in the United States, and invite you to consider the serious crisis we face in the home building field. One of the best examples I can refer to you exists in Greater Indianapolis; not far from my home. In that area, according to the National Association of Home Builders, housing starts took a tremendous dip in July, while the House considered this bill. July is traditionally considered the height of the building season. As a result, good housing for either purchase or rent is scarce and becoming more scarce. Interest rates which undoubtedly would be raised by the adoption of this bill, are already at record levels. This production of low and moderate income housing is reaching the vanishing point.

If, indeed, any further evidence is required, I would point out that sales prices on housing have risen from 13% to 16% in just the last 12 months due to inflation, land costs, labor costs, and the higher cost of money. Obviously, the passage of the tax reform bill as it presently stands would only exacerbate this situation.

If the situation is not so serious, gentlemen, why is it that craftsmen and subcontractors are working less than a forty hour week, and thus are being forced to seek other employment? Indeed, unless the situation improves, it is predicted that many of these men will be lost to an already critically short skilled housing labor force.

Another critical point to examine in the bill, gentlemen, is the change in the rules of depreciation on utility companies which will be used as an excuse by utility companies all over the country to raise their rates. If this bill is enacted in the next congressional campaign, candidates will be running against incumbent congressmen on the issue that they raised utility rates.

Addressing your attention now to the agricultural area, I wish to point out that the proposed bill heavily penalizes the farmer if he should choose to sell his farm, and to further clarify this, permit me to list a few examples of why I believe this.

1. If he needs to sell for cash, especially, he is subjected to the proposed 32½% capital gains tax even after 20 years of ownership.

2. If the farmer tries to sell his land on installments, he is limited in his ability to contract with the buyer because of the new restrictions on installment sales.

3. The farmer depends upon the economic function of the land investor to provide a ready market for the farmer's land, should he wish to sell before his land is ripe for its next higher use. The investor pays taxes and interest on his investment and takes the risk of a profitable resale in the unknown future. The farmer receives an intermediate price, higher than warranted for farm use, but lower than for the anticipated ultimate use.

Under the proposed law, the farmer's land becomes less marketable on the installment plan because the land investor cannot surely deduct all the interest cn the purchase money mortgage he gives the farmer (Limitation on Interest Deduction).

Even if an investor at the time of proposed purchase should be within the interest limitation (as for example because of a large down payment), an investor will hesitate to commit large sums to a non-income producing, non-liquid investment when he knows he cannot later borrow on it in an emergency except at the risk of losing his interest deduction. Thus, the market for the farmer's land is deprived of a large segment of would-be investors, such as physicians and business executives, who have high incomes but not high investment income against which interest is deductible.

The interest limitation is a fearful specter to a potential land investor because a miscalculation can make the interest offset and completely wipe out any concurrent capital gains.

All the above provisions can only restrict the free sale of farm land, and for that matter, all land.

The placing of the curtailment of capital gains of breeding stock will necessitate cutting down the numbers of breeding stock and definitely will bring about an increase in the price of food.

Placing a tax on municipal bonds even though minimal, is already having the effect of crippling those markets and causing great loss to any individuals who bought the bonds with the belief that those bonds were tax exempt. Such an effect would make it far more difficult for states and communities to finance their public institutions. They would be forced to rely on federal assistance, adding greatly to our national budget and further undermining the federal system of government by shifting more responsibility toward Washington.

Commercial banks, mutual savings and loan associations have all been fighting each other as to the amount of our Bed Debt Reserves. The Ways & Means Committee under the Chairmanship of Mr. Mills clobbered all of us in the financial institutions field by curtailing all bad debt reserves. The net effect on all financial institutions is to weaken the capital accounts which serve as a protection for bank depositors fund. If we have any economic trouble in this country, it will mean that there is less money to pay the depositors.

Many of our young people are disillusioned by society as it is and want to bring about its reform through various social service institutions. The provisions of this so-called "reform" measure which will substantially discourage the giving of appreciative assets not only hurts all types of existing groups and organizations, but dangerously weakens the giving of similar type organizations in the future. Such an effect would of course greatly limit the opportunities which many young people have taken advantage of to express their social commitment. This would substantially increase the alienation of many of these people.

Senator ANDERSON. Congressman Mikva.

STATEMENT OF HON. ABNER J. MIKVA, A U.S. REPRESENTATIVE IN CONGRESS FROM THE SECOND CONGRESSIONAL DISTRICT OF THE STATE OF ILLINOIS

Mr. MIKVA. Mr. Chairman and distinguished members of the committee, I am Abner Mikva, Congressman from Illinois. I am most grateful to the committee for allowing me this time to present my views on the bill which we so recently passed out of the House. I think that the need for substantial reform of the Federal tax laws is real and urgent. It has been a necessity for years. But most citizens simply are too busy to understand the complications of the code or what is wrong with the code and thus the case for tax reform has been in terms of the dramatic issues like the oil depletion allowance, tax-free municipal bonds and high-income citizens who pay little or no tax. I think every one of you gentlemen has heard over and over again the example of the lady from Detroit who has this six-figure income and pays no tax whatsoever.

But I would remind the committee of something that may have become lost sometimes in the debates in the House, and that is that the longstanding and long-recognized need for tax reform was not what brought this issue before the Congress. It was the agonized screams of the middle-income taxpayer who wanted relief, and he doesn't care whether you call it reform or what you call it; he wants to obtain some tax relief. To the average American taxpayer reform means tax relief. This is what Congress must provide if we are to avert the taxpayer's revolt which former Treasury Secretary Barr described so well.

In that respect, Mr. Chairman and members of the committee, I appeal to you to remove from this tax reform—tax relief bill the further extension of the surtax which is now contained in it in section 701. This surtax has been touted by the administration as an absolute necessity to stop inflation. But there is no evidence whatsoever that the surtax has had even a minimal anti-inflationary effect. To the contrary, it is easier to contend that the surtax actually produces inflation because we certainly have had a worsening of the inflationary spiral even since we passed the surtax last year.

But the most ironic thing of all is that it is that same middle-income taxpayer who is asked to foot the bill for inflation even though he is the victim rather than the cause. The Government goes along its merry way pouring billions into a war we said we were going to end. That money finds its way into the marketplace. Corporate profits rose almost $4 billion last year after taxes. And yet we find the Secretary of the Treasury making an appeal for relief for corporations. The middle-income taxpayer has no place to pass on this surtax. That tax comes out of his salary. No matter how hard he works he can't keep pace with inflation and taxes. This is the man who may not understand completely what tax reform is all about, but he knows that he needs some relief.

Mr. Chairman, members of the committee, I just returned home from my home in Illinois. Most of you have returned from talking to your constituents during the recess. There is one thing on their minds. They have been squeezed, milked, rolled, and drained until they just don't want to stand for it any longer. They are not even sure who is doing it to them. Sometimes it is the State, as in my State of Illinois, sometimes the local government by way of real estate taxes, and sometimes the Federal Government by way of income tax. We have had a tax system which has always been the envy of the world because of the high level of voluntary compliance. I fear that record may be in danger unless we show our citizens that we are willing to give them a break. The moderate income, salaried taxpayer is now paying more for his goods and services, he is borrowing money at higher rates than ever, and in addition, we are asking him to continue to pay a surtax on top of already high State and local taxes and Federal incomes taxes. This is too much to ask.

So I would ask you gentlemen to see if you cannot correct the error of the House in one of two ways. First, rethink the decision which we both made earlier this year to extend the surtax for 6 months at 10 percent. End it on October 31, which would give the American citizen a tax dividend for the last 2 months of this year. If the committee feels that such action is not possible on the 10-percent surtax, then I urge

you at least to delete the provisions in H.R. 13270 which would extend the surtax for still another 6 months. It just doesn't belong in anything that we would like to call a tax reform bill. If we keep our word and begin to withdraw some of our men and material and money from South Vietnam, even the administration's justification for the surtax will have been ended. Much has been demanded from the American citizen and taxpayer and much has been given, but I fear to think what will follow if our tax reform does not include substantial tax relief for that long-suffering taxpayer who has been bearing the brunt of the burden.

I hope, finally, that this committee will come to the conclusion as I have that for the great majority of the American citizens there will be no tax reform if it doesn't include some long and strong measure of tax relief.

I thank you for your time. I will be glad to answer your questions.

The CHAIRMAN. Thank you, Mr. Mikva. I would be glad to ask you some questions except for one thing. We have had more than 700 people who have asked to testify before these hearings and I am convinced that if we Senators extend our time on this committee expressing our views across this record, we will just never get these hearings over with. So nothing will happen. That being the case I am going to withhold. I hope you will understand.

Mr. MIKVA. That would be the worse result of all.

The CHAIRMAN. Thank you. Senator?

Senator ANDERSON. No questions.

Senator WILLIAMS. I don't have any questions, Congressman. You note perhaps that there is quite an absenteeism here. Most of our members are attending the funeral of our colleague from your State and I am sure you understand.

Mr. MIKVA. I am aware of that.

The CHAIRMAN. As a matter of fact, we have been in recess on this committee for 3 days because of that very fact, as you are well aware.

Senator Talmadge?

Senator TALMADGE. No questions.

The CHAIRMAN. Thank you very much, sir, for your very fine statement.

The next witness will be Mr. Jacob Clayman, administrative director, Industrial Union Department, AFL-CIO. Is he here?

All right, the next one will be Mr. Barlow, counsel for the National Tool Builders Association, American Machine Tool Distributers Association, and the National Tool, Die & Machining Association. We appreciate your associations combining in one witness, sir.

STATEMENT OF JOEL BARLOW, COUNSEL, NATIONAL MACHINE TOOL BUILDERS ASSOCIATION, AMERICAN MACHINE TOOL DISTRIBUTORS ASSOCIATION, AND NATIONAL TOOL, DIE & PRECISION MACHINING ASSOCIATION

Mr. BARLOW. Mr. Chairman, thank you very much. It is very good indeed to have an opportunity to appear again before this committee. It is my understanding the written statement we have filed will be included in the record.

We would like to direct our testimony today to what we consider the principal deficiency in this tax reform bill. The machine tool and tool and die industries I represent here have their machinery and equipment installed in every metalworking industry in the country, so that I would like to think that our proposals are not selfish interest pleading. We are talking about the necessity for tax reform to provide adequate recovery of investment in productive equipment. With the proposal for the repeal of the investment credit we had understood that some reform would have to be included in the tax structure in the way of liberalized depreciation provisions to make the allowances reasonable and the depreciation guidelines workable.

The prior administration had represented that the investment credit and the depreciation guidelines were to be a package, and it was not reasonable to expect the tests of the guidelines could be met without the credit. Under the statute the depreciation guidelines were required to have a reserve ratio test, as you know, based on the individual taxpayer's experience, and the only way that a taxpayer can keep the shorter guideline depreciation lives that are now in the regulation is to meet the requirements of the reserve ratio test. The problem with the reserve ratio test is that it is very complex and difficult, and it is clear the cash floor of funds from the investment credit will be required by most taxpayers not only to meet the test and keep the liberalized depreciation of the guidelines, but also for replacement and modernization to stay competitive. This is all documented in our written statement.

The reason that we are here today is to urge this committee to include depreciation reform in this major tax reform bill. Principally because of our inadequate tax depreciation structure we have the highest percentage of obsolete facilities in the United States of any industrial nation in the world. We also have, as Secretary Dillon pointed out in 1962, and it is still the fact, the lowest rate of capital investment in the United States in relation to gross national product of any of the industrial nations.

And as we have pointed out in detail in our statement, the reason for this is, we believe, that we have had since 1934 a depreciation tax structure that requires each taxpayer to prove the impossible and failing that, to stay in the straitjacket of his own depreciation practices which are almost invariably bad because of the strictures of the tax structure itself.

The other industrial nations of the world do not have such a system with allowances based only on the individual taxpayer's experience. They have a system in which one can claim as a matter of right the recovery of his facility costs based on the most enlightened depreciation practices in the industry, taking into consideration also the amount of allowance, capital recovery allowance, that can be expected to be needed by the taxpayer to replace and modernize these depreciable facilities.

With the highest labor rates in the world, the highest labor costs, the only way that U.S. industry can compete in the markets of the world is to constantly step up investment to modernize and have cost-reducing facilities. This is also the only way that the United States can provide jobs in the United States, and keep more and more capital investment from going abroad, as it has in the past 10 years. It is

essential then to have tax allowances—a recovery of cost against taxes—that will enable these U.S. companies to expand in the United States and provide jobs here.

American capital investment in industrial plants has been moving abroad in the past 10 years at a phenomenal rate because of the more liberal writeoffs under the European system. There are other reasons too, but the tax allowances have been compelling and often controlling. And I would like to emphasize in view of some of the earlier comments here today that the United States is no longer a self-sufficient economic unit that can write tax laws concerned only with its internal affairs. We have to compete in the markets of the world, and we have to write tax laws that will not hamper U.S. industry in that competition. One of the principal problems of this bill is its almost exclusive concern with tax preferences within the United States. If we persist in disregarding the effect that our tax structure has on our ability to compete in world markets, we shall continue to be in serious trouble in maintaining our exports and a favorable balance of trade and payments.

I think that we can all agree that many of the changes in this bill are very important. Some of the reform proposed in the rate structure and in eliminating hardships is long overdue. But the difficulty here is that the pendulum has swung so far over in favor of the consumer and against investment that it is really punitive, particularly in its discrimination against capital investment in productive facilities. As Senator Long mentioned the other day at the opening of the hearings, there are seven provisions here specifically directed against percentage depletion and the oil industry. I think there is a general understanding that some changes are necessary but——

The CHAIRMAN. You misquoted me. There are nine provisions directed against the oil industry.

Mr. BARLOW. Yes. Well, in any event, there are too many. We have a most serious problem of disrupting our economy if we move too fast in penalizing capital investment, and that is just what this bill does.

And so the great weakness in this bill is in the pendulum swinging too far. Take the tax treatment of real estate for example. Clearly we have some problems of indefensible tax shelters in connection with real estate transactions but it seems to me there is no need to go to the very extreme penalties of the bill and provide no ameliorating provisions in the transition. For instance, there is really no justification for taking away the accelerated depreciation methods for real estate if section 1245 is further revised in its recapture provisions. And I might say this morning in view of some of the comments of the prior speaker, Mr. Stern, about the alleged tax advantages of capital gains, that I am not talking here in terms of his kind of passive investment, but in terms of the great risk-taking investment in productive facilities. There is no longer any conversion of ordinary income to capital gains but instead a complete recapture, as you know, under section 1245 on the sale of productive machinery and equipment.

But for limitations of time I would comment on other provisions of the bill as I have in our statement. It is much too complex. No longer can an individual prepare his tax return. Accounting firms, people who prepare returns say that computers will now be required.

But my great concern with this bill and the reason the industries I represent wanted to concentrate on this one phase is the failure of the framers of this bill to include any of the provisions that are required even on a minimum basis if the investment credit is repealed. We are making four proposals which are explained in detail in our written statement.

The first proposal briefly stated is that the reserve ratio test of the guidelines be eliminated. Many small and medium sized companies have not adopted the depreciation guidelines because of the complexity and uncertainty of the reserve ratio test. The guidelines were a tremendous step forward in 1962 because in improving our capital recovery tax structure they moved in the direction of the same kind of liberal and workable system the other industrial nations of the world have adopted. Today, the countries of the economic community in Europe are increasingly adopting a value added tax. Under the value added tax of the consumption type they allow their industries to write off the total annual cost of productive facilities in 1 year or in 2 years or 3 years, as contrasted with a writeoff of longer than 12 years in the United States if a company fails to meet the reserve ratio test.

Taxpayers write off their facilities in France, Germany, Japan, and some of the other principal industrial countries, as I have mentioned in my statement, in just a fraction of the time permitted in the United States. Unless something is done in this tax reform bill to offset the adverse impact of repealing the 7 percent investment credit such as eliminating the reserve ratio test, U.S. industry will be at more of a disadvantage than it is at present. Taxpayers will also be at a disadvantage once again in dealing with revenue agents just as they were before the guidelines were adopted.

Our second proposal is that the salvage value requirement be eliminated for productive facilities. No longer is there any reason to have a salvage value requirement in our tax structure in view of the recapture provisions of section 1245. I am truly surprised that the Treasury did not propose either of these two reforms—the elimination of salvage value and the reserve ratio test—in a major tax reform bill. In fairness to the Assistant Secretary of the Treasury, I hasten to add that he took office pretty late in the day and had a problem of making reform proposals in something of a hurry. Instead of adopting these reforms, the Under Secretary of the Treasury says they will continue to study these depreciation proposals. The Treasury has been studying these proposals for years. They know all about them. They know that the guidelines and the investment credit are interrelated and interdependent. And yet in proposing repeal of the credit they have come in with no proposal at all to improve our depreciation structure.

The third proposal we are making is to put these depreciation guidelines that the Treasury evolved so very helpfully into the law and thus move in the direction of other industrial nations in making the allowances a matter of right and certainty, with permanence for long-range industrial planning and investing.

One of the reasons that industry in the United States had not been modernizing and replacing at a desirable rate historically and the investment credit like 5-year amortization became necessary was the

lack of any certainty in our statute for long-range planning. Even the investment credit as helpful as it has been had not provided the requisite certainty. As you know, it has been turned off and turned on, and now the proposal is to repeal it. We badly need permanence in the tax structure to get an adequate level of investment in risk-taking productive facilities. This, as we have pointed out in our four proposals, can only come from basic tax depreciation reform.

Parenthetically, I want to voice my disagreement with the speaker who said earlier today that the United States can tax all different kinds of income in the same way without adverse consequences of any kind. It is almost a truism that different kinds of income have to be taxed differently simply to get taxpayers to take different kinds of risks that are in the national interest. I don't take as much economic risk, for example, in practicing law as other taxpayers do when they go into Indonesia and spend tremendous sums in exploring for oil. It is essential that our tax law does not discourage these unusual risks.

It is equally clear and most important that we eliminate the hardship area for taxpayers by rate reduction and removal of poor people from the tax rolls. In this the bill moves in the right direction. The bill does well also in eliminating obvious tax loopholes such as multiple surtax exemptions. But, Mr. Chairman, I must come back to the principal difficulty with the bill—the pendulum has swung too far against investment and even the most radical changes in tax treatment and tax concepts in the bill have not been softened in a transitional way to try to avoid a serious disruption of the economy.

I want to mention also, Mr. Chairman, that there are two provisions in this bill providing for amortization of facilities. The inclusion of these provisions for the amortization of facilities makes it evident that our present depreciation structure without the credit is inadequate to get the investment show on the road—to get the investment that is critically needed in pollution facilities and even in railroad rolling stock. Think of the many other critical items in short supply for which no amortization has been provided. We have such an inadequate depreciation structure that we must once again apply a patchwork of special amortization to get a part of the additional investment and facilities the Nation needs. Instead of giving these special provisions, as important as they are, there should be a major change in our depreciation structure, as I have proposed, which would obviate the need for preferential amortization.

Our final proposal, Mr. Chairman, to make U.S. allowances somewhat more comparable to the allowances of other industrial nations, is to take off the $10,000 ceiling on the section 179 initial allowance and reduce the percentage figure from 20 percent to 15. The initial allowance of section 179 as it stands today is insignificant and largely meaningless. Machine tools today that are used even by small companies cost as much as $400,000. The average small company in the tool and die industry with something like a million and a half dollars of sales simply cannot finance or afford to buy these expensive machine tools costing many thousands of dollars unless they have the more liberal allowances an adequate depreciation structure would provide.

Many of them do not even have all the benefits of our present limited system just because they are small and afraid of the reserve

ratio test. One survey in the metalworking industry disclosed that 30 percent of the companies did not adopt the depreciation guidelines but continued with longer depreciable lives just because they did not understand the resreve ratio test, and in addition they were afraid that if they could not meet it, they would be bogged down once again in endless depreciation controversies with revenue agents.

Now, without the investment credit, without the 7 percent credit to help finance their purchases, they are handicapped even more. Their facilities will continue to have a higher degree of obsolescence than those of their larger competitors.

And so again I say I am surprised that the Treasury would not make good on its assurances that the investment credit and the depreciation guidelines are a part of one package, and recognize that if the investment credit is repealed, some depreciation reform is mandatory.

I thank you very much.

Senator FULBRIGHT. Mr. Chairman, could I ask just one question?

The CHAIRMAN. Go ahead.

Senator FULBRIGHT. The impression is that these companies go to Europe to build because of depreciation. I thought they went over there to take advantage of the preferences under their tariffs and a number of other things, the cost of production there. What bothers me is that our country cannot even compete here in the United States with foreign production. I think there are other reasons that indicate why they go and build a plant in Europe.

Mr. BARLOW. There are other reasons—excuse me.

Senator FULBRIGHT. But what is serious is the intrusion here of foreign produced materials by foreign companies because of the inefficiency to compete right in the United States.

Mr. BARLOW. Well, Senator Fulbright you are quite right. They go across because of lower wage rates.

Senator FULBRIGHT. There are other reasons. Tariff too. There are many reasons.

Mr. BARLOW. That's right. As a matter of fact, I am surprised that in a major reform tax bill the Treasury has not recognized these foreign tariff and tax advantages and come along with some proposal in the nature of a value added tax so that the tax can be rebated in this country to make our industry more competitive, and border taxes can be imposed as the other countries of the European economic community do to slow down unwelcome imports. We place far too much reliance on the income tax which cannot be rebated to make us more competitive.

Senator FULBRIGHT. This committee suggested, the members did, to the Treasury to study that and Mr. Surrey rejected it, saying if you are going to do anything like that, why don't you put in a sales tax. He rejected the idea of a value added tax.

Mr. BARLOW. I know he rejected it, but now he is not Assistant Secretary and the Treasury should give a value added tax the most careful consideration.

Senator FULBRIGHT. The committee did ask him last year.

Mr. BARLOW. It is my recollection that both the Senate Finance Committee and the House Ways and Means Committee as early as 1959 suggested the study of the value added tax as a substitute in whole or

in part for the income tax. The corporate income tax, which except in the case of marginal taxpayers is largely passed on not unlike a sales tax, handicaps U.S. industry just as our depreciation structure does in competing in the markets of the world.

Senator FULBRIGHT. Well, lastly, you will agree that to continue to spend $80 billion, about half of which is on capital assets, and so on, for military matters is not very healthy for our economy, is it? It contributes to the dislocation of our standards and our inflation, and so on, does it not?

Mr. BARLOW. Yes, I think it certainly contributes to our inflation.

Senator FULBRIGHT. Don't you think it would help our economy a little if we could stop that kind of extravagence?

Mr. BARLOW. Well, you are the expert in that area. I am just a tax lawyer, Senator Fulbright. But I do think that the military investment and expenditures of our Government are highly inflationary. The Secretary of the Treasury has said, as you know, that one of the reasons for repealing the investment credit, and apparently doing nothing to improve or liberalize our depreciation structure, is his fear of the inflationary effect of capital investment.

It would appear, however, that our problem is somewhat different. There was a 20-percent downturn in the purchase of machine tools in August as compared with July. This is in part, due to the announcement of the repeal of the investment credit and no prospect of any depreciation change. Today we may be fighting inflation some by postponing investment in productive machinery and equipment, but if history repeats itself, we shall be sorry in about 2 or 3 years that we did not continue to make this investment in productivity to prevent another round of inflation.

Technological change in machinery and equipment—in machine tools with their new numerical controls—is moving so fast that tremendous expenditures are required to stay modern and competitive. A man today sits in an office and operates with a single control a whole shop full of complex machine tools instead of operating a single machine tool by hand as he did just a few years ago. Technological change is so great that the industries I represent don't agree with the Secretary of the Treasury that the $400 billion we have spent on facilities since the investment credit was enacted in 1962 has largely solved our problem of modernization and replacement, and we can now ease off in the 1970's and not have the same rate of expenditure as in the 1960's.

Of course, one of the reasons that we have a higher percentage of overage, obsolete facilities than other nations is that we have had a larger industrial base for many years and there is always an inclination to use the old and a reluctance to modernize. When the Secretary talks about overcapacity and the danger of overcapacity, he should keep in mind that the real danger is the high percentage of high cost obsolete facilities in this "overcapacity" that makes it so difficult for U.S. industry to compete.

The Under Secretary of the Treasury said the other day in an interview in a steel industry magazine that the Treasury would study this depreciation problem some more now that the investment credit is to be repealed but there would be no Treasury proposals until 1971.

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I submit, gentlemen, that this will be much too late. Senator Hartke, who is a member of the Senate Finance Committee, introduced a bill in 1965, I think it was, to repeal the investment credit because it was evident then that the test defeats the whole purpose of the depreciation guidelines to provide adequate and certain investment allowances. A number of Senators joined with him in introducing that bill. It was opposed by the Treasury but resulted in a helpful Treasury liberalization of the reserve ratio test. As a matter of fact, it was possible for industry to live with the handicap of the reserve ratio test in these early years of transitional rules as long as it had the investment credit. But it cannot do so any longer simply because a large segment of industry will lose the intended benefits of the guidelines as well as the credit.

The CHAIRMAN. Thank you very much, sir.

Incidentally, as you know, we have a summary of your testimony as well as all the others prepared for us, and in the event you overlooked something, we are usually reading it while you are testifying.

Mr. BARLOW. Thank you very much, Senator.

STATEMENT OF JOEL BARLOW, COVINGTON & BURLINGTON, WASHINGTON, D.C.

My name is Joel Barlow, and I am a member of the Washington law firm of Covington & Burling.

The national trade associations representing the machine tool industry and the tool, die and precision machining industry, and their more than 2,000 member companies in every state in the Union,[1] have asked me to appear before the Finance Committee today to comment on one important deficiency in H.R. 13270—the failure to include in this major tax reform bill any part of the long promised and overdue reform of the depreciation tax structure. They had thought that there was a general recognition[2] in the Treasury and Congress that there must be immediate depreciation reform not only to tax the capital intensive industries more equitably and realistically, but also to make our tax structure as vital and as effective as the tax structures of the other industrial nations of the world with which we must complete.[3]

These other industrial nations are deadly serous about facility modernization and replacement in their effort to capture America's traditional markets. Their more liberal tax allowances[4] not only give their industries a great competitive advantage, but in addition encourage American industry to expand abroad instead of in the United States.

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[1] The national organisations of these industries are the National Machine Tool Builders Association (NMTBA), American Machine Tool Distributors Association (AMTDA) and National Tool, Die & Precision Machining Association (NTDPMA). The size of these 2,000 member companies varies from 5 employees and $100,000 of sales to nearly 15,000 employees and more than $250,000,000 in sales.

[2] Innumerable legislative and administrative proposals and promises have been made over the years, and countless depreciation reform bills have been introduced. The American Bar Association has formally approved a specific legislative proposal containing some features of the Canadian "bracket" system. This was introduced as H.R. 11450 in 1965. H.R. [illegible] was introduced in 1968 providing for the repeal of the reserve ratio test.

[3] Most industrial nations make their more liberal depreciation or capital recovery allowances available as a matter of right under a simple, easily administered tax structure. The allowances are provided under broad classes of facilities and are generally based (a) on the most enlightened or acceptable depreciation practices, and (b) on the amount and rate of recovery required to stimulate modernization and replacement.

In contrast, depreciation allowances in the United States are determined under a very complicated tax structure, and usually only after protracted negotiation and controversy with a revenue agent. The agent has the difficult or impossible task of conforming the tax life to the individualized service life unless the taxpayer sustains his equally difficult burden of proving that the tax life should not conform to his actual practice.

Instead of having tax allowances available to him based on the most enlightened and acceptable practices in his industry as in other nations, he may be left for years in the straitjacket of his own unenlightened practices. Smaller companies particularly have had difficulty sustaining this burden of proof and in coping with revenue agents.

[4] Germany, Japan, England, Canada, France, Italy, Sweden, and other nations permit the writeoff of investment in industrial facilities in a fraction of the time permitted in the United States, making possible a much greater cash flow for both facility acquisition and research and development.

Instead of moving ahead to meet this competition, this tax reform bill steps backward to give foreign industry an even greater advantage. Quite unbelievably, H.R. 13270 represents a deliberate effort by the Treasury, to which the House has responded, to make our capital recovery tax structure even more restrictive.

The only exceptions are the special 7-year amortization provision (Section 705) limited to railroad rolling stock other than locomotives, and 5-year amortization for pollution control facilities (Section 704). Of course, the inclusion of these necessary provisions is in itself a clear recognition of the inadequacy of our present depreciation tax structure to keep U.S. industrial facilities modern and adequate.[5]

Unless the Senate and the conferees change H.R. 13270 to restore the more than seven billion dollars of investment American industry will lose in cash flow in the next three years, there will almost certainly be a serious dislocation in the economy.[6] At the very least, as Treasury officials concede, there will be another slowdown in the modernization and replacement of industrial facilities. These are the very facilities that are so necessary to provide essential jobs in this country for American workers, and to make the United States the lower cost producer it must be in competing with other nations.

Until the present Administration gave capital recovery tax legislation such a low priority in its surprise announcement last April 21, the capital intensive industries had reason to believe from continuous discussions with the Treasury that the Government would have to reform and improve our outdated depreciation tax structure in any general reform bill. Of course, if the investment credit did not remain a permanent part of the tax structure as some had predicted, reform would be mandatory.

Both the Kennedy and Eisenhower administrations had recognized the need for reform and had moved ahead in initiating some important improvements.[7] It was, therefore, hardly believable that the Nixon Administration would turn back the clock by eliminating the investment credit and proposing no depreciation reforms at all or any other capital recovery improvements in announcing its reform legislation. All that has been proposed thus far is another Treasury study.[8]

The very least the Administration could have done when it decided it could not honor the Treasury's (and the Government's) earlier assurance[9] that the credit was to be a permanent part of the tax structure, was to make certain

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Their tax structures give their industries other competitive advantages (all with GATT approval) such as a greater reliance on indirect taxes, such as the value-added tax, which are rebated to foster exports and imposed as "border taxes" on imports to discourage foreign competition. Most of these nations also have a single integrated tax system instead of the 52 separate, overlapping systems we have in the United States. Any major reform legislation must counter these tax advantages also if the United States is to maintain its competitive position.

[5] An equally cogent case can be made by many of the metalworking industries (machine tools, aircraft, steel) for the same special amortization of the machine tools and other equipment they use. Technological change in both product and equipment is even more rapid in these industries as, for example, in numerically controlled machine tools, and the need for replacement and expansion to meet national needs is just as great. It must be kept in mind that it is machine tools that are so urgently needed to produce this rolling stock and pollution control equipment, just as it is machine tools that are so urgently needed to produce the airplanes, the steel mill facilities and other equipment in critically short supply. Machine tools are known as the "master tools of industry." Everything made of metal is made on machine tools.

[6] The Treasury estimates of revenue gain from repeal of the credit for 1970, 1971 and 1972 total $7.2 billion.

[7] The Eisenhower Administration proposed the accelerated depreciation provisions which were enacted in 1954 (Section 167(b)), and the Kennedy Administration adopted the Depreciation Guidelines in 1962 (Revenue Procedure 62-21) and proposed the investment credit which was enacted in 1962. The Depreciation Guidelines moved very helpfully into the better depreciation pattern of other nations except for the effect of the reserve ratio test which will be discussed later. All of these improvements were represented as being permanent reforms of the tax structure, but they have turned out to be something less. The credit was suspended and is now recommended for repeal. H.R. 13270 would also put new restrictions on the availability of the accelerated methods adopted in 1954 (Sections 451 and 521) and their utilization in computing earnings and profits for dividend purposes (Section 452).

[8] Apparently, even this study may now be delayed. Under Secretary Charles Walker is quoted in IRON AGE (August 14, 1969, pp. 79-81), as saying that the Treasury "is looking at it (depreciation), in fundamental reforms terms," that there will be no "quid pro quo for the repeal of the investment credit," and that the Treasury's depreciation proposals will not come before Congress "until January, 1971." This announcement and timetable cannot help but have the effect of slowing down still further the modernization and replacement of industrial facilities until 1971 or even 1972.

[9] As recently as March 21, 1969, in his address to the Business Council, Secretary of the Treasury Kennedy had said that the credit was a permanent part of the tax structure and the Treasury had no intention of tinkering with it.

that the repeal would minimize the hardships of those who had made formidable commitments in reliance on the credit. It could have done this in two ways: (1) By recommending liberal transitional rules for those taxpayers who had committed themselves to long-range plans or programs even though they had not made purchase commitments,[20] and (2) by repealing or at least modifying the reserve ratio test because of the difficulty or even impossibility taxpayers would now face in meeting the reserve ratio test without the intended help of the investment credit. It must be kept in mind that the Government had repeatedly assured taxpayers that the credit and Guidelines were "a package," and that the investment credit had been designed and adopted so that taxpayers could continuously utilize it in meeting the rigorous and restrictive reserve ratio test.

FOUR ESSENTIAL DEPRECIATION REFORM PROPOSALS

To comply fully with the Committee's proscription on testimony relating to the investment credit, no presentation will be made, of course, on the importance of continuing the 7% credit at least until reforms in the depreciation structure can be adopted. My testimony will deal only with four specific reforms that are immediately required to correct the deficiencies in our depreciation tax structure, particularly if the investment credit is repealed:

(1) The amendment of Section 167 to make possible the elimination of the restrictive reserve ratio test from the Depreciation Guidelines because of (a) its complexity, (b) the difficulties taxpayers face in meeting the test, and (c) the importance of following the simpler and more effective patterns of other nations so as to get rid of all the headaches and controversies involved in individualization of tax depreciation lives and service-life auditing.

(2) The inclusion of the depreciable lives of the Depreciation Guidelines by amendment in Section 167 of the Code to deter the Treasury from unilaterally (and even arbitrarily) extending depreciation lives to increase the revenues as it did in the 1960's.[21]

(3) The amendment of Section 167 to eliminate the requirement for establishing salvage or residual value for productive equipment so as to preclude adjustments by and controversies with the IRS, which are wholly unnecessary now with the advent of additional recapture provisions in Section 1245.

(4) The amendment of Section 179 to eliminate the $10,000 ceiling with a possible reduction in the rate of the additional first-year depreciation allowance from 20% to 15%. This would make U.S. capital recovery allowances more comparable to those of other nations, and it would make up in part at least for the reform bill's tremendous loss of cash flow for U.S. industry that could be so disruptive for the economy in the next few years. Unlike the investment credit, this allowance would not exceed cost and presumably would be less vulnerable to change.

The NMTBA, the AMTDA and the NTDPMA have authorized me to say that if as a condition to depreciation reform the Treasury should insist that tax depreciation be booked for financial reporting purposes, they believe industry should accept the condition.

Actually, these industries are convinced that, given a reasonable transitional period under these new depreciation reforms, all taxpayers would be able "to book their tax depreciation," and industry could get rid of the stigma attached to "to sets of books."

They base this conclusion not only on their own individual experiences, and the actual practice of many other taxpayers in using the Guideline lives and the accelerated methods for both tax and financial reporting, but also on the following factors that have emerged out of their surveys and studies:

(1) Technological change will come so much faster than in the past, and obsolescence will be so much more important than wear and tear, that service lives will generally conform to (or be shorter than) the present class lives of the

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[20] The Treasury reportedly acquiesced in the so-called "Lockheed Amendment" (Section 703(a) of H.R. 13270 adding Section 49(b)(10) to the IRC) which recognizes the hardship and inequity in the transitional rules but strives narrowly to limit the relief to one company or to a very few companies when all companies who made similar commitments in plans and programs in reliance on the credit should be granted relief.

[21] There is some concern that the Administration might take such action in view of (1) its announced concern with the loss of revenue in H.R. 13270, (2) its action on the investment credit, (3) its indicated attitude toward capital recovery allowances generally, (4) recent Treasury surveys and studies that reportedly indicate that the Guideline lives are too short under traditional service life concepts, and (5) trial balloons the Treasury has sent up in the past year suggesting that tax depreciation deductions should be limited to those taken for financial reporting purposes.

Guidelines. Thus there will be fewer claims of "distortions in income" and "subsidy by the Government" that have been the basis for variations in accounting treatment.

(2) This development together with the adoption of the proposed depreciation reforms themselves will bring about a change in depreciation and accounting concepts that will eliminate the emphasis heretofore placed by both the Government and the accounting profession on the individual taxpayer's experience. Instead there will be a recognition for all purposes of the importance of industry standards (minimum lives or maximum rates) based on (a) the most enlightened replacement practices, and (b) projections of the rate of capital recovery required for replacement.

OBSOLETE FACILITIES AND AN OBSOLETE SYSTEM

The Treasury in recommending no overall depreciation reform seems to be quite unmindful of the fact (and the public and the Congress are obviously quite unaware of it) that the United States has the highest percentage of overage and obsolete industrial facilities of any of the leading industrial nations;[12] and that the United States also has the most restrictive and outdated capital recovery tax structure of any of these industrial nations.[13]

If the investment credit is repealed with no offsetting depreciation reform, American industry will be at an even greater disadvantage in competing with other industrial nations for the export markets of the world, and in slowing down the increasingly serious inroads foreign importers are making into our own domestic market. With the highest wage rates and labor costs in the world, American industry can stay competitive only through a constantly increasing investment (1) in the research required to maintain our technological superiority in productive facilities, and (2) in the technologically superior cost-reducing facilities themselves. This investment must come principally from the cash flow of U.S. industry which the Treasury and H.R. 13270 propose to reduce by over $7 billion in the next three years.

FULL CYCLE TO OBSOLESCENCE AND TAX CONTROVERSIES?

In 1934 the Treasury drastically cut back depreciable allowances across the board by approximately 25% to increase tax collections, and in addition placed an almost impossible burden on the taxpayer of proving the service or useful life of each facility.[14] This was the beginning of our present system that is so badly in need of change.

Since that time (except for the three-year moratorium under the Guidelines) tax administration has been marked by interminable and wasteful depreciation controversies, and our industrial history has been one of recurring facility shortages and pernicious obsolescence both in peacetime and wartime. It is plain that the facility investment required to keep the United States modern and strong and fully competitive will not and cannot be made under the restrictive tax structure we have at present which is based on individualized service-life auditing and negotiation.[15] We must also be aware that it is fast becoming more restrictive now that the revenue agents are applying the reserve ratio test under the Depre-

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[12] 1969 Survey of McGraw-Hill, Inc.

[13] The urgent need for a capital recovery tax structure comparable to those of other leading industrial nations and a history of the development of the United States structure are set out at some length in testimony and statements heretofore submitted by me and others on behalf of these industries before this Committee and the Ways and Means Committee: Hearings on Suspension of Investment Credit before the Senate Finance Committee (H.R. 17607), October 5, 1966, pp. 106–139, pp. 407–410, pp. 434–445; Hearings on Incentives for Investment in Urban Poverty areas before the Senate Finance Committee (S. 2088 and S. 2100), September 14, 1967; Hearings on Tax Revision before the Committee on Ways and Means, November 1959, Vol. 2, pp. 827–840; Hearings on the President's 1961 Tax Recommendations before the Committee on Ways and Means, May 12, 1961, Vol. 2, pp. 983–1006, pp. 1547–1549; Hearings on the President's Proposal on Suspension of the Investment Credit before the Committee on Ways and Means (H.R. 17607), September 14, 1966, pp. 208–231, pp. 396–404; Statements of the NMTBA, the AMTDA and the NTDPMA before the Ways and Means Committee, May 1969.

[14] T.D. 4422, XIII–1 Cum. Bull. 58 (February 28, 1934); Mim. 4170, XIII–1 Cum. Bull. 59 (April 4, 1934).

[15] To reduce accumulated industrial obsolescence and to provide adequate industrial capacity, temporary emergency allowances had to be added in 1940, 1950 and 1962 to shore up our ineffectual depreciation tax structure. As already mentioned, special amortization provisions have once again had to be included in H.R. 13270 to bolster the structure and make possible certain critical industrial expansions.

ciation Guidelines to to extend depreciable lives just as they did under old Bulletin F.[16]

In insisting on a continuance of the reserve ratio test, the Treasury does not seem to realize that there simply has not been time, since the adoption of the Guidelines in 1962, for many companies (particularly smaller companies) forced to incur tremendous capital extenditures to get rid of accumulated plant obsolescence, to correct entirely the unwise depreciation practices that persisted for so many years and caused the obsolescence in the first place. These bad practices of the past were sometimes the result of unsophisticated management and poor financial and accounting advice, but always they resulted in part at least from the shortsighted tax depreciation policies of the Government that the Treasury has been so reluctant to change.[17] Unless the reserve ratio test, which is based on the taxpayer's unfortunate experience, is eliminated, he will be forced back into the same old depreciation rut and the same old depreciation controveries in which he was bogged down so long under Bulletin F procedures.

Any thoughtful person will be enthusiastic about many of the tax reform proposals in H.R. 13270 to minimize hardships, inequities and discrimination; and we can all agree with the high tax priorities that must be given to the demands of the Vietnam War, inflation and the pressing needs of our cities. But it seems crystal clear that the Administration unnecessarily handicaps itself in trying to provide these necessary revenues and in fighting inflation by giving no priority at all in H.R. 13270 to the investment allowances that will assure the industrial capacity and the low cost production to fight inflation, to increase exports, to improve our balance of payments, and thus to increase the revenues.[18]

HISTORY REPEATS ITSELF

President Nixon has stated quite candidly that other reasons or rationalizations to the contrary notwithstanding, the need for additional revenue to make possible the termination of the surtax as promised is the real reason he proposed a reduction in capital recovery allowances and proposes no offsetting reforms. It was this same need for additional revenue that President Roosevelt gave in 1934 as the reason for instructing the Treasury to reduce depreciation allowances across the board.

So far-reaching were President Roosevelt's 1934 disallowances (and those President Nixon proposes are of the same magnitude in today's economy) that the industrial plant of the United States has not yet fully recovered from the obsolescence and higher cost production that resulted from depreciation policies and practices the Government required and business adopted following the 1934 ruling. As I have already mentioned, even at this late date the United States has the highest percentage of overage obsolescent production facilities of any of the leading industrial nations of the world.

Despite the beneficial effects of the liberalized Depreciation Guidelines, the 7% credit, the 1954 accelerated depreciation methods and the 60-month amortization allowances of the 1940's and the 1950's, the United States has not been able to do more than slowly narrow the obsolescence gap since World War II.[19]

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[16] The three-year moratorium during which revenue agents could not lengthen depreciable lives by applying the reserve ratio test of the Guidelines is no longer in effect. Once again, as under the old Bulletin F procedures, the taxpayer is bound by all the deficiencies of his past practices. He may lose entirely, through circumstances completely beyond his control, the right to use the more liberal Guideline lives; while at the same time his competitor, quite fortuitously, may be entitled to continue with the shorter Guideline lives with all the competitive advantage this entails.

[17] As a result of T.D. 4422, capital intensive corporations were caught up in a vicious cycle of inadequate depreciation, overpaid income taxes (and renegotiation refunds), inadequate earnings and cash flow for modernization and replacement, still less depreciation and cash flow, more obsolescence, higher cost production, still lower earnings, etc.

[18] According to many economists, there is a very present danger of "overkill" in the proposed tax damper on investment. There are already some ominous signs in the capital goods industry. Machine tool orders which have come to be regarded as a reliable economic barometer were down more than 22% in July from the corresponding period in 1968. Manufacturers' new orders showed their second monthly decline in June. After-tax corporate profits turned down in the second quarter. As a result of these factors and indicators, a marked leveling off in plant and equipment expenditures is now protected by business economists. Instead of the original prediction of a 13% increase in 1969 over 1968, the figure has been revised to 8–10%. The Federal Reserve Board survey as reported in the *New York Times* for August 20, 1969, predicts no increase in 1970 in authorizations for plant and equipment over 1969.

[19] Annual Surveys of McGraw-Hill, Inc., 1945–1969. While the United States has been having difficulty closing the obsolescence gap, foreign nations with their more modern industrial facilities have made considerable progress in closing gaps where they have been behind the United States in total prdouction and exports. Taking machine tools as an ex-

These interim remedial provisions have generally been too temporary and uncertain, or too hedged in with restrictions in both language and administration to insure the continuous modernization and replacement of the productive facilities that are so sorely needed. At no time has there been the permanent change in direction away from the restrictive 1934 policy upon which the taxpayer could rely in his long-range planning.

Surveys in the metalworking industries show that many companies (30% in one survey) were not willing to use the shorter Guideline lives simply because of the uncertainty and complexity of the reserve ratio test.

It is clear that the United States will not be able to close the obsolescence gap until it adopts a permanent capital recovery tax structure that is as liberal, realistic and simple as the tax structures of other industrial nations such as our next-door neighbor Canada, for example.

We can criticize the subsidy policies of other nations; we can be opposed to all subsidies as a matter of principle; and we can somewhat disparagingly label every capital recovery tax allowance, including percentage depletion, "a tax subsidy" as President Nixon labeled the investment credit in his tax message; but we must not forget that the United States is no longer the self-contained and self-sufficient economic unit it once was, and if other nations subsidize investment to compete with us, we have little choice but to provide equivalents.

However, it is by no means necessary to concede that reform or liberalization of our tax structure as proposed involves any government subsidy to investment simply because tax lives do not conform to past service lives. A very persuasive case can be made that there is no "subsidy" element in the accelerated depreciation allowances permitted by the Code, and that none was injected by the enactment of the investment credit (despite the recovery in excess of cost) because the credit was required to make up for the deficiencies in the structure that precluded a reasonable capital recovery allowance in the first place. If the recovery does not exceed actual cost, as in the depreciation reforms proposed, it is possible to argue that no claim of subsidy should be made simply on the basis of timing. There may be, o. course, a resulting disparity in treatment of taxpayers simply on the basis of timing; but it should be noted on this phase that the present system has been an utter failure not only in trying to avoid such disparity, but even in its effort to conform tax lives to service lives.

THE TREASURY'S DEFENSE

Although President Nixon has relied principally on revenue needs as the reason for cutting back on investment allowances, Secretary of the Treasury Kennedy has attempted to defend the Administration position on other grounds as well.

In his testimony before the Committee on Ways and Means he took the position that the 1970's will be distinguished from the 1960's in not requiring a tax structure designed to provide the same stimulus to modernization, replacement and expansion of productive facilities as was required in the 1960's.

In his testimony he seemed to be saying, to use his own words, that because "business has put close to $400 billion into new plant and equipment in the 1960's," the same high level of investment will not be required in the 1970's. Although he recognizes that the United States has had a "sluggish rate of business investment" in the past in the absence of tax stimulation, he thinks that a high rate of investment will nevertheless continue in the 1970's with stimulation coming only from "the fundamental incentive to invest—good prospective markets for industry's products." [illegible]

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ample, we find that U.S. exports of machine tools decreased from $286,667,000 in 1964 to $286,034,000 in 1968. Japanese machine tool exports increased from $21,240,000 in 1964 to $60,148,000 in 1968, or an increase of 183%. West German exports of machine tools increased from $389,959,000 in 1964 to $587,500,000 in 1968, or an increase of 50%. Imports of machine tools into the United States increased from $36,364,000 in 1964 to $163,576,000 in 1968, or 349%.

[illegible] These statements which are quoted in full below were made by Secretary Kennedy before the Ways and Means Committee on May 20, 1969. Just a few weeks before, on March 21, in his Business Council presentation, the Secretary stated unequivocally that the Administration recognised the need for tax encouragement to long-run investment. These were his words: "We have no plans for tinkering with the investment tax cerdit. Congress intended the credit to be a part of the regular tax system, and not a device for stimulating or slowing the economy. Moreover, the credit has been highly effective in encouraging the long-run investment that creates additional jobs and income."

His May 20 statement follows:

"Stated simply, the case for removal of the investment credit rests primarily upon the fact that the social needs and economic conditions of the 1970's will be greatly different

This kind of thinking is, of course, not at all understandable to the capital intensive industries. They already see as they move into the 1970's the breathtaking rate of technological change in both products and the equipment that produces them. They also see the tremendous cash flow and expenditure demands of the 1970's for research, development, modernization and replacement to beat back obsolescence to meet foreign competition. They are convinced that the rate of technological change and capital investment will far exceed that of the 1960's. To them even the thought of returning to anything like the old sluggish rate of investment is anathema, just as it is in Germany and Japan and the other industrial nations where every government aid is being given to stimulate investment in productive facilities.

If such investment is not encouraged and made in the United States, more and more capital funds for plant expansion will move abroad as they have for years, and more and more U.S.-owned plants will be built abroad instead of in the United States. With this U.S. expansion abroad will continue to go, unfortunately, many jobs for American workers, and in many instances an essential part of our industrial and defense base that the United States can ill afford to lose.

One of the principal inducements to the many machine tool companies that have expanded abroad in the past ten years, instead of in the United States, has been the liberal foreign depreciation allowances that permit the complete writeoff of a plant in a fraction of the time allowed in the United States.

INCREASED CAPACITY AND PRODUCTIVITY ARE DISINFLATIONARY

The Treasury has repeatedly pointed out that putting tax restrictions on facility investment will dampen the fires of inflation. They seem to persist in the view that capital investment allowances can be used as short swing contracyclical measures despite the almost conclusive evidence that effective timing is impossible, and that cutting back on productivity is self-defeating and does much more harm than good.

Certainly, the experience of the 1960's in suspending and reinstating the investment credit suggests that (1) the legislative wheels move too slowly and uncertainly to achieve an effective short swing anti-inflationary effect, and (2) that cutting back on the source of future productivity simply means another round of inflation later on. The unintended, and inevitable, adverse effects of reducing investment allowances in the 1930's, 1940's, 1950's, as well as the 1960's, are already on the record.

One well known economist and editor recently answered the Treasury argument with some plain speaking:

"How silly can you get? The only ultimate answer to inflation is more capital investment now and more productive capacity later on . . . the cries of outrage against the rise planned for private capital investment are the same as those of the farmer that killed the goose that laid the golden eggs. The stop inflation now philosophy ignores this key fact.

"The best and most successful way to halt inflation is to increase the supply of available goods and services over and above demand, to modernize and automate, to cut the unit costs of production, and to decrease the amount of natural resources used in production. And that's what we're doing now. Hail our secret weapon against inflation: capital investment." [11]

INDUSTRY LOOKS TO THE FINANCE COMMITTEE

Quite understandably, depreciation and other technical tax allowances for business investment seldom if ever enjoy a very high priority in the public mind or in the world of politics, principally because their essential function is not understood. It is only when the President, or the tax-writing committees of the Congress provide the necessary leadership to educate the public and the Congress, as they did in wartime and in 1954 and 1961, that major reforms and improvements can be made in the tax depreciation structure to reduce industrial obsolescence and provide adequate facilities for both peacetime and wartime economies.

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from those of a decade ago. Stimulation of a sluggish rate of business investment was a high priority goal in the early 1960's. Since that time, business has put close to $400 billion into new plant and equipment. Even without the credit, a high rate of investment is expected to continue because the fundamental incentive to invest—good prospective markets for industry's products—is likely to remain strong. Instead of inducing still more business investment, additional resources will be available to meet pressing needs for housing, to aid State and local governments, and to improve the lot of the poor."

[11] Statement of P. A. Rinfret, Rinfret Associates, letter dated Apr. 28, 1969.

At a time when the public and even the Congress are somewhat understandably emotional about tax reform,[a] it is easy to discredit business investment allowances in the public mind, no matter how essential they may be to the nation's economic health, by labeling them tax subsidies, tax preferences and tax loopholes.

The much more difficult task that is so essential for this Committee at the moment is to make the public and the Congress understand that it is not in the national interest in this competitive world to put further restrictions on investment, or to postpone any longer the enactment of the proposed depreciation reforms.

The pendulum has swung too far in this bill. It has not swung too far in the commendable provisions for rate reduction or the relief from hardships provided for the lower income groups, but in the wholly unwarranted exercise of minimizing the importance of all types of risk-taking capital investment by penalizing it and seeming to discredit it.

Not only is capital investment penalized unduly, but security investment as well, and also the high risk-taking investment involved in developing natural resources. Some reforms and changes in these areas are entirely justified, but they should not take the form of somewhat extreme penalties emotionally imposed across the board on the basis of isolated examples of unusual tax avoidance. Even "investment" in our schools, our churches, our museums and our art galleries can be said to be penalized together with the institutions themselves, in some of the extreme restrictions placed on charitable contributions.

With the leadership this Committee can provide in educating the public and the Congress, there will be no "taxpayer revolt" if the pendulum swings back to recognize the essentiality of capital investment in a capitalistic economy, and the necessity for taxing different kinds of income differently. These truisms are too often overlooked and ignored.

Even the emotional furor stemming in part at least from some misunderstanding of percentage depletion may subside so that a sensible solution on a transitional basis can be found for this controversial problem. Disruption of our economic system is the exorbitant price all taxpayers are likely to pay for a hurried and emotional application of tax theory.

GENERAL COMMENTS ON H.R. 13270

By way of a lawyer's comment on H.R. 13270, I feel constrained to say that although the Ways and Means Committee and the Joint Committee Staff have performed a truly remarkable job of composing and drafting a milestone tax reform bill in a very limited time, it is nonetheless a hurried measure with many errors, omissions, inconsistencies, ambiguities and no end of complexity. As the tax-writing committees and their staffs know full well, H.R. 13270 requires a major overhaul and revision and the closest kind of scrutiny since the text of the bill was not under review in the hearings in the House.

I think we must all reluctantly agree when we contemplate the 368 pages before us that any remaining notion that simplicity can be attained in reforming our tax structure, or that a taxpayer can any longer prepare his own return, has been pretty well dispelled by all this fine print and complexity. Algebraic computations are now required, and even computers will have to be used by accountants and other advisers in the preparation of individual as well as corporate returns.

One of the great virtues of the proposals we have made here today for depreciation reform is the simplicity and ease of understanding and administration they will bring to the tax law.

On the following pages of Appendix A is a more detailed and somewhat technical explanation of the proposal to eliminate the reserve ratio test and include the Guideline lives in Section 167.

APPENDIX A TO STATEMENT BY JOEL BARLOW

It is generally recognized by tax authorities both in and out of the Government that the reserve ratio test cannot be eliminated without a change in Section 167.

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[a] When a Secretary of the Treasury announces that without immediate tax reform there is likely to be a taxpayers' revolt, the thought, if not father to the deed, can be father to some emotional tax reform, particularly in an election year. The Secretary was entirely right in pointing to some long overdue tax reforms that have now been included in H.R. 13270, and it may be that the inordinate delay in overall reform warranted his impassioned plea. It must be said, however, that a less dramatic call might have resulted in somewhat less imbalance in this tax bill between what might be called reform *for* consumers and reform *of* investors.

The courts have repeatedly interpreted Section 167 as requiring that depreciation allowances be based on the taxpayer's individual experience.

There was some indication at the time the Guidelines were adopted in 1962 that the reserve ratio test would not have been included if it had not been for the courts' interpretation of the statutory requirement. It was recognized at the time that the U.S. system had been notably unsuccessful in trying to conform tax lives to service lives under similar depreciation reserve tests that had been used, and it was thought that the proposed reserve ratio test would be no more successful.

The Guidelines represented what has been referred to as a "noble effort" to get away from the complexities and controversies of service-life audit procedures. The Treasury officials who conceived them deserve great credit for going to the broader class life approach and for resolving doubts in favor of more liberal allowances in determining class lives. Even the reserve ratio test was a well intended and ingenuous formula. The only difficulty is that even with its transitional rules and "brownie points" it is much too restrictive to say nothing of its great complexity.

The test is so restrictive, so complex and so inapplicable to certain types of depreciation accounts that it has discouraged many taxpayers, particularly small taxpayers, from using the Guidelines. It is clear now that if this test is not eliminated, its application will give rise once again to a repetition of the wasteful and needless tax controversies that have plagued the administration of the tax laws for so many years.

The Treasury in the past has disputed the test's complexity, and even the present Administration may do so in view of its announced interest in postponing depreciation reform so as to avoid any diminution of the revenues. But, unfortunately, it seems clear from extensive discussions with businessmen and their accountants that the test's complexity is the deciding factor for many businesses that do not adopt the Guidelines. This was confirmed in recent surveys in the metal working industry in which most of those responding referred to this complexity as an important or even controlling factor in their decisions to continue to use non-Guideline lives.

It is no answer to the complexity argument to suggest, as the Treasury has in the past, that other provisions of the Code—for example, Subchapter C and Subpart F—also are complex. Usually, in cases involving reorganizations and foreign-based company income, large corporations are involved, and tax specialists are in control. Moreover, many of these questions are not of a continuing nature, and taxpayers are more inclined to call in professionals' help in such circumstances. The Guidelines, on the other hand, frequently must be mastered by small individual proprietors and by factory accountants on a day-to-day basis, and this is where the principal difficulty arises.

In recent industry surveys of depreciation practices, a number of companies stated that although they could pass the reserve ratio test currently, they did not adopt the Guidelines because they did not want to expose themselves to possible future adjustments under the reserve ratio test. In other words, they would take what they conceived to be the certainty of inadequate depreciation against the uncertainty of additional depreciation, and particularly the uncertainty in the timing of depreciation deductions under the Guidelines. This uncertainty in timing—because of the application of the reserve ratio test—has deterred these taxpayers from adopting the Guidelines in the first instance.

The argument has been made that the threat of depreciation adjustments under the Guidelines will stimulate taxpayers to invest in order to meet the reserve ratio test. This may have some force once a taxpayer has adopted the Guidelines, but the taxpayer's feet cannot be held to the fire until the fire is lit. I have found no businessman, tax lawyer or accountant, who believes that the threat of depreciation adjustments has any significant effect upon investment decisions.

Probably the most compelling reason next to its complexity for getting rid of the reserve ratio test is the benefit to be gained by both the Government and the taxpayer in getting away from the individualization of tax depreciation. As I have stressed in the accompanying statement, most countries have learned that trying to arrive at service lives based on the taxpayer's experience is an expensive administrative exercise in futility. They have also learned that there is just about the same disparity in treatment in individual service-life auditing as there is in permitting the unrestricted use of minimum Guideline lives (or maximum Guideline rates) for broad classes of facilities based on industry surveys. Revenue Procedure 62-21 without the reserve ratio test falls into the simpler, more administrable pattern adopted by other nations.

It must be pointed out that the Treasury has opposed any suggestion that depreciation should be based other than on the taxpayer's own experience despite the fact that it was the Treasury that injected the capital recovery concept into the tax law in the form of the investment credit. The Treasury in subsequently focusing only on the depreciation aspect has pointed out that it believes more is involved than simple interest on the tax saving if experience is not the test. The Treasury stresses that for a taxpayer engaged in a growing business, the allowance of additional depreciation means a permanent tax savings, and from the fiscal standpoint, a permanent revenue loss.

The Treasury's basic objection to a new statutory system without an experience test is that it would permit a taxpayer to depreciate its assets at a rate faster than it is replacing. As a result of the so-called "excess" depreciation, the taxpayer would earn a higher after-tax rate of return and be subject to a lower effective tax rate on its investment in the assets than would a second taxpayer whose depreciation deductions correspond to its acquisition and retirement cycle. This is no different, the Treasury says, than purposefully taxing some taxpayers at one rate and others at a different rate.

The Treasury goes on to point out (although somewhat uncertainly) that the consequence would be that investors would tend to invest in slowly replacing companies, and this, of course, is undesirable from an economic standpoint.

Moreover, according to the Treasury, because non-depreciable assets like inventory and accounts receivable would be taxed at a higher effective rate and produce a lower after-tax return than depreciable assets, there would be too much investment in depreciable assets and too little in non-depreciable assets.

All of this, the Treasury concludes, would result in a misallocation of economic resources and ultimately a slowdown in economic growth. The Treasury insists that to avoid this, the reserve ratio test must be retained to ensure that a taxpayer's depreciation deductions are consistent with its replacement cycle.

It is indeed true that different after-tax rates of return result where two taxpayers claim the same depreciation for tax purposes but in fact use identical assets for different periods of time. However, the implication of the Treasury position is that such differences do not presently exist. This is not the case. Today's differences arise from two principal factors:

1. Where the Guidelines are not in use, or where it becomes necessary to resort to the "facts and circumstances" under the Guidelines, Revenue agents in different districts or offices, or even in the same district or office, usually have completely different views (often uninformed and erroneous) as to the proper lives for various depreciable assets. The conclusions reached may even be influenced by the number of other issues in dispute and the respective "horse-trading" abilities of the representatives of the taxpayer and the Revenue Service.

2. Whether or not the Guidelines are applicable, rate of return differences result from the option given to taxpayers to use the straight line, the declining balance, or the sum-of-the-year's digits method of computing depreciation.

Furthermore, as to the problems of inventory and receivables that the Treasury also has raised, we should remember that there already are significant after-tax rate of return differences among taxpayers under the existing rules.

For example, some taxpayers use prime or direct cost accounting while others cost on a full-absorption basis. Some will treat a particular expense as part of the burden pool; others will treat it as G & A. Some taxpayers use FIFO, others LIFO. Some taxpayers charge off bad debts using the specific charge-off method and others the reserve method.

Finally, while most taxpayers report on the accrual basis, there are some who use the installment or cash methods. Each of these methods affects the after-tax return with respect to inventory or receivables, and in some instances, the differences resulting from the use of one method or another may be as much as, or more than, the differences that would be created with respect to depreciation charge-offs if the reserve ratio test is scrapped.

It should be noted also that neither the reserve ratio nor any other test which relies on past experience can be of real assistance in determining the proper life of an asset in advance. This was proved over and over again in the depreciation controversies and cases following the adoption of Bulletin F.

It is easy, of course, for the Treasury to demonstrate its rate of return and effective tax rate computations with the use of hindsight. For example, the Treasury can point to two taxpayers who purchase identical assets on the same day and dispose of them ten years later, but one has depreciated on a ten-year

basis and the other uses a five-year life. The fact that the taxpayer using the five-year life has in the Treasury's view obtained an undue benefit does not even become apparent until after the fifth year and does not become absolutely clear, because of normal deviations from an average, for some time thereafter.

The point is that even under the reserve ratio test, a taxpayer may be subject to adjustments which prove to be unwarranted by his future experience. To put this another way, the taxpayer is penalized under the reserve ratio test after the fact, for it is only after the fact that it can be known with certainty that too rapid depreciation has been claimed. The result is, of course, that even under the reserve ratio test, there is no assurance at the time depreciation on any asset is claimed that the rate of return and effective tax rate with respect to that asset are appropriate from the economic standpoint.

Under the Canadian bracket system of depreciation, use of the double declining balance method with multiple asset accounts is mandatory. While this combination of methods does not eliminate the rate of return and effective tax rate problems referred to above, it does have the tendency to produce roughly identical depreciable charges after a period of years, regardless of the life that is used. This is not true of either the straight line or the sum-of-the-year's digits methods. Thus, by requiring the use of double declining balance-multiple asset accounting, a measure of general equality or rough justice can be introduced into our depreciation system, and, at the same time, rate of return and effective tax-rate differences can be kept within reasonable limits.

It must be conceded that differences in the effective after-tax rates of return earned by similarly situated taxpayers may result in "uneconomic" investment. But it must also be conceded that application of the reserve ratio test cannot eliminate these differences. Nor would its abandonment significantly increase them if taxpayers are required to use double declining balance-multiple asset accounting.

In view of the experience under the Guidelines since 1962, it seems clear that the stimulation to capital goods investment resulting from the elimination of the uncertainty and complexity caused by the reserve ratio test would do the economy more good in the long run than whatever benefits may be derived from penalizing taxpayers for having claimed excessive depreciation in prior years. It would also greatly improve and simplify the administration of the tax laws by the IRS, and increase taxpayer confidence in the IRS and in our unique self-assessment system.

The Chairman. Now, our next witness will be Mr. Charles W. Stewart, president of the Machine & Allied Products Institute.

STATEMENT OF CHARLES W. STEWART, PRESIDENT, MACHINERY & ALLIED PRODUCTS INSTITUTE

Mr. Stewart. Good morning, sir.

The Chairman. Mr. Stewart, there is no invidious inference at all to it, but I think that now would be a good time for us to put our egg timer into operation because we are trying to—we have asked each witness to limit himself to 10 minutes and that being the case I thought we would just mention this to the witness and when his time is up he will hear the bell ring. And your entire statement will be printed in the record and also we will see that your summary is available, and we will now be pleased to hear you, sir.

Mr. Stewart. Thank you, sir.

I am accompanied by William J. Healey, MAPI staff counsel.

May I say that you won't time me for this comment: I congratulate the committee on suggesting that statements not be read. This is a policy that might well be followed throughout the Congress. In behalf of the organization that I represent, the Machinery & Allied Products Institute, I would like to deal first with one point that does not violate your preclusion as to the investment credit discussion but does bear on it. You will recall, Senator, that on the Senate floor on July 31,

there was an extensive discussion regarding certain technical rules pertaining to phaseout of the investment credit, assuming the investment credit is repealed. A number of Senators including Senator Talmadge suggested that these problems had to be considered carefully in the event the Congress finally does repeal the investment credit. If the repeal provision is removed from the bill before this committee at this time and is attached to the Interest Equalization Tax Act extension or if it remains in this bill, I trust that consideration will be given to the extensive testimony on the transitional rules previously submitted to the Senate Finance Committee.

In addition to the full text of our statement to which you have referred, I would like to suggest that certain items be included in the record. They were mentioned in our printed statement but not attached to it. First, we request that a memorandum which MAPI published in April of 1969 on taxation of advance payments be appended to our statement.[1] Secondly, as indicated in our statement, we request that the table submitted by Secretary Dillon appearing on page 82, part 1 of the 1962 Revenue Act hearings before this committee be included in the record. We also refer to a clipping from the Wall Street Journal of September 3 discussing this bill from the point of view of a prominent tax attorney. And, finally, in our statement we refer to extensive studies in which we are now engaged on the subject of depreciation. An advance draft of "Underdepreciation From Inflation—A Ghost Returns" by George Terborgh, MAPI research director, is now available. May I ask that it be considered for inclusion in the record, if you please, sir?

The CHAIRMAN. They will be made a part of the committee record, and we will print the parts of it that we believe should be in the record and some of it will perhaps be kept in the committee files available to all Senators.

Mr. STEWART. Thank you. I think that Mr. Willkie put his finger on a central point which I trust will be given major consideration in the evaluation of the contents of the House bill now before this committee. He made certain statements and I would prefer to put them in the form of questions. It seems to me that the central problem about this bill is that it homes in on alleged preferences or so-called loopholes, but it does not to our satisfaction reflect consideration of certain public policy objectives or certain public policy impacts that would result from closing or modifying the so-called loopholes. Mr. Willkie warned about effect on real estate, on risk taking, on the stock market, and so on. An evaluation, in other words, of the public policy objectives which underlie these various provisions in the code and what damage would be done to the achievement of those objectives, as distinguished from the individual loophole-closing proposition, whether you are talking capital gains or charitable contributions or any of these issues seems to me to be a critical requirement in order to appraise the value of this bill.

I think the first witness this morning was thoroughly naive when he related his experience with regard to Xerox, for example. When he invested as he said he did in Xerox, Xerox of today was just a dream. It might have fallen on its face. It never would have been

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[1] The memorandum referred to is made a part of the official files of the committee; the table, the article, and the advance draft referred to follow Mr. Stewart's prepared statement.

developed effectively, it never would have provided the thousands of jobs that it did, it never would have rewarded the risk-taking investors that it did, if it had not succeeded. And the only reason it was able to get off the ground was because this gentleman, who now doesn't like risk taking, took the gamble. That is the answer to his two questions at the end of his statement, and he knows the answer better than you and I do.

I would like to concentrate, if you don't mind, on that portion of our statement which relates to the discussion of the effect of this bill on investment and in particular the need for replacing the investment credit with an equivalent support for capital investment, assuming the credit is to be repealed.

The repeal of the investment credit we will not discuss as an issue, in accordance with the chairman's instructions, but the effect of that removal is relevant. The timing is extremely bad from the standpoint of the danger and the gap that it creates. The country is fortunate at the present time to be enjoying an accelerated rate of technological progress. Investment opportunities are not only plentiful but they are thoroughly challenging. At the same time that technological advance is surging and that there are these many challenging investment opportunities, we are pulling the rug out from under the tax support of capital investment.

To make your evaluation of what to put in place of the credit, should it be repealed, you should be aware of the number of limitations on the sources of funds for investment. Corporations relay primarily on internal funds—capital consumption allowance and retained earnings—to support such capital investment. Retained earnings have been declining since 1966. Capital consumption allowances for tax purposes are likely to rise at a diminishing rate hereafter, especially if the reserve-ratio tax which has been referred to by the previous witness remains in effect. Moreover, as pointed out in the document which we have furnished as a supplement to the record, such allowances being based on historical cost, become increasingly inadequate because of inflation. Corporate tax depreciation will be deficient next year because of inflation by $7 to $8 billion. If forecasts are realized, corporate internal funds next year will cover only 80 percent of plant and equipment expenditures, the lowest ratio for more than 20 years.

Thus a great void has been created or will be created if the Congress and the administration stay on the track of repealing the investment tax credit. And we submit that a proper substitute for the investment credit and an equivalent substitute must be designed. We set out in our statement a number of alternatives, or items which could be considered in combination, and I will not take the time of the committee to repeat them. I should call attention to the fact that according to our preliminary studies the United States will have to go to 5-year amortization for all productive equipment across the board to achieve an equivalent of the present combination of the investment tax credit and the guideline system of depreciation.

Our statement goes much further in addressing this bill than merely covering the anti-investment aspects of it. We deal with particular technical provisions of the bill. We oppose the deferred compensation section. We oppose the restricted tax plan section. We think the moving expense section is a move in the right direction, but it does not go

far enough. The taxation of foreign earnings section represents a minimal look at a very complicated problem. The section of the bill on real estate depreciation reflects an obstinate determination on the part of the Treasury Department to discriminate against industrial realty. Why? If you have a speculative problem in real estate, deal with it. The capital gains and losses section we oppose. We agree with the modifications that Assistant Secretary Cohn suggested, but carry our opposition further.

And may I call the attention of the committee to the fact that tax reform ought to cut both ways. This is essentially a negative bill. We ought to have some liberalization in it beyond the personal income tax rate changes. One of the major problems that confront equipment industries in this country today is the question of advance payments taxation. The Treasury, subject to a current reevaluation study, is now trying to tax advance and progress payments when received even though a long-cycle piece of equipment that may not be delivered until 5 years later is involved. This makes no sense in tax policy, accounting thinking, or practical economics.

Another item that ought to be looked into in the sense that tax reform should cut both ways is the accumulated earnings tax which needs a thorough overhaul. And finally, obviously charitable contributions as dealt with in the bill badly need another look, as I am sure you have been hearing from educators and other heads of eleemosynary institutions who are terribly concerned that the "contribution well" may dry up as a result of some of these provisions.

In general, as the title to our statement indicates, the institute believes that the tax reform bill needs reform.

The CHAIRMAN. Well, thank you, sir. I will make you a fair proposition. I am willing right now to vote against nearly everything in this bill that does not raise the Government any money. And there is plenty of this that will lose money rather than make money. And insofar as those provisions exist, I personally plan to vote against them.

Senator Anderson.

Senator Williams.

Senator WILLIAMS. No questions.

Senator HARRIS. No questions.

The CHAIRMAN. Thank you so much.

Mr. STEWART. The institute appreciates the opportunity to be here.

The CHAIRMAN. Congratulations, Mr. Stewart. You hit the egg timer right on the bell.

(The prepared statement with attachments, of Mr. Charles W. Stewart, follows:)

STATEMENT OF THE MACHINERY AND ALLIED PRODUCTS INSTITUTE, PRESENTED BY CHARLES W. STEWART, PRESIDENT

THE TAX REFORM BILL NEEDS REFORM

We appreciate this opportunity to present our views to the Committee on Finance of the United States Senate on H.R. 13270, the proposed Tax Reform Act of 1969. The Machinery and Allied Products Institute and its affiliate organization, the Council for Technological Advancement, represent the capital goods and allied equipment industries of the United States. These industries naturally have a deep interest in the provisions of any comprehensive tax revision bill such as that now pending before the Committee. That interest relates not only to the direct impact of certain proposed changes on individuals and corporations but also includes a deep concern and sense of responsibility to address the public policy implications of provisions of the current bill. With our commitment to

research in the economics of capital goods, technological advancement, and investment, we hope that some of the study work carried on by the Institute will be helpful to this Committee and to others concerned with tax legislation both in the Executive Branch and the Congress.

GENERAL OBSERVATIONS

It is with considerable reluctance that we state our general and strong objections to the overall character of the tax reform bill before the Senate Finance Committee because we fully appreciate the complexity of the legislative process, particularly when it is applied to federal tax changes. Moreover, we are sensitive to the tremendous work load carried in the Executive Branch, in the House Committee on Ways and Means, and by the very able staff of the Joint Committee on Internal Revenue Taxation, in connection with development of the content of the proposed Tax Reform Act of 1969. At the same time we do feel an obligation to underline our substantial reservations about the philosophy, the approach, and the content of this bill, so that thé Senate Finance Committee, giving consideration to the views of others and the results of its own study, may be assisted in taking whatever action it feels is appropriate to modify H.R. 13270.

First, we have concern as to how this bill was developed. It is true that extensive hearings on tax reform were conducted by the Ways and Means Committee but the witnesses at no time had an opportunity to address themselves to all of the proposals contained in the bill as passed by the House and at no time had before them detailed bill language for consideration. The bill which was reported favorably by the Ways and Means Committee is long and complex. Debate on the floor was very limited by rule, amendments on the floor were precluded, and we believe it is fair to say that many members of the Congress had no opportunity to study and reflect on the detail and the implications of the contents of the bill. These hearings, therefore, take on critical importance because for the first time the views of interested parties can be addressed to the specifics of the Tax Reform Act of 1969 and the philosophy underlying it.

Giving due deference to the tremendous work load carried by those responsible for the development of the provisions of this bill and recognizing the political judgment that was apparently made that passing a tax reform bill promptly is a must, we submit that this is not the way to legislate in the tax area. Tax legislation is difficult enough when considered by the Congress under the best possible circumstances; it becomes almost impossible to produce a sound result when it is rushed through Congress and neither the technical aspects of the proposals nor the full implications from a broad public policy view can be given appropriate study.

Characteristics of the Bill and Its Approach

The thrust of the proposed legislation seems to be that without any particular pattern or overall criteria the Congress is attempting to identify a significant number of so-called "tax preferences" or "tax loopholes" and attack them. In many cases with respect to individual provisions of the bill there does not appear to have been an adequate examination of the probable policy implications of the tax action being taken. There seems to be too much of an atmosphere of a judgment that "we have to pass a bill which we can call a tax reform bill."

We have additional objections to the overall approach embodied in this bill. They can be summarized briefly as follows:

1. Tax reform cuts both ways. It should result in some tightening where justified and clearly liberalization should be considered where appropriate. This bill is essentially negative with the primary exception of the proposed reductions in personal rates.

2. The bill is terribly complicated. It does not take one constructive step toward simplicity; indeed, it adds complexity to an already terribly complex Internal Revenue Code. It is not only complex from the standpoint of its detailed provisions but the regulations and the interpretations which must follow will pile complexity and difficulty on top of the chaos which we already have under the present tax laws. In this connection, perhaps the Committee would like to have the record include an article in *The Wall Street Journal* of Wednesday, September 3, 1969, by a prominent tax attorney, Rene A. Wormser, entitled "Tax Reform: Adding Hodgepodge to Hodgepodge." Reference should also be made to the "Separate Views" of Congressman James B. Utt in House Report No. 91-413 (Part 1), page 216, on H.R. 13270. The Congressman's opening statement deserves most careful consideration:

"I have reservations about this legislation, not because I am opposed to tax reform, but because I realize it is so essential. The ostensible purpose of this bill is to comprehensively reform our Federal income tax law, and it is being heralded as the broadest and most comprehensive tax reforms that have been enacted since 1954. The actual result may be to introduce greater complexity and inequity into our tax laws."

3. It reflects the typical supertechnical, overprecise approach which has characterized tax thinking in the federal government for so many years. Simple solutions seem to be rejected out of hand, lint picking, fussy qualifications or exceptions are once again spread throughout the bill.

4. There seems to be a growing tendency to reject what for many years was a long-standing principle in tax legislation; namely, that changes adverse to the taxpayer would not be made retroactively. There are a number of retroactive effective dates in the present bill.

5. The bill clearly is unbalanced in terms of its treatment of corporations versus individuals. Not only is relief provided primarily for individuals but the negative provisions of the bill are balanced heavily against corporations. We deal with this in more detail below.

6. A most serious aspect of the bill is that it punishes investment versus consumption. This point is developed later in this statement.

7. Finally, certain sections of the bill seem to ignore inflation and the prospects for its continuance.

Discrimination Against Corporations

H.R. 13270, the bill currently before the Committee, would extend the surcharge at a 5-percent rate for the first half of 1970. In addition, the 7-percent investment tax credit would be repealed with respect to property acquired, constructed, or placed under a "binding contract," after April 18, 1969.

Further, in the case of depreciation on industrial buildings, the corporate taxpayer would be required, with respect to buildings acquired after July 24, 1969, to use either the straight-line or the 150-percent declining-balance methods of depreciation instead of the double declining-balance method or the sum of the years-digits methods which are available under present law. In addition, the depreciation "recapture" on the sale of industrial buildings would be stepped up considerably.

Finally, the capital gains tax rate for corporations would be increased from a 25-percent rate to a 30-percent rate, an increase of 20 percent.

It seems to us that this treatment illustrates a very serious weakness in the bill. Unter the statistical information which was made available by the House Ways and Means Committee during House consideration of the bill, there would be a total tax relief provided under the bill of $1.7 billion in the calendar year 1970, $6.8 billion in calendar year 1971, and $9.3 billion in 1972 and future years. This is to be counterbalanced by a revenue increase from other provisions of the bill which would amount to $4.1 billion in 1970, and would gradually increase to $6.9 billion by 1979. A major item in this revenue increase would, of course, be the repeal of the investment credit which would increase federal tax revenues $3.3 billion by 1979. Beyond the repeal of the investment credit, it seems clear that corporations would be required to make up most of the remaining $3.6 billion in increased federal revenues.

This raises a very serious question of equity in our minds. We recall that, in connection with the Revenue Act of 1964 in which substantial rate reductions were accomplished, corporations were afforded approximately one-third of the total of $14 billion in reduced federal revenues (the 4-point corporate rate reduction, plus the effect of the investment tax credit and the depreciation guidelines). Now this earlier division of benefits is being offset by proposed repeal of the investment credit and the new bill as a package has a very negative impact on corporations. Beyond the question of equity, however, there is the very fundamental problem of the impact of the House bill on corporate investment generally. It seems clear to us that the effect of this legislation will very clearly be to discourage investment.

Disparate Impact on Investment Versus Consumption

It follows from the discussion above regarding the impact on corporations that the bill bears much more heavily on investment that on consumption. This, of course, would have a very negative effect on economic growth in the United States. The corollary to that proposition is that economic growth not only supports prosperity but is the principal contributor to the creation of jobs. It is a

major prop to tax revenues. It is essential to our national security. Yet this bill, seemingly on a deliberate basis, punishes investment. Repeal of the investment credit has already been discussed before congressional hearings at length. Its negative investment implications, at least over the long run, are clear and largely conceded. Continuation of the surcharge and the other provisions affecting corporations as briefly referred to above and discussed in more detail later in this statement all add up to a very unfavorable effect on investment. Certain of the provisions affecting individuals have negative investment implications also.

Especially bad timing.—The timing of this action seems to be especially poor. The country is fortunate to be enjoying an accelerated rate of technological progress. Investment opportunities are not only plentiful and challenging but in terms of some of the competitive pressures confronting this country domestically and internationally and the cost-push pressures, notably a skyrocketing increase in cost of labor per unit of output, the necessity for investment at a high level seems obvious. The investment needs of the economy are also traceable in significant measure to the accelerated rate of growth in the labor force, a labor force which must be equipped with tools to produce, and an accelerated rate of growth in household formation which in turn will increase the demand for goods and require increased production to meet that demand.

Limitations on sources of funds for investment.—If we proceed from the premise that the investment needs of the economy are very large and will grow and can be expected to grow further, and perhaps at an even more accelerated rate in the 1970s, it is logical to inquire into the extent to which there are limitations on the sources of funds to support this needed investment.

In brief, with respect to the supply of funds for investment, the following points are critical:

1. Corporations rely primarily on internal funds—capital consumption allowances and retained earnings.
2. Retained earnings have been declining since 1966.
3. Capital consumption allowances for tax purposes are likely to rise at a diminishing rate hereafter, especially if the reserve-ratio test of tax depreciation lives is continued in effect.
4. Moreover, such allowances, being based on historical cost, become increasingly inadequate because of inflation. Corporate tax depreciation will be deficient next year by something like $8 billion for this reason.
5. If forecasts are realized, corporate internal funds next year will cover only 80 percent of plant and equipment expenditures, the lowest ratio for more than 20 years.

Ratio of fixed investment to internal funds.—Let us discuss the question of internal sources of funds for corporate investment in a bit more detail. General indications from preliminary studies now being conducted by MAPI are that internal sources of nonfinancial corporate financing are falling well short of fixed investment. Historically, investment tends to be approximately determined by the availability of internal funds as indicated by the fact that fixed investment has averaged out at roughly 100 percent of internal funds (corporate depreciation plus retained earnings) over most of the post-war period.

During 1966–68 the ratio of fixed investment to internal funds has substantially exceeded 100. This clearly reflects the urgent need felt by business to offset rising production costs (wages, interest, and materials prices) through the use of modern, cost-cutting machinery. It may also reflect some recognition of the expected growth in demands to be put on our productive capacity as the U.S. Government increases its efforts to meet expanding social needs.

Yet, however high the urgency ratings assigned to prospective investments, business cannot go on indefinitely increasing their reliance on external sources of financing at present rates. Ultimately, they will be forced to cut back to levels more consonant with internal sources of financing in spite of future needs to further reduce costs and increase productive capacity.

At the same time there are indications that the future growth in internal funds may be adversely affected by a reduced rate of growth in capital consumption allowances which represent the major component of the total. This growth will be reduced further from the increasing impact of the reserve-ratio test as it serves to extend tax lives of depreciable plant and equipment over the next several years.

Fundamental fallacy in the bill.—Yet, in spite of these indications of growing investment requirements in excess of the growth in the means for financing these investments, this bill is essentially anti-investment in thrust.

The Void Created by Investment Credit Repeal

In his hearing instructions, the Chairman of the Finance Committee has made it clear that the Committee does not wish to have the question of proposed repeal of the investment tax credit reargued. This is understandable in view of the fact that extensive hearings were recently conducted by this Committee on that subject, but we do wish to call attention to the Institute's testimony on July 11, 1969, during those hearings which is published beginning at page 296 of the printed hearings. It does seem not only appropriate, however, but necessary, and perhaps even an obligation, to underline the fact that although this is not the forum for rearguing the pros and cons on investment credit repeal—as strongly as we feel that repeal will prove to be a national blunder—repeal will create a void in our programs to support capital investment and that void is of massive proportions.

Persuasive government testimony.—One of the most persuasive and thoroughly documented presentations bearing on this point was submitted by then Secretary of the Treasury Douglas Dillon in connection with hearings before this Committee in 1962 on the Revenue Act of 1962. In Part 1 of those hearings covering April 2, Secretary Dillon compared the United States with other leading industrial countries with particular reference to capital expenditures and the need for a continuing permanent support for such expenditures through our tax system. It should be noted that among other observations Secretary Dillon pointed to the fact that capital expenditures constitute a smaller percentage of the Gross National Product in the United States than in any major industrial nation in the world. On page 82 of those hearings he submitted a very interesting table which we ask be included in the record of these hearings. The data presented in the table demonstrated clearly that even a drastic downward revision of depreciable lives would still not bring capital allowances in the United States to a level comparable with that permitted by our foreign competitors. It was his conclusion that only the combination of the depreciation guideline system and a special incentive with the same impact as the investment tax credit would place United States business firms on substantially equal footing with their foreign competitors in this respect.

A proper substitute for the investment credit.—What should be considered as a proper substitute for the investment tax credit if it is to be repealed on a permanent basis? In addition to the study referred to above which involves an examination of sources of funds for capital investment, the Institute has been reviewing again the impact of the reserve-ratio test under the depreciation guideline system and approaches which might be taken by the federal government to fill the gap which will be created should investment credit repeal take effect. Very high on our list is the necessary revocation of the reserve-ratio test which is a qualification to a taxpayer's entitlement to use the guideline lives provided under the depreciation guidelines. We have documented our criticisms of the reserve-ratio at length. They are set forth in the MAPI pamphlet entitled "The Reserve-Ratio Test—A Palpable Delusion" and this publication is available for study by the Committee and its staff. We do not feel, however, that scrapping the reserve-ratio test should be considered as one of the principal alternatives to the investment tax credit. This revocation should take place as a minimal move regardless of what choice is made among the various alternatives to be considered in lieu of the investment credit.

Some of these other substitues which deserve very careful consideration and might be undertaken as alternatives, or possibly to some extent in combination, include the following:

1. The 20-percent additional first-year writeoff provided under Section 179 of the Code for up to $10,000 in new depreciable property could be amended to remove the $10,000 ceiling or at the very minimum to increase it to some more realistic level.
2. Triple-declining-balance depreciation.
3. Five-year special amortization applied across-the-board to productive equipment as distinguished from the limited application of this device under the proposed bill to pollution control facilities and to certain railroad rolling stock.
4. Consideration of further and substantial liberalization of the depreciation system with perhaps some streamlining in structure such as that embodied in the Canadian system.

How to achieve an equivalent impact.—The Committee will be interested in knowing that our preliminary examination of alternatives to the investment

tax credit indicate that in order to achieve the same level of capital investment support that is attained from the combination of the depreciation guidelines and the investment tax credit presently in effect, the country would probably have to go to five-year amortization. For certain assets grouped by useful lives, five-year amortization might be a bit more potent than the present combination in effect but generally speaking the result would be in the same ball park. There should be no misunderstanding on the part of the Congress that when it repeals the investment tax credit it is creating an almost frightening gap in the federal program to support capital investment in the United States and that at least for the long run this gap will have to be filled. By no means is it too early to be thinking and studying as to how the substitute device or system should be shaped. As a matter of fact, if the anti-inflation program of government is constructive to any significant degree, even from the government point of view, we will need this substitute system in a matter of months. Without it we might very well turn an economic adjustment or a moderate recession into something considerably more serious.

The need is immediate.—In brief, we suggest strongly that if the Congress continues on its present track toward repeal of the investment tax credit, working with the Executice Branch Congress should begin immediately to develop a satisfactory substitute. The studies which we are now conducting on sources of funds for investment, on the comparative impacts of various approaches to capital investment support, some of which we have referred to, and on the impact of the reserve-ratio test, we trust will be helpful as government deals with the serious implications of its act, assuming it pursues repeal of the investment tax credit and especially if it compounds that misadventure by enacting other anti-investment provisions contained in H.R. 13270.

We now address ourselves to specific sections of the bill and to certain additional tax areas which deserve consideration in the context of current tax reform.

In order to conform to requirements of the Committee regarding delivery of copies of statements in advance of oral testimony, it was necessary to finalize this written presentation before Secretary of the Treasury David M. Kennedy testified on Thursday, September 4. For this reason any comments that we may have on the Treasury testimony will be offered in our oral presentation.

DEFERRED COMPENSATION

(SECTION 331)

We oppose the deferred compensation provisions in the bill and ask that they be deleted in their entirety; if not deleted, they should be substantially modified.

Under the provisions of the bill, deferred compensation in amounts in excess of $10,000 paid out under unfunded deferred compensation plans would be subject to a "minimum tax" on payment at the rate which would result from adding that amount to the employee's taxable income in the taxable year in which that amount was deemed to have been earned. This requirement would not apply to any deferred compensation payment which is made under a written plan which meets the current Code requirements of being nondiscriminatory or which would meet such requirements but for the fact that the plan is unfunded, or under a plan in existence on August 4, 1969, which is amended to meet these requirements before January 1, 1972. Deferred compensation payments not in excess of $10,000 would continue to be treated as under present law. It is to be noted that the $10,000 exception would apply to the rate of payout and not to the rate of accrual.

The "minimum tax" would be the lower of two alternative amounts:

1. The aggregate increase in tax resulting from adding to the employee's taxable income for each taxable year in which such excess over $10,000 is deemed to have been earned, the portion of such excess deemed to have been earned in each such year; or
2. The average increase in tax computed by adding to the employee's taxable income for the three taxable years for which his taxable income is highest during the last ten years of the earning period, the portion of the excess over $10,000 deemed to have been earned in those three years.

The minimum tax would not apply to the ratable portion of any deferred compensation payment attributable to a taxable year beginning before January 1, 1970. It also would not apply to the ratable portion of any deferred compensation payment attributable to a taxable year beginning before January 1, 1974, if

paid or made available pursuant to an obligation which was binding on July 11, 1969, and at all times thereafter, without regard to the effect of any possibility of forfeiture by the employee. Thus, if an employee receives in 1976 a $25,000 payment under a contract now in effect, only that portion of the $15,000 attributable to service performed after December 31, 1973, would be subject to the minimum tax.

These provisions would be effective with respect to taxable years ending after June 30, 1969.

Our opposition to this proposed change in the tax treatment of deferred compensation is unequivocal. If a participant in a deferred compensation plan is willing to defer receipt of a portion of his compensation until he retires, dies, or leaves the company, and if the company is willing to forego a tax deduction for the part of the compensation deferred until such compensation is actually paid to the individual, we can see no reason why the individual should not be taxed at the regular tax rates which are applicable when he receives such compensation. What government appears to be trying to do in this case is to get around the requirements of the "constructive receipt" doctrine under which an individual on the cash basis is not taxable on income not actually reduced to his possession unless that income is credited to his account or set apart for him so that he may draw upon it at any time. Even though the tax is not owed until such time as the deferred compensation is actually paid to the individual, the tax rate to be used would be that applicable to the earlier years in which the deferred compensation was deemed to have been earned. This treatment is contrary to sound accounting principles. Its difficulties are particularly apparent when the individual earning the deferred compensation has died, and the compensation is to be paid to his estate.

A part of this problem may result from the fact that there seems to be a belief that deferred compensation is substantially limited to large companies and to highly paid executives within such companies. This theory is not in accord with the facts. Many of the companies using deferred compensation plans are in the medium-sized and smaller range. Moreover, such compensation is frequently made available to a much wider group than the company's top management team. Deferred compensation can often be a critically important incentive to an employee who realizes that his ultimate receipt of the deferred compensation depends on his company's success in the period before the payment comes due.

Beyond the principles involved, the provision would clearly be difficult to administer from the company's point of view. The difficulties would be even more formidable for the individual. An individual affected by these provisions would have to engage in very elaborate record-keeping so that he would be able in appropriate instances to reconstruct his income situation with respect to prior years.

In any event, adoption of the proposal would clearly be disruptive in the extreme, requiring major changes in many deferred compensation arrangements. Another major problem is the continuing inflation we are likely to experience which is completely ignored in this proposal. The inflation factor would work particular hardship because the payments when technically received would in most cases be taxed at rates considerably in excess of those which would apply at the time of actual income receipt.

Assuming (which we do not concede) that some form of tightened taxation should be imposed on deferred compensation, the method followed in the House bill does not seem to be the best way to accomplish this goal. For example, the $10,000 exemption appears hardly adequate. It would be much more desirable to set this figure at perhaps $25,000.

The method to be used to calculate the so-called "minimum tax" seems unduly complicated. We think it desirable to abandon completely the concept of computing the tax on the basis of the rates which would have applied in earlier years. It would seem much more sensible to handle this by a modest surtax.

Another special problem would occur when the incentive compensation in question takes the form of a "phantom stock" plan. Under such a plan, the compensation to be credited to an individual's account would be so many unit equivalents of company stock. These equivalents would appreciate or depreciate in value as the market value fluctuates. The problem is that the proposal would not only tax appreciation in phantom stock as ordinary income but it would also bunch such appreciation so that it would be taxed at the highest rate brackets in that individual's lifetime. Another problem that would be particularly acute with respect to the phantom stock plan would be the "throwback" standard under which the years would be identified to which payments would be attributed

or "thrown back." The Internal Revenue Service would have the power under these standards to determine that the deferred compensation was earned during only a portion of the individual's employment period rather than during his complete employment period. It would be helpful to make sure that any such "throwback" is to be limited only to the amount which would have been paid in cash at the time the deferred compensation was earned, thus ensuring that any apperciation in value would not be included.

Still another major problem with the text of the bill is that the term "deferred compensation" is not defined. This becomes important because it is not clear whether bonuses payable under incentive compensation plans are to be considered deferred compensation simply because they were not actually paid within the year earned. It would appear that such payments should be considered current compensation. This problem can probably be substantially cured by deeming all payments for services made within 2½ months following the close of the employee's taxable year in which the services were rendered, as not constituting "deferred compensation." In addition, it would be desirable to treat payments made to a retired individual or to an individual's estate as being current compensation if they would be so treated if paid to a person still in the active employment of that company.

The above comments on technical defects in the deferred compensation proposal should not be interpreted as departing in any way from the Institute's complete opposition to the proposed changes in the tax treatment of deferred compensation plans. We strongly recommend that Section 331 of the bill be stricken.

RESTRICTED PROPERTY (RESTRICTED STOCK PLANS)

(SECTION 321)

The Institute opposes the bill's changes in the tax treatment of restricted stock plans.

Under present law, no tax is imposed upon the transfer of stock to an employee pursuant to a restricted stock plan until such time as the restrictions lapse. At that time, the employee is taxed at ordinary income rates on the market value of the stock at the time of transfer or the value at the time the resrictions lapse, whichever is the lesser amount. Any increase in the value of the stock between the time of transfer to the employee and the time the restrictions lapse is treated as a capital gain.

The bill includes a provision relating to restricted property generally, which would change the current tax treatment of restricted stock plans. Under its provisions, the person who receives a beneficial interest in property by reason of the performance of services would be taxed on the fair market value of the property at the time of receipt, either if his interest in the property is transferable or if it is not subject to a substantial risk of forfeiture. The operative phrase "substantial risk of forfeiture" is defined by the Committee report only to the extent of asserting that "[a] substantial risk of forfeiture will be considered to exist where the person's rights to the full enjoyment of the property are conditioned upon his future performance of substantial services." The alternative of referring the question of whether there is a substantial risk of forfeiture to the facts and circumstances of the case is hardly more definitive.

Generally, these rules would apply to property transferred after June 30, 1969, except for property transferred:

(1) pursuant to a binding written contract entered into before April 22, 1969,

(2) upon the exercise of an option granted before April 22, 1969, or

(3) before February 1, 1970, pursuant to a written plan adopted and approved before July 1, 1969.

We object to this provision for some of the same reasons governing our opposition to the provision on deferred compensation. In general, this proposal tries to do equity by ending supposed tax discrimination in favor of large companies and highly salaried individuals. Here again, we believe that the premises on which this theory is based are in error. The fact is that restricted stock plans, like deferred compensation generally, are of great significance to medium-sized and smaller companies which wish to attract and retain executives without paying them full compensation for services rendered in the taxable year in which such services were rendered.

We think that the proposal would certainly be disruptive; it hardly seems likely that there would be much future utilization of restricted stock plans

if this proposal is enacted into law. It is also quite clear that there would be no revenue gained by the Treasury from enactment of this proposal. Indeed, it is likely that in most cases there would be a significant revenue loss which would result from the fact that the appreciation of the stock, although taxed at ordinary-income rather than capital-gain rates to the individual, would then become fully deductible as additional compensation paid by the employer. No such employer deduction is available, it should be noted, when the appreciation is treated as a capital gain rather than as ordinary income with respect to the individual employee.

From a technical standpoint, one of the major problems with the House provision is the fact that continued capital gains tax treatment would be available with respect to the restricted property only when there is a "substantial risk of forfeiture." As noted, although there is some description of that term in the House Ways and Means Committee report, no precise statement of meaning and scope is offered. Clearly, without substantial modification of the bill on the Senate side, Treasury regulations would have to deal in detail with this term. Until that time, of course, there would be substantial uncertainty as to what the term really means, and resulting uncertainty as to whether or not specific restricted stock plans would be subject to the new provisions.

There are additional arguments against this proposal. In a very basic sense, the appreciation in value of the restricted stock which would be subject to ordinary income taxation is really capital appreciation. Furthermore, there is the very practical problem of the individual's ability to pay the tax when, in many cases, the restricted property in question can not be sold or disposed of in order to get the money to pay the tax. Finally, we believe that the straitjacketing effect which results from Treasury's continual nibbling at restricted stock options and stock options as well, on the assumption that compensation is compensation regardless of the form in which it is distributed, is totally unsound. It misses the point. While it would be naive to argue that such plans are not designed with the tax laws in mind, it is important to recognize that compensation dollars are not homogenous in either the eyes of those being rewarded or those providing the remuneration. The stock form of compensation has a much more important impact than ordinary compensation. Stock in whatever manner received represents an ownership affiliation which is absolutely keyed to providing proprietorship motivation to employees.

STOCK OPTIONS

At the same time that the Congress examines the tax status of restricted stock plans, some consideration should be given to stock options. We feel there is a need for liberalization. In our judgment, the adjustments made in 1964 have swung the pendulum too far in the direction of those who see "tax fairness" as requiring ordinary income tax on every compensation dollar. At this time we suggest two relatively modest amendments. First, the maximum period during which the stock option can be outstanding should be stretched out beyond the current five-year maximum. We think in light of the long-term commitment impact of an option plan coupled with the "vagaries" of the market that the old 10-year rule makes more sense. It would reduce pressure on the employee to exercise his option before it is convenient to do so. Second, the current three-year holding period for optioned stock is too arbitrary and artificial a restriction because it is totally unrelated to the dynamics of the marketplace. Because a stock option plan is encouraged through the tax laws on the grounds it is an incentive to good management doesn't remove the nagging reality that stock prices are not wholly related to managerial performance. We recommend a holding period of not more than 18 months and preferably one year.

MOVING EXPENSES (SECTION 231)

In brief, it is our view that Section 231 of the bill on moving expenses is a step in the right direction but much bolder relief is warranted and technical deficiencies in the proposal should be avoided.

Before considering the specifics of the bill's provisions on moving expenses and in order to lay a foundation for our recommendations, it may be useful to sketch briefly the nature and history of this problem as it affects industry.

To remain competitive and to adjust to continually changing circumstances, corporations frequently find it necessary to relocate employees. One important impediment to maintaining the mobility of the corporate work force is the re-

luctance of employees to accept the financial and psychological burdens involved in company-directed moves. Most companies attempt to minimize at least the financial burden by reimbursing employees for all or a major part of the moving expenses incurred. However, the tax laws, as now written and interpreted, present serious obstacles.

At the present time, allowances or reimbursements with respect to an employee already on the payroll are considered nontaxable to the extent that such payments are limited to the so-called "direct costs," i.e., the costs of moving the employee, his family, and his household goods. In the case of a "new" employee, such payments must be included in his gross income, but he is provided a tax deduction for the reasonable expenses actually incurred in these so-called "direct" moving expense categories. The deduction is also available in the case of an employee who receives no such allowances or reimbursements from his employer. In addition, payments for such moving expenses are not subject to withholding of federal income taxes or federal social security or unemployment compensation taxes to the extent that it is reasonable for the employer to believe that the expenses to which these payments relate are within the scope of the existing deduction for moving expenses. Finally, under the present law, the deduction is available only if the taxpayer's new principal place of work is located at least 20 miles farther from his former residence than was his former principal place of work. In addition, it is required that the taxpayer be employed full-time during at least 39 weeks of the 52 weeks immediately following his arrival at the new principal place of work.

The federal judiciary to which Congress confided this problem at the time of its last legislative action has restricted deductibility to the three classes of "direct" expense, administratively sanctioned by Treasury and noted above, and has indicated that further deductibility must depend upon congressional action. We believe that Congress should now act to recognize that reimbursements for expenses ordinarily and necessarily incurred in the course of an employment-related move are not truly income.

The pending bill would take only limited action by expanding the allowable categories of deductible moving expenses to include the following:

(1) expenses of pre-move house-hunting trips;

(2) temporary living expenses at the new job location, incurred within any 30 consecutive days after obtaining employment; and

(3) residence sale, purchase, or lease expenses, including a real estate agent's commission, escrow fees, appraisal fees, title costs, etc.

These additional categories of moving expenses would be subject to an overall deduction limitation of $2,500, and the expenses related to house-hunting trips and temporary living expenses at the new location would be limited to $1,000 of the $2,500.

Unfortunately, the existing rules granting a tax *exclusion* for payments attributable to the "direct" categories of moving expenses would in effect be repealed by this legislation, so that *all* allowances or reimbursements for moving expenses would be considered items of gross income. Finally, the 20-mile test—one of the two limitations relating to qualifying for the deduction—would be modified to require that the new job location be at least 50 miles farther than the old job location from the former residence. In the case of the other limitation—the 39-week test—the bill would permit its waiver in some cases.

These provisions would apply with respect to taxable years beginning after December 31, 1969.

So far as it goes, the broadening and liberalization of the moving expense deduction which would result from enactment of this proposal should be commended. In general, we feel that the employee should be made whole—without tax penalty—as to all moving expenses ordinarily and necessarily incurred in connection with an employment-related move. Moreover, we question the practicality of some of the specific limitations on time and money included in the bill. There may well be instances in which the 30-day limitation on temporary living expenses at the new location is inadequate. We think that 60 days, or at least 45 days, would be a more reasonable limitation under such circumstances. Secondly, we are concerned about the use of dollar limitations in connection with house-hunting trips, which do not take into consideration the distance involved between the old and the new location. For example, it is reasonable to assume that the cost of a single house-hunting trip across the country by an employee and his wife would consume the entire $1,000 allowance and indeed a substantial part of the total $2,500 allowance. Finally, it would seem only reasonable that any limitations on the allowance for expenses relating to the purchase and sale

of homes should be based at least to some extent on the market values of those homes. We fear that if the rigid dollar limitations are not removed, the form of relief which has been proposed will prove to be grossly inadequate. This, of course, is the type of problem that is always present with a dollar limitation, especially when one considers that any such limitation, even if adequate at the present time, will almost surely become inadequate simply because of the continuing general increases in price levels.

We are strongly opposed to the proposed change from a "20 mile" to a "50 mile" standard. This refers to the provision in the present law under which the deduction is not available unless the taxpayer's new principal place of business is at least 20 miles farther from his former residence than was his old place of business. This requirement is apparently designed to deal with what the House has regarded as abuses when a person might move from one point to another in a suburban area within which the individual's place of business is located. To increase the "20 mile" standard to 50 miles seems to be a niggling and unreasonable type of change. Take the case of an employee who lives within walking distance of his company's location; the company decides to move 45 miles from the former residence of the employee in question; under the new rule, he would not qualify for the moving expense allowance even though he considers it mandatory to move his residence. We strongly urge that if such a test is to be employed at all, it should not be increased to 50 miles.

A final point should also be made with regard to proposed relief on moving expenses. The proposals currently before the Committee are based upon a "deduction" approach. This sort of approach is intended to do equity as between "old" and "new" employees and as between employees who receive moving expense reimbursements from their employers and those who do not. On the other hand, to require reporting of moving expense allowances and reimbursements as gross income even when it is relatively certain that these amounts will be fully deductible, would add greatly to the detail and complexity of the individual employee's tax return. In this connection, we suggest that the Committee should consider the simplified approach taken with respect to the somewhat similar problem of travel and entertainment expenses. In the latter area, if a taxpayer indicates that he has fully accounted to his employer with respect to such expenses, he is not required to report his expenses and reimbursements in detail. We see no reason why such a simplified "exclusion" approach cannot be adopted with respect to an employee's reporting of such moving expense advances and reimbursements, so long as he accounts fully to his employer with respect to the expenses relating to such advances and reimbursements.

Finally, we take note of the related problem of the loss on the sale of a home resulting from an employment-connected move.

It is our hope that enactment of legislation concerning moving expenses will provide full relief at this time; if only limited action is taken, a further and complete relief provision should be enacted as soon as possible.

FOREIGN TAX CREDIT AND OTHER TAX PROBLEMS RELATING TO FOREIGN EARNINGS

(SECTIONS 431 AND 432)

We oppose this section of the bill; what is needed is an overall rethinking of foreign source income taxation, including a reexamination of certain specific matters to which we call attention.

Under present law the credit against U.S. taxes for foreign taxes may be computed on the basis of either the "per country" limitation or the "overall" limitation. The bill would provide that, in the case of a U.S. taxpayer who uses the "per country" limitation, any tax benefit resulting by reason of a loss from a foreign country is to be recaptured when income is subsequently derived from that country. This would be accomplished by reducing the taxpayer's taxable income from that country (or his foreign source taxable income if the "overall" limitation is being used in the subsequent year) by the amount of the loss previously sustained in that country. However, the amount subject to recapture in this manner would be limited to one-half of the taxpayer's taxable income in the subsequent year from sources within the country in which the loss was previously sustained, with any remaining amounts of the loss to be recaptured in years following.

The loss recapture rule contained in this provision would be applicable with respect to losses sustained in taxable years beginning after December 31, 1969.

This provision would mean in essence that any tax advantage derived from

a loss with respect to foreign operations would be recouped by the Treasury out of additional taxes imposed on future profits derived from the country within which such losses were incurred. In effect, such losses would be only temporarily recognized. It would seem to us that if taxes are to be increased in subsequent years to reflect the loss deduction, there should be further liberalization to reduce the impact of such increased taxes.

This provision seems particularly inequitable to us because both the House and the House Ways and Means Committee appear to have ignored the problem of the availability of the "deemed" foreign tax credit with respect to second- and lower-tier subsidiaries in which an American corporation owns less than a 50-percent stock interest. In its original announcement concerning the tax reform hearings, the House Ways and Means Committee expressed interest in whether or not there should be a revision of the "deemed" foreign tax credit in the case of a corporation receiving dividends from a foreign subsidiary.

Presently, the deemed credit is available to an American company with respect to foreign taxes paid by its first-tier foreign subsidiary when the parent company owns at least 10 percent of the voting stock of the first-tier subsidiary. However, a credit is available with respect to a second-tier subsidiary only when the first-tier subsidiary owns at least 50 percent of the voting stock of the second-tier subsidiary.

We recommend that pertinent Code provisions be amended to make the deemed credit fully available with respect to foreign taxes paid by any second- or lower-tier foreign subsidiary so long as there is at least a 10-percent voting stock ownership by an upper-tier foreign subsidiary in which the American taxpayer holds at least a 10-percent interest. In our judgment, the information-reporting requirements imposed by Code Section 6038 and under Subpart F are sufficiently extensive in nature as to assure that adequate information will be available to justify the claim for the foreign tax credit in the case of second- and lower-tier foreign subsidiaries.

Subpart F.—We believe the Committee should consider whether Subpart F of the Code is still serving any valid purpose in preventing alleged tax abuses through the use of foreign subsidiaries. Much has taken place since enactment of Subpart F as part of the Revenue Act of 1962 to prevent any abuses that may have existed. Most significantly of all, transactions between an American parent company and its foreign subsidiaries are now governed by comprehensive Treasury regulations issued under Section 482. At the very least, we urge the Committee to consider the interrelationship between Subpart F and the Section 482 regulations and the extent to which there now exists an unnecessary overlap in these two areas.

Double taxation of foreign earnings.—The new and far-reaching Section 482 regulations have accentuated those problems arising from the fact that a foreign country in which an American taxpayer does business does not treat an item of income for tax purposes in the same manner in which it is treated by the Internal Revenue Service. For example, in some cases, a foreign country will not permit a tax deduction for a payment made by a foreign subsidiary to an American parent company in circumstances under which a deduction would be available under American tax law. In some measure, such problems can be resolved under pertinent double-tax provisions of a tax treaty between the United States and the foreign country in question. Under treaties presently subsisting with other major industrial countries, double-tax problems of this character are to be adjusted through negotiation by the "competent authorities" of both countries.

We are informed that these treaty provisions have not led to a satisfactory resolution of double-tax problems affecting individual companies. Although we recognize the inherent difficulties of such negotiations and the need for U.S. Government representatives to gain experience, some problems appear to have resulted from dilatoriness or less-than-vigorous pursuit of reasonable settlement by the U.S. "competent authority"—the Office of International Operations of the Internal Revenue Service. In addition, there is the overriding question as to whether the double-taxation problem should be left to negotiation by country representatives. This issue is of such importance—involving both equity to a U.S. taxpayer and equity to the U.S.—that, in our judgment, it deserves priority considerations by the Congress and the Treasury Department.

Section 367 rulings.—The present Code Section 367, dating back to 1932, requires a U.S. taxpayer to obtain an advance Treasury ruling that tax avoidance is not a principal purpose in certain types of transactions which relate to the organization, reorganization, or liquidation of foreign subsidiaries. In the absence

of such a ruling, the taxpayer must recognize as a gain for tax purposes the difference between the value of the property transferred and the cost basis of the property.

To repeat a point made earlier, much has happened in recent years—particularly during the 1960s—to avert alleged tax abuses relating to income earned abroad by foreign subsidiaries of U.S. parent companies. These include, for example, Subpart F enacted as part of the Revenue Act of 1962, the comprehensive regulations under Section 482 issued last spring, and the very extensive regulations implementing the information-reporting requirements relating to foreign business operations under Code Sections 6038 and 6046.

Serious practical difficulties result from the necessity for literal compliance with Section 367. One of the major problems, of course, is the delay normally incident to a Section 367 ruling. Business opportunities often cannot await the four to five months typically required to obtain such a ruling. Another problem arises where the U.S. company does not have sufficient advance notice of a transaction which might fall within the scope of Section 367, and this difficulty is often compounded by the fact that the U.S. parent company may not have effective day-by-day control of the management of the foreign corporation.

It is true that the Service has recently issued general guidelines with respect to criteria relating to Section 367 rulings, but it would appear that such guidelines do not solve the basic problem under Section 367. In our judgment, the primary difficulty lies in the fact that the Service normally will exact some type of "toll" as it were, in the form of a taxpayer agreement to recognize some gain and pay some tax, in connection with the transaction.

For the reasons indicated above, we recommend that Section 367 be amended to drop the advance ruling requirement and that there be substituted for it authority for an after-the-fact justification by the taxpayer. In addition, we urge that Section 367 be included as a part of a comprehensive and urgently needed congressional study of the taxation of foreign earnings and what might be done to improve present policies and procedures in this area.

In conclusion beyond reemphasizing the need for an overall reexamination of foreign source income taxation by the Congress, we call attention to a dangerous drift in U.S. policy of which foreign source income tax policy is only a part. This drift adds up to significant interference with private foreign investment decision making and free capital flows. Other elements in the picture include the enactment and repeated extension of the Interest Equalization Tax Act, foreign investment controls, the termination of which is not in sight, an apparent desire on the part of our government to favor, by regulation or by providing incentives, investment in developing versus developed countries, etc.

REAL ESTATE DEPRECIATION (SECTION 521)

The House bill would permit only straight-line depreciation or declining-balance depreciation limited to 150 percent to be taken with respect to depreciable real property. However, there would be a specific exception for new residential housing which would continue to be eligible for the accelerated methods of depreciation—double declining-balance and sum of the years-digits. In all cases, however, any again on the sale after July 24, 1969 of new real property would be taxed as ordinary income to the extent of depreciation in excess of straightline depreciation taken after July 24, 1969. Under present law, any such recapture is limited to property held for 20 months or less; beyond that period of time, recapture is reduced by 1 percent per month for each full month the property is held over 20 months, and when the property is held for 10 years or more the amount recaptured is zero.

Our remarks are limited to the impact of this provision on *industrial* realty. We oppose this provision because it fails to recognize the special problems relating to industrial real property—that is, real property used in connection with the manufacturing process. In our view, such a provision, if adopted, would increase the existing discrimination against industrial real property implicit in the investment credit provisions of he Code under which buildings and the structural components of buildings may not qualify for the investment credit. Even assuming that this Committee concurs in the House action repealing the investment credit and putting aside the fact that the investment credit provisions have discriminated against industrial realty for as long as they have been effective, it should be noted that under the depreciation guidelines promulgated by the Treasury in 1962 (Revenue Procedure 62-21), there is no general

reduction in useful lives for buildings comparable to that provided for machinery and equipment. For example, useful lives for productive machinery and equipment were reduced by 33⅓ percent while the life for factory buildings was reduced by only 10 percent.

We urge the Committee to instruct the staff of the Joint Committee on Internal Revenue Taxation to investigate what appears to be a continuing discrimination against industrial realty. In this connection, the Committee should bear in mind that modern buildings and building components are essential to dynamic technological development. Machinery modernization must be coordinated with plant modernization and design. This is especially true in the "systems" approach to manufacturing. It is fair to say that worker safety and comfort are also involved.

CAPITAL GAINS AND LOSSES (SECTIONS 511–516)

Significant changes would be made under the provisions of the bill in the present system of taxing long-term capital gains. We oppose the proposed changes both on substantive grounds and because, like certain other sections of the bill, they seem to represent a "hit and run" attack on a major area of tax policy without an overall review of the widesweeping tax policy considerations involved and without a careful balancing of public policy impacts. As to the latter, the bill reflects an apparent desire to narrow an alleged area of tax preference without fully considering the public policy objectives of favorable treatment of capital gains and losses under our tax system.

Tax policy affecting capital gains and losses has been the subject of extensive study over the years. The area has been addressed from the standpoint of equity, national economic objectives, and considerations of tax administration. It seems to us that economic goals in connection with capital gains taxation are central. In his book *Federal Tax Reform*, McGraw-Hill Book Company, Inc., 1961, at page 125, the distinguished tax scholar and former government tax official Dan Throop Smith puts it this way:

". . . Capital gains represent a reward for risk investment, and risk investment is especially important for economic growth. Capital gains also represent a form of 'income' which is most likely to be saved; in fact, realized capital gains are automatically reinvested along with the rest of one's capital when one sells one security and buys another. . . ."

There is a further argument for special tax treatment of capital gains which is a threefold economic one in character. Dr. Smith continues:

". . . Special taxation [of capital gains] is advocated to increase the total amount of capital, to encourage its use in more risky investments, and to prevent successful investments from being frozen into their existing form. These are all significant points.

"Increased savings are needed to finance new capital investment which may increased labor productivity and national income. . . .

"It is also important to have capital go into new ventures and equity investment which is necessary for economic development. . . .

"Finally, there is the economic argument for fluidity in investment markets. A willingness to shift from successful ventures permits risk-minded investors to finance new ventures. More importantly, fluidity will help to prevent overvaluations in market booms. . . ."

In a later book entitled *Tax Factors in Business Decisions*, Prentice-Hall, Inc., 1968, at page 80, Dr. Smith underlines the fact that the capital gains tax is probably paid out of capital to a greater extent than any other tax except the estate and gift taxes. Some carry this point one step further and argue that the capital gains tax is a capital levy and therefore if capital gains are taxed at all the impact should be minimized.

Turning to the views of another tax authority as expressed in the book *Federal Tax Policy* by Joseph A. Pechman, published by The Brookings Institution, Washington, D.C., 1966, Mr. Pechman concludes at page 63: "Numerous studies have demonstrated that the opportunity to earn income in the form of capital gains stimulates investment and risk taking." He also points out that much of the nation's investment is undertaken by large corporations, a fact which has considerable bearing on the thrust of the proposed changes in the treatment of capital gains taxation as contained in the current bill; these changes affecting both capital gains to individuals and to corporations.

Proposed Changes Affecting Rates and Holding Period

Turning to the specific provisions of the bill, in the case of individuals the 50-percent deduction from ordinary income for long-term capital gains would

continue to apply but the alternative of a 25-percent maximum rate on such gains would no longer be available. Since the bill otherwise provides for lowering the top rate on individual income from 70 percent to 65 percent this would mean that the maximum rate on long-term capital gains for individuals eventually would be 32½ percent. The repeal of the alternative 25-percent maximum rate would apply to sales and other dispositions after July 25, 1969. With respect to corporations, the capital gains rate would be increased from 25 percent to 30 percent, for sales and other dispositions after July 31, 1969.

The holding period for qualification of a capital gain as a long-term capital gain (and thus eligible for favorable capital gains tax treatment) would be changed from six months to one year. This provision would also apply to taxable years beginning after July 25, 1969.

Applying the considered judgments quoted above, an increase in the capital gains rates affecting individuals (and clearly they wuold be increased in the upper brackets of the personal income tax structure) and for corporations will have a deleterious effect on risk investment, particularly as to new ventures and equity investment, on economic growth, and on the element of fluidity in investment markets. As to individuals, for example, the changes in capital gains treatment would clearly induce holding down on the number of capital transactions. In the case of an individual in the top bracket (assuming that in accordance with the House bill the maximum rate for individuals on the ordinary income is reduced from 70 percent to 65 percent) the increase in the capital gains rate from 25 percent to 32½ percent would amount to an increase in the capital gains tax rate of nearly one-third. When this result is coupled with the change in the required holding period, how can this bill fail to cause a slowdown in the number of capital transactions with its adverse effect on the economic considerations to which we have referred? There also is the question as to whether the changes in the capital gains structure contained in the current bill will have a perverse effect on tax revenues. Clearly, the impact on corporate investment flowing from the increase in capital gains rates is bound to be adverse, particularly as to marginal projcts.

In general, to evaluate the pros and cons of the proposed changes in the taxation of capital gains requires an overall examination of the whole capital gains picture and, as we have said previously, a careful weighing of all of the public policy objectives underlying present tax treatment. We venture to suggest that this job of study has not been done and that the piecemeal and, in our judgment, ill-conceived changes now contained in the pending legislation if enacted into law will represent a disservice to the country. They are particularly dangerous if they serve to establish a precedent for further and more severe tightening of capital gains taxation.

Finally, although there may be some debate under normal economic conditions as to the degree to which the capital gains tax is a capital levy, during periods of inflation the effect of a capital levy certainly seems to be present. It is not at all unreasonable to suggest that a very high percentage of the so-called capital gain computed on the basis of original cost without allowance for inflation is illusory.

Capital Losses

Another major change in the bill would apply to the deductibility of capital losses in the case of individuals. The present Code provisions specify that such losses are fully deductible against ordinary income up to the amount of $1,000, after first being offset against capital gains. Any excess may be carried forward for an unlimited number of future taxable years. The bill would change this treatment to the extent that only 50 percent of net long-term capital losses would be deductible against ordinary income subject to the $1,000 limitation, effective for taxable years beginning after July 25, 1969.

We are opposed to this provision. As we understand it, this proposal is intended to equalize the treatement between long-term capital losses and long-term capital gains to reflect the fact that only 50 percent of such gains are required to be included as taxable income. But this overlooks the fact that a long-term capital loss is deductible against ordinary income only to the extent of $1,000 in any particular year. Accordingly, the proposal would seem to make no sense logically unless it also included a repeal of the $1,000 limitation.

Beyond the question of logic, however, it seems to us that the proposal can be faulted on the grounds that it will discourage capital transactions and thus in the long term reduce federal revenues. Even more importantly it clearly will deter investments entailing high risk of loss, simply because tax recognition

of such losses would be drastically limited. Much of what we have said above about the economic policy underlying special treatment of capital gains applies here also.

Distribution From Qualified Employee Pension, Profit-Sharing, Stock-Bonus, and Annuity Plans

The bill would also change the current tax treatement as a capital gain of a lump-sum distribution to an employee from a qualified pension, profit-sharing, stock-bonus, or annuity plan. Such distributions, to the extent of benefits paid within one taxable year and to the extent of employer contributions made on or after January 1, 1970, would be treated as ordinary income. These provisions would be effective with respect to employer contributions to qualified plans made during plan years beginning on or after January 1, 1970.

Our opposition to the capital gains sections of the bill extends to this provision also. The current capital gains treatment has now been in effect since 1942. To impose an ordinary tax on the full amount of lump-sum payments would cause a severe tax result if the recipients were pushed into much higher tax brackets. Moreover, the present rule, in our opinion, has worked reasonably well in encouraging the establishment and growth of such plans. This is, we think, a desirable public policy goal. Unquestionably, this proposal, to the extent that it calls for increased taxes, would discourage the continuance of the existing widespread utilization of such plans. Moreover, the provision would have a particularly adverse effect upon profit-sharing plans because this type of plan relies very heavily for its success on lump-sum distributions. In most instances, employees have an option to choose between a single lump-sum distribution of these benefits or distribution in installments over a period of years. The suggested change in tax treatment would weigh so heavily against a lump-sum distribution as to make it impracticable for employees to exercise that option. We feel that such a result would be highly unfortunate because it would tend to decrease the usefulness of profit-sharing plans. Our opposition to the proposal for full ordinary income treatment for unrealized appreciation on employer stock is based primarily on the fact that we feel that such a change would mean the end of stock distribution plans from a practical point of view.

TAX ACCOUNTING PROBLEMS

In recent months the Treasury and the Internal Revenue Service have taken major administrative steps in respect to certain fundamental accounting questions. They are of such importance, both currently and prospectively, as to justify comprehensive legislative review. Each is discussed briefly below.

Advance Payments

We wish to call the Committee's attention to efforts of the Internal Revenue Service to apply in inappropriate cases the rule of the Tax Court in the *Hagen* case in which that court held that a manufacturer of advertising signs, who received advance payments from customers in a taxable year prior to that in which the goods are received, must include such payments in income in the year they are received. This decision, which has recently been affirmed by the U.S. Court of Appeals for the Sixth Circuit, has been applied in cases involving the sale of equipment which is frequently purchased under long-term contracts.

In our view there is very considerable doubt as to the merits of a general rule taxing advance payments received in connection with the sale of tangible property. But, of much greater significance is the undesirability of imposing any such rule with respect to the receipt of advance payments in connection with the sale of medium- to long-production cycle items of capital equipment at relatively high cost as distinguished from the high-volume sale of retail goods at relatively low cost. Because of the high unit cost and production cycle characteristic of capital goods, advance payments have by custom and usage come to be regarded as an essential means of financing production.

We think that the time has definitely arrived for a comprehensive review by the Committee of accounting rules and problems under the Code with a view toward making some fundamental changes in this area. We are, of course, familiar with the abortive experience with respect to Sections 452 and 462 in the Code. These provisions, permitting the deferral of tax on prepaid income—including, of course, advance payments—and the accrual of reserves for estimated expenses, were a part of the original Internal Revenue Code of 1954 but were repealed rather suddenly in early 1955 at the urgent request of the Treas-

ury. At the time of the repeal, it was indicated that the accounting problems which these provisions were designed to deal with would continue to undergo intensive study in the Congress with the eventual goal of bringing federal income taxes into harmony with generally accepted accounting principles.

Reverting to the *Hagen* case specifically, as previously indicated, we believe the rule of the case is being administratively applied to inappropriate situations. The problems involved are so diverse that judicial decisions alone are not likely to solve them. We submit that legislation is needed and that Congress should follow through on its original commitment to consider the matter. There is much merit, in our opinion, to suggestions that legislation be enacted permitting tax deferral on advance payments with respect to the sale of tangible goods and products. Among the advocates of this position is the American Institute of Certified Public Accountants.

In concluding our observations on this issue, we summarize our objections to the overapplication of the *Hagen* rule to advance or progress payments on sales of industrial goods:

1. It violates good accounting in two respects.

(*a*) By taxing receipts at a time when it is uncertain as to whether or not they will result in any taxable net income, and

(*b*) It poses almost insuperable problems of matching costs and related revenues.

2. The taxation of advance and progress payments poses a threat to the very structure of the capital goods industries inasmuch as such payments are characteristically contracted for to provide working capital to finance long-production cycle projects.

3. Finally, producers, in effect denied the use of advance or progress payments when they are taxed on receipt, must resort to external financing, the cost of which is tax deductible. In revenue terms the result could well be disadvantageous to Treasury and the tendency would be to force prices upward.

May we also submit for the record a copy of an analytical memorandum published by MAPI on April 25, 1969 entitled "Taxation of Advance Payments."

"Methods of Accounting"

Last December the Revenue Service released for public comment proposed regulations under Section 446 of the Code on changes in "methods of accounting," which for the first time spell out what constitutes a change in accounting method. Only a limited number of accounting changes are recognized as changes in accounting method by the new proposal. Presently, if a change in a taxpayer's accounts represents a "change in accounting method" within the meaning of the Code and pertinent regulations, Code Section 481 provides a partial amelioration of the tax impact of any such change by authorizing in effect a "three-year spread" for accounting gains realized from the change in method.

In February 1964, the Revenue Service issued Revenue Procedure 64–16 which authorizes taxpayers, with permission of the Commissioner, to make certain changes in accounting "practices"—not "methods"—with any resulting tax adjustments to be taken into account ratably over a 10-year period. It is to be assumed that final regulations concerning "changes in accounting method" will probably modify—in the direction of making the two directives compatible—the existing Revenue Procedure 64–16 relating to "changes in accounting practice."

Although highly technical in character, these regulations, existing and proposed, can so seriously affect a taxpayer in the individual case as to justify congressional oversight of their realignment. We urge that consideration be given to revising Sections 446 and 481 of the Code. Specifically, we recommend that the "three-year spread" authorized for absorbing the impact of changes in accounting method by Section 481 be amended to permit a "ten-year spread" as now permitted for changes in accounting practice by Revenue Procedure 64–16. Additionally, we recommend that final regulations should substantially broaden eligibility for the types of changes qualifying as a "change in accounting method."

Inventory Valuation

Another Internal Revenue Service proposal which would affect established accounting practice is now under active consideration by the Service. Although not published officially pursuant to the Administrative Procedure Act, a draft revenue ruling defining permissible—and impermissible—methods of inventory valuation has been circulated by the Service to various interested groups for review and comment. In brief, this proposal would declare as unacceptable for

income tax purposes the "prime cost" (excluding all overhead) and the "direct cost" methods of inventory valuation. Conversely, the "normal capacity" method of inventory valuation, under which the ration of actual capacity or production attained in the current year to the normal or maximum practical capacity attainable is used as a basis for allocation of fixed expenses properly includable in indirect maunfacturing cost to inventories, would be considered acceptable for tax purposes.

Adoption of this proposal in final form would cause extensive and costly changes in inventory valuation procedures long employed in industry and sanctioned by professional accounting authority. It would amount to a substitution by the Revenue Service of its judgment for that of the taxpayer as to the accounting method best adapted to the taxpayer's situation. We do not believe this directive should be issued in its present form and we recommend the subject for inclusion in the legislative review suggested above.

Reserves for Estimated Expenditures

Finally, we believe that there should not only be statutory sanction for the deferral of tax on prepaid income but that accrual of reserves for estimated expenditures should be authorized by statute. Such provisions (consistent with the now repealed Section 462) should permit a deduction for additions to reserves for estimated liabilities to customers, including, for example, liabilities for trade and cash discounts, allowances of product guarantees, advertising allowances, sales returns and allowances, etc. Taxpayers on the accrual basis should be permitted an option, as in the case of bad debts, of deducting such expenses when incurred or electing to deduct additions to reserves for such expenses. Such an election would in itself reduce the revenue loss which would result if taxpayers were required to adopt an all-inclusive treatment for all possible items of qualified estimated expenses.

ACCUMULATED EARNINGS TAX

A significant number of the members of the Machinery and Allied Products Institute are closely held enterprises and thus particularly concerned with the application of the accumulated earnings tax.[1] In our judgment, the statutory provisions calling for imposition of such a tax as well as administrative regulations and their application in the field require at least periodic review by the Congress. Some years have passed since Congress has considered this matter, and we think it timely for such a review. Such reconsideration should as a minimum include consideration of the following questions:

1. Is the administration of the law inhibiting growth and development?
2. Are the burden-of-proof provisions in the 1954 Code working as intended and/or can they be improved?
3. Does it make any sense to provide for a shift of burden of proof in the Tax Court but not in cases before a United States District Court or the Court of Claims?
4. Are specific "business needs" such as "redemption of stock," "contingency funding, " "future needs," "investment needs," etc., given proper weight in the light of current operating conditions?
5. Is the intent of Congress to protect the continuity of small business, as illustrated in Section 303, being achieved?
6. Is further liberalization required in order to assure the future growth and development of smaller firms?

CHARITABLE CONTRIBUTIONS (SECTION 201)

Although tax treatment of charitable contributions is not within the area of tax policy to which the Institute has given special attention over the years, we should like to make a few brief comments and suggestions as to the pertinent provisions in the bill. In our judgment, this section of the bill is a perfect example of the fallacy of attempted loophole closing without careful consideration of possible or probable counterproductive impact on public policy objectives. For example, the proposed repeal of the unlimited deduction provision and the change in the treatment of the appreciation in value of property which is contributed may very well have exceedingly adverse effects on the pattern of giving by the category of individuals upon whom our system has depended heavily for support of social, educational, and other charitable causes. James Reston of the *New*

[1] See *The Accumulated Earnings Tax—Reasonable Business Needs Versus Tax Avoidance*, MAPI, 1967.

York Times has underlined this concern in his column on August 31, 1969, and he reports widespread apprehension by the universities and their administrators.

In addition to this general observation one specific and technical point should be made. We understand that some companies have followed the practice of entering into commitments to contribute at some future date, as in the case of donation of equipment to educational institutions. The effective date provision of this new tax treatment might therefore have a significant retroactive effect as to such agreements if changes are finally legislated along the lines of the pending bill. In our judgment, this point should be sympathetically considered.

In brief, we believe that the whole section on charitable contributions needs a hard second look. Public policy considerations must be given a heavier weighting in the decision; this loophole closing effort should be put in perspective and carefully reexamined.

This concludes the formal statement of Machinery and Allied Products Institute on H.R. 13270. If the Institute and its staff can be of further assistance to the Committee, we hope you will call on us.

TABLE 1.—COMPARISON OF DEPRECIATION DEDUCTIONS, INITIAL AND INVESTMENT ALLOWANCES[1] FOR INDUSTRIAL EQUIPMENT IN LEADING INDUSTRIAL COUNTRIES WITH SIMILAR DEDUCTIONS AND ALLOWANCES IN THE UNITED STATES

	Representative tax lives (years)	Depreciation deductions, initial and investment allowances (percentage of cost of asset)		
		1st year	1st 2 years	1st 5 years
Belgium	8	22.5	45.0	92.5
Canada	10	30.0	44.0	71.4
France	10	25.0	43.8	76.3
West Germany	10	20.0	36.0	67.2
Italy	10	25.0	50.0	110.0
Japan	16	43.4	51.0	68.2
Netherlands	10	26.2	49.6	85.6
Sweden	5	30.0	51.0	100.0
United Kingdom	27	39.0	46.3	64.0
United States:				
Without investment credit and lives equal to current Bulletin F weighted average of 19 years		10.5	19.9	42.7
With lives of—				
15 years		13.3	24.9	51.1
14 years		14.3	26.5	53.7
13 years		15.4	28.4	56.6
12 years		16.7	30.6	59.8
11 years		18.2	33.1	63.0
10 years		20.0	36.0	67.2
With investment credit and lives equal to current Bulletin F weighted average of 19 years[2]		(24.5) 26.5	(33.9) 35.9	(56.7) 58.7
With lives of—				
15 years		(27.3) 29.3	(38.9) 40.9	(65.1) 67.1
14 years		(28.3) 30.3	(40.5) 42.5	(67.6) 69.7
13 years		(29.4) 31.4	(42.4) 44.4	(70.6) 72.6
12 years		(30.7) 32.7	(44.6) 46.6	(73.8) 75.8
11 years		(32.2) 34.2	(47.1) 49.1	(77.0) 79.0
10 years		(34.0) 36.0	(50.0) 52.0	(81.2) 83.2

[1] The deductions and allowances for each of the foreign countries have been computed on the assumption that the investment qualifies fully for any special allowances or deductions permitted. The deductions in the United States have been determined under the double-declining balance depreciation method, without regard to the limited 1st-year allowances for small business.

[2] For purposes of this table, the 8-percent investment credit has been considered as equivalent to a 16-percent investment allowance. For corporations subject only to the 30 percent normal tax it is equivalent to an investment allowance of 27 percent. The figures in parentheses indicate the effect of a 7-percent credit, equivalent to an investment allowance of 14 percent (23 percent for corporations subject only to the normal tax).

Source: Treasury Department, Office of Tax Analysis, Apr. 2, 1962.

[ADVANCE DRAFT]

UNDERDEPRECIATION FROM INFLATION—A GHOST RETURNS

(By George Terborgh, MAPI Research Director)

To the accountant, an investment in plant or equipment is a prepaid cost, to be charged to operations and recovered to cash over the serviceable life of the facility. It is the object of depreciation policy to allocate this cost over successive periods of time or units of production by some systematic procedure calculated to complete the process by the time the asset is retired. While we

may quarrel with some of the methods of allocation used (a matter not discussed here), the general principles and purpose of depreciation are correctly stated—subject, however, to one proviso. The total of charges over the service life should recover the cost of the asset *in dollars of equivalent purchasing power.*

Ordinarily, depreciation recovers only the number of dollars originally committed to the asset, regardless of differences in their purchasing power. This recovery is satisfactory enough in periods of relative stability in the price level, but can be seriously, or even ruinously, inadequate during and after periods of inflation. Under such conditions we cannot assume that a dollar is a dollar. To protect its *real* capital, a company must recover each year a number of *current* dollars equivalent to that year's capital consumption in *original* dollars. This yields a result in real terms identical with that accomplished by a recovery of the original investment itself in a period of stable prices.

THE GREAT DEBATE

Shortly after World War II, there was a lively controversy over the adequacy of business depreciation charges based on historical cost. It engaged a wide variety of disputants—academicians, management, the accounting profession, government agencies, and stock exchanges.

Throughout the debate, the federal agencies concerned with the regulation of business accounting practices—the Internal Revenue Service, the Securities and Exchange Commission, the Federal Power Commission, the Federal Communications Commission, the Interstate Commerce Commission, and others—stood uncompromisingly for original-cost depreciation.[1] As for the accounting profession, it went only so far (in its official pronouncements at least) as to suggest annotations to financial statements—the "footnote" solution. Management might append its estimate of the inadequacy of the original-cost depreciation charged, but the notation would have no effect on the accounting results.

This largely negative outcome of the great debate may be attributed in part to an illusion shared by most of the participants. It was assumed that the stiff wartime and postwar inflation had about run its course, and that if nothing were done about the underdepreciation problem it would gradually shrink and disappear.

This proved in the event to be an optimistic expectation. It is true that the rate of inflation did slow down after the surge of 1945–48, and that subject to a couple of renewed spurts for limited periods (1950–51 and 1955–57) it remained generally moderate until the mid-sixties. But since then it has been rapid and persistent. The underdepreciation problem has returned like a ghost from the past to haunt both public and private policy. It is timely, therefore, to take a fresh look at it.

RATIOS OF CURRENT-DOLLAR TO HISTORICAL-COST DEPRECIATION

If the purchasing power of the dollar had remained where it was left by the initial postwar inflation of 1945–48, the addition of new assets to the existing stock of productive facilities at current prices and the progressive retirement of old assets acquired at earlier and lower price levels would have gradually raised the average of prices underlying historical-cost depreciation toward parity with current prices. Because of the continued uptrend of current prices, however, the convergence of the two series was never completed.

While the ratio of current-dollar to historical-cost depreciation declined irregularly after 1948, it remained significantly above 1.00 even at its low in the mid-sixties, and is now rising rapidly. This is portrayed graphically in Chart 1 on page 4.[2]

Note that the ratio rose rapidly during the early postwar years to 135 percent, declined thereafter to around 108 percent in the mid-sixties, and has since been rising at an accelerating rate (the prospect for 1970 being about 115 percent).

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[1] In this they were supported by the New York Stock Exchange. It joined forces with the SEC to attack a leading steel company which undertook to charge price-adjusted depreciation on its own books (though not for tax purposes).

[2] Department of Commerce estimates, except for 1969 and 1970, which are ours. For [illegible] Allan H. Young, "Alternative Estimates of Corporate Depreciation and [illegible]," Survey of Current Business, April 1968, p. 17, and May 1969, p. 18. [illegible] double declining-balance depreciation [illegible] of prior years (exclusive of residential property), at [illegible]. The accruals so computed are converted [illegible] by the use of indexes of capital goods prices. The [illegible] (reduced) indexes of business construction costs developed by the Department for this purpose.

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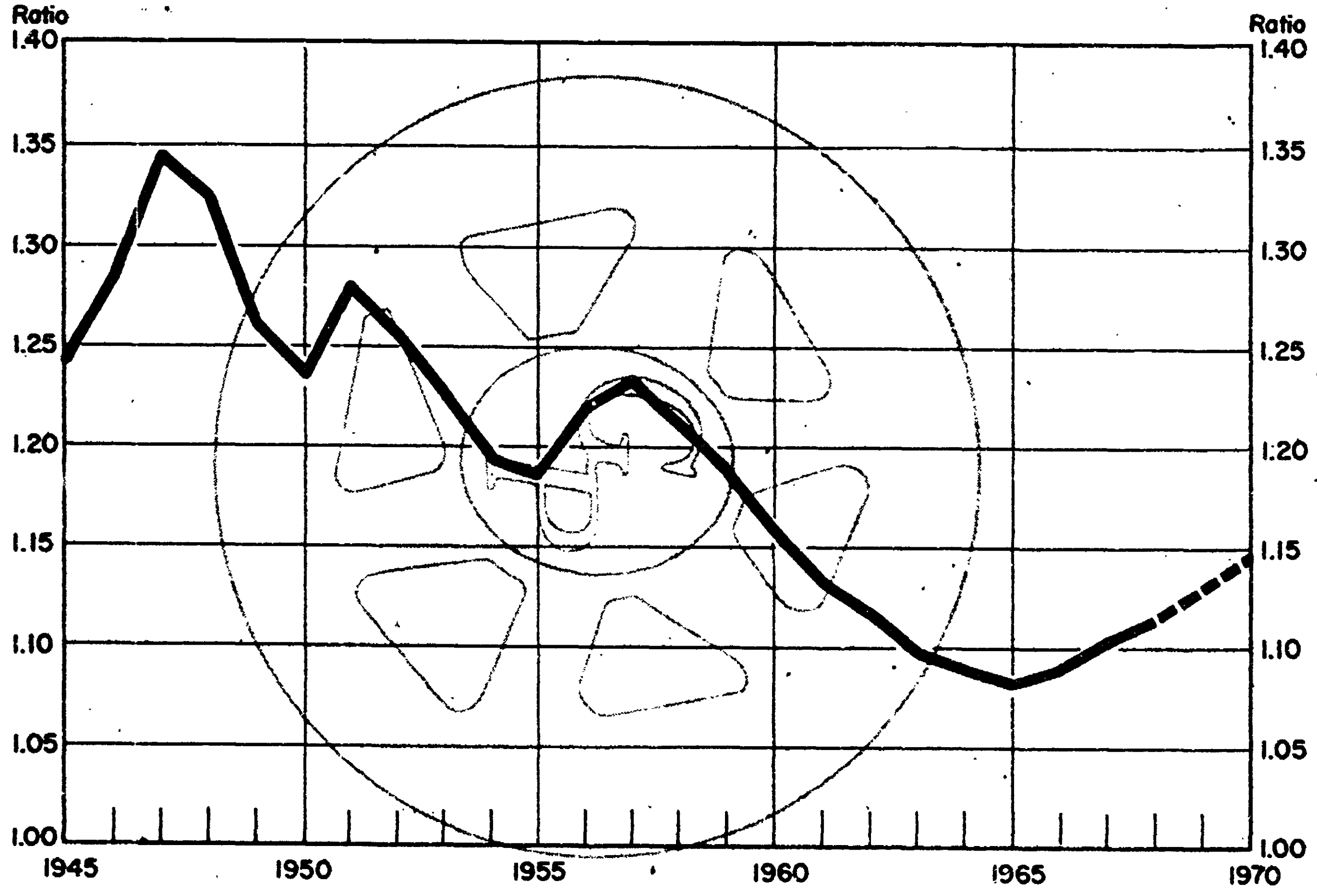
CHART 1.

RATIOS OF CURRENT-DOLLAR TO HISTORICAL-COST DEPRECIATION, FOR ALL NONFINANCIAL CORPORATIONS

(Double Declining-Balance Method)



AMOUNT OF UNDERDEPRECIATION

We turn now to the next step in the analysis, the measurement of the *amount* of underdepreciation. This is of course the excess of the current-dollar over the historical-cost accrual.

Notwithstanding the fact that the ratio of current-dollar to historical-cost depreaction declined after the postwar peak, the volume of assets to which it applied grew so rapidly that the *amount* of underdepreciation continued to rise for many years (to 1957). This is shown in Chart 2 on page 6.[1]

Note that the estimated deficiency of historical-cost depreciation will be around $7 billion next year (1970). If we add to this an allowance for financial corporations and for unincorporated enterprises, the total for all American business will be nearly $10 billion.[2] If we added further an allowance for residential property and for nonprofit institutions, we would get a still higher figure for all privately-owned assets.

These computations are based, of course, on the assumption that depreciation is taken consistently by the double declining-balance method. Actually, it has been taken by a variety of methods, including not only this one but sum-of-digits, straight-line, units-of-production, and others. It appears, however, that the combination of methods taken *for income-tax purposes* has yielded an historical-cost accrual in recent years close to the computed figure.[3] This suggests that the computed deficiency is reasonable realistic.

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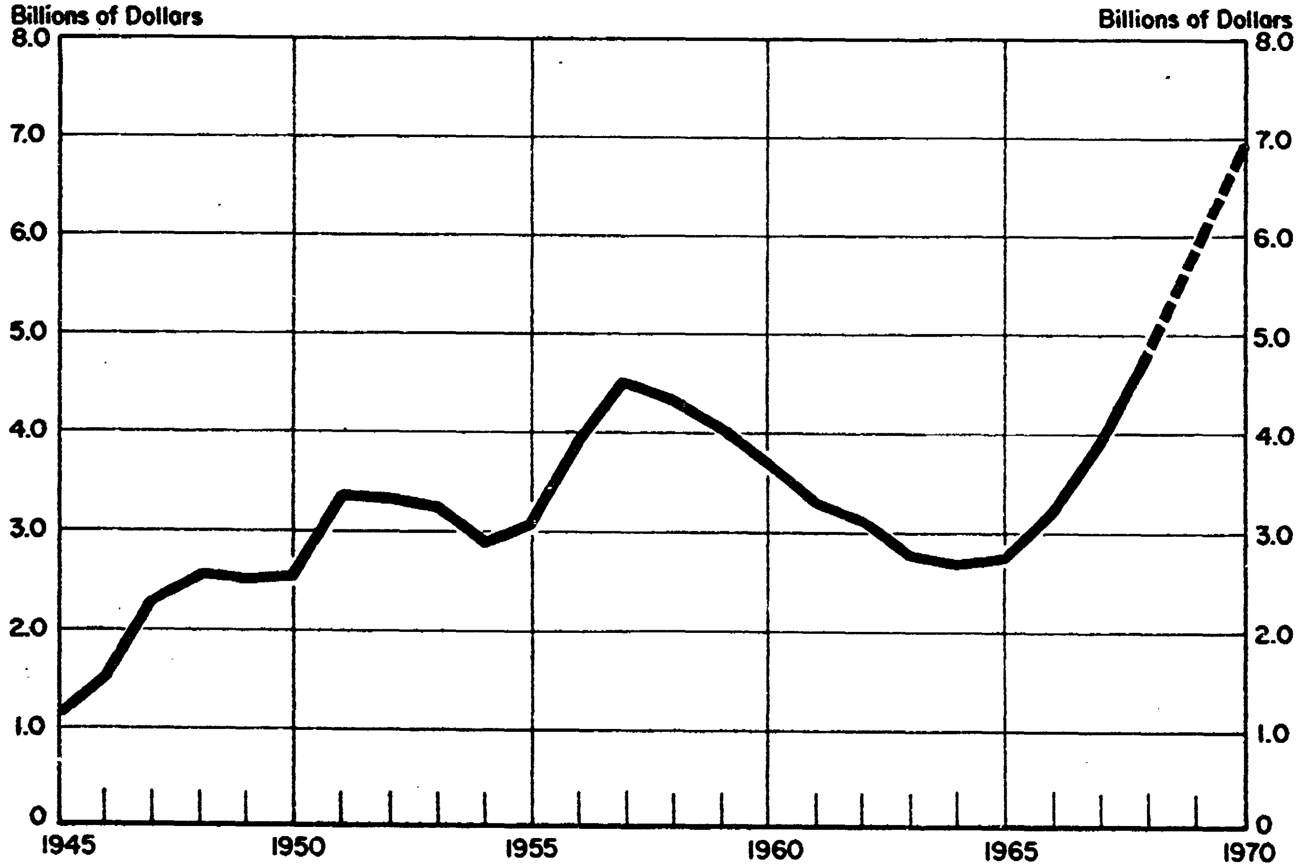
[1] The source is the same as for Chart 1.

[2] Since they are computed for double declining-balance depreciation, these figures are relatively conservative. As this is an accelerated writeoff, a larger proportion of the historical-cost accrual is on recent installations than would be the case with the straight-line method, hence computed deficiencies are lower than would be obtained with that method.

[3] For 1966, for example, the computed figure was $36.3 billion, against the comparable "NIA-IRS" depreciation of $35.6 billion.

CHART 2.

AMOUNTS BY WHICH CURRENT-DOLLAR DEPRECIATION EXCEEDED HISTORICAL-COST DEPRECIATION, FOR ALL NONFINANCIAL CORPORATIONS
(Double Declining-Balance Method)



SOME TREND CALCULATIONS

Historically, the inflation rate has been highly irregular, and the computed current-dollar to historical-cost ratios reflect this fact. It may be interesting to inquire on a hypothetical basis what they would settle at if inflation were to be maintained indefinitely at a constant rate.

We have computed this for equipment and plant (buildings and structures) separately on the following assumptions: (1) The growth rate of installations in *real* terms (ex inflation) is 4 percent per year; (2) Equipment has an average life of 15 years, plant of 40 years; (3) Depreciation is by the double declining-balance method at rates corresponding to these lives; (4) Inflation is alternatively 3 percent and 5 percent per year. The results follow.

Inflation rate	Ratio of current dollar to historical cost depreciation (percent)	
	Equipment	Plant
3 percent	114	132
5 percent	124	152

If the recent 5-percent inflation rate were to continue indefinitely, historical-cost depreciation would have to be raised by nearly a quarter for equipment and by more than half for plant. Given the usual mix of the two, the increase factor for both combined would be close to 30 percent. This compares with the 15 percent anticipated for next year on the basis of *past* installations and price-level changes.

CONCLUSION

The problem of underdepreciation from inflation is not going to go away. On the contrary, it is almost certain to get worse.

American business will pay income tax next year on something like $10 billion of capital consumption. This is a curious state of affairs in a country as devoted as ours to the idea of progress, economic expansion, and rising standards of living. For the taxation of capital consumption as income is not only inequitable, it has one certain effect: the retardation of progress through curtailment of the funds available to industry for capital investment. Under present conditions historical-cost tax depreciation is a "built-in" decelerator of progress.

If the present deficiency of depreciation due to inflation is not made good by the restatement of historical-cost accruals in current dollars—the most direct and equitable solution—it clearly makes urgent some alternative measure or measures. This is particularly true in view of the proposed repeal of the investment credit, a powerful support of investment over the past seven years. The United States cannot afford to tax capital consumption as income if it wants to stay competitive in international trade, to say nothing of realizing its technological potential for the benefit of its own citizens.

One remedy less direct and effective than the price-level adjustment of tax depreciation is a further acceleration of the historical-cost writeoff itself. The United States is behind most of its industrial rivals in this respect. But such an acceleration would have to be very substantial indeed to offset the $10 billion of underdepreciation estimated for the next year, not to say the higher deficiencies expected later. If this is the route taken by the Administration (and there are rumors that it may be), it is to be hoped that the proposal will be commensurate with the dimensions of the problem.

[From the Wall Street Journal, Sept. 3, 1969]

TAX 'REFORM': ADDING HODGEPODGE TO HODGEPODGE

(By Gene A. Wormser)

It is to be hoped that the Senate will use a sharp knife in operating on The Tax Reform Act of 1969. The House gave itself only a few days to consider it, permitted only short debate, and allowed no amendment. In view of the shortness of time and the truly unbelievable chore of even reading it, it is reasonable to conclude that few Congressmen had much comprehension of the act's detail.

Its amazingly intricate provisions would stump the understanding of even a highly experienced tax expert without his giving it extremely long and intensive study.

In its own time, the Internal Revenue Service would have to offer a long set of complicated regulations required to explain and amplify the act's obscurities. These alone would not clear the air. There would have to be ruling after ruling; and taxpayers would have to sue and be sued, year after year, so that the courts could add their interpretations. All of this, as has been said, would mean good business for lawyers and accountants, but endless worry and great cost to their clients.

MORE STUDY REQUIRED

Tax reform is badly needed but it cannot, sensibly, be rushed through Congress. It requires far, far more study than has been given to it by the Ways and Means Committee. It is virtually impossible to anticipate all the collateral and ramified effects of even a single change in law, yet it is essential to take the time to attempt to anticipate as much as one can.

The need to discover and to weigh the subsidiary effects of a change in law is illustrated by provisions of the act calculated to "soak the rich." Some of these also "soak" the middle class. Others propel inflation. Still others would have a retarding effect on our economy. Some would retard culture. Some would result in a need for additional taxation. How carefully has the committee evaluated such unhappy results against the value of plugging some alleged loopholes to "soak the rich"?

During a long period before the presentation of the act, the Congressional Record almost daily reported a speech by a Congressman or Senator calling for "tax reform." The indignation took the form of holding that if we would only plug the "loopholes" of which the "rich" take advantage, we could assist the "poor" materially.

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This approach was and is illusory. Some benefits are proposed to be granted, by the act, to the lower economic groups and even some to the generality of taxpayers. But all this is predicated on the assumption that most of the consequent loss of Government revenue would be made up by making the "rich" pay, an assumption which may well turn out to be unsound. But the basic illusion is that the truly poor can be given substantial aid through tax relief. They do need relief. This could come, however, only through a more thoughtful approach than tax "reform" through loophole-closing, a procedure which generally merely adds hodgepodge to hodgepodge.

One wonders what attempt the Ways and Means Committee made to establish basic principles to guide its deliberations, other than the politically attractive principle of attacking the rich. Did it, for example, conclude that private philanthropy should be discouraged with its inevitable result that Government would have to step in, through additional tax levies, to take its place? If so, then many of the provisions of the act are admirably designed to this end. On the other hand, if philanthropy is to be encouraged, many of the act's provisions are nothing short of disastrous. Among them are the various punitive distinctions in the treatment of "private" as against other foundations; the instances in which a charitable donation could precipitate a capital gains tax; and provisions which would curtail intervivos and testamentary charitable benefactions.

Did the committee conclude that the expansion of industry should be curtailed? If so, the act promotes this objective. Or did it just forget the obvious, that, essentially, man's material welfare can be improved only through the expansion and improvement of production? It seems so, as many provisions of the act would operate in the opposite direction.

As Congressman Burleson put it in the short debate on the floor of the House:

"It is my feeling that the underlying philosophy in these proposals before us is not healthy to continued freedom of our free enterprise system under democratic government. . . . The increased taxes on capital gains strike at the very heart of the free enterprise system by discouraging the accumulation of capital for investments."

To what extent the tax law should be used to achieve special objectives is subject to question. Granting that its sociological use is here to stay, however, there is surely a serious defect in the approach of the act, unless its intention is to

promote economic equalitarianism. Concentrating on soaking the rich and (ineptly) helping the poor, the middle class has virtually been forgotten. It is a growing class, for masses of what is called labor are entering the middle class through increases in earnings.

Much of the tax misery to which the now great middle class is subjected results from the apparent unwillingness of Congress to recognize the relationship of inflation to taxes. I must note one exception to this comment. Congress has recognized inflation insofar as its own members are concerned, by raising their wages very substantially and by providing handsome increases to the Executive department personnel. Naively enough, Congress hopes that labor will contribute to the curbing of inflation by holding down its own demands for wage increases. This is a vain hope. In the face of rapid increases in the cost of living brought on by Governmental errors of the past, labor cannot be blamed for trying to catch up with inflation.

So labor and the rest of the middle class progressively push for higher earnings to compensate for spiraling inflation. Our tax system, as administered under Congressional guidance, accelerates this push. There has been a position that higher taxes will, in themselves, curb inflation. True, higher taxes do tend to cut the public's buying power and thus to reduce the pressure of money chasing after goods. But higher taxes propel inflation insofar as they press the taxpayer to seek ever higher income to make up for a progressive loss in purchasing power.

He has had so to struggle for decades, for we have had a progressive increase in taxes, apart from any action by Congress in increasing rates—we have had it because Congress has been unwilling to react to the interaction of inflation and a progressive rate tax system. This interaction has produced a progressive increase in true taxation. By true taxation I mean the amount of the taxpayer's purchasing power which the Government extracts in taxes.

As the taxpayer is able to increase his gross income in an effort to keep pace with the inflationary cost of living, he reaches higher rate-brackets in the income tax scale. To have done equity, Congress should have reduced the rates in the graduated income tax scale in consonance with inflationary increases in the cost of living. No effort whatsoever to do this has been made.

How neglectful Congress has been of the impact of inflation is illustrated by the retention of the figure of $600 as an allowance for a dependent. As Congressman Rodino said: "The $600 individual deduction is perhaps the most glaring anachronism in the Federal tax system." After the inflation we have had, this allowance should be raised to at least $1,200, a measure which would most benefit, incidentally, the lower of the economic classes, for which Congress shows concern.

The income tax system is replete with absurdities. The Social Security rules are an example—for Social Security is funded by income taxation. How ridiculous that, having paid through taxation for his retirement benefits, the retired taxpayer loses those benefits if he continues to earn more than a Congress-stipulated gross amount, though if he had an income of $1 million a year from security investments he could still get his Social Security benefits!

Periodically, Congress does come to a realization that the public is faced with some especially severe living expense. It is currently concerned, for example, over the high cost of medical services and of education. Yet the usually considered relief is some form of Government subsidy. This, in essence, consists of taking some of the taxpayer's income away from him in taxes and, after deducting the generally high cost of administration, returning it to him in the way of subsidized benefits. A simple way of giving the taxpayer welcome and more valuable relief would consist of allowing him an income tax deduction for all medical expenses without any limitations, and for all educational expenses. But this apparently is too simple an answer to a problem.

The Treasury is necessarily conscious of the need to produce enough revenue to run Government. This leads it, all too often, to oppose a proposed tax reform because, though it may be eminently desirable to produce equity, it would reduce the Government's tax-take. This is an utterly immoral position for Government to assume. If a tax impost is unfair or undesirable, it is unconscionable for Government to oppose a correction.

DOUBLE AND TRIPLE TAXES

We seem to have become wedded to the graduated scale of income tax. States have found this perhaps the most politically convenient method of tax collection; even cities have followed suit. A resident of New York City, for example, now

pays a Federal income tax, a state income tax and a city income tax. True, the taxpayer is given a deduction, on his Federal income tax return, for state and city income taxes paid, but this is a deduction against gross income, not a credit against Federal tax payable. Therefore, it would seem that Congress ought to take into account, in considering ways in which the Federal income tax system becomes unfairly burdensome, that so many taxpayers are subject to a double income tax and, in some instances, a triple one.

The Tax Reform Act of 1969 proposes to intensify the application of the capital gains tax: In some instances by increasing the rate; in others by imposing it where it has never before been imposed. Again Congress (the House, for the moment) has given no recognition to the impact of inflation. If I have bought an item of property for $20,000 and, because of inflation, its value has risen (in depreciated dollars) to $40,000 I am now the possessor of no more valuable an asset than when I purchased it. Yet, when I sell it at $40,000, I am taxed on an alleged "gain" of $20,000. The result is that government has levied a capital assessment—it has destroyed part of my capital.

If the capital gains tax is to be retained (and there is something to be said for abolishing it entirely), would it not make sense to apply a declining rate of tax depending on successive holding periods? Recognizing that inflation seems to be with us to stay, can we not assume that, on the average, property will increase in dollar value through inflation?

The taxpayer has been treated shamefully in relation to gift and estate taxes, for Congress has again failed to recognize the impact of inflation. The progressive estate tax scale is, in itself, subject to severe criticism insofar as it rises all too quickly in the lower and middle brackets. Here, once more, the "ability to pay" theory is applied illogically. However, if no correction of this social inequity is to be considered (though why it shouldn't be, I cannot understand), at least the progressive scale should have been remodeled to reflect inflation. Certainly, the present $60,000 deduction should have been raised to at least $120,000.

TAX AND THE SINGLE MAN

To illustrate the cruelty of our estate tax system operating in conjunction with inflation, let us consider the case of a single man who accumulates a net taxable estate, before taxes, of $100,000. Along comes inflation and doubles the dollar value of his property, so that his net taxable estate is $200,000. There is a $60,000 Federal estate tax deduction. So, in the case of the $100,000 estate, the tax would be on only $40,000, and the tax would be $4,800. Therefore, with an estate twice the size ($200,000) the tax on $140,000 ($200,000 less the $60,000 deduction) would be doubled, or $9,600? No, indeed—the tax would be $32,700.

Little attention is given by Congress to the extent to which the taxpayer is subjected to double or repetitive taxation. We have this situation in connection with death taxes. Most states now impose an estate or inheritance tax which operates to increase the cost of dying above that caused by the Federal rates themselves. There is a partial credit against Federal estate tax for state death taxes paid, but this is only a partial credit. Therefore the result of the interpretation of the Federal and state tax systems very often results in an aggregate cost of dying considerably over that which the Federal rates alone would produce. This situation ought to make Congress more alert to the injustice of not recognizing the obvious fact that, during an inflationary period (and we have been in one for long), static rates in a graduated tax system create automatic increases in true taxation.

There is another form of double taxation, the logic of which is difficult to grasp. The net profits of a corporation are taxed with corporate income tax. When the profits, after this tax, are distributed to the stockholders, they are taxed again, this time with personal income tax.

Congress has given some relief against double taxation is one situation. This is in the case of what is called a "Subchapter S corporation," one organized under pertinent sections of the Internal Revenue Code. In such a corporation there is no corporate income tax impact. The net profits are taxed directly to the stockholders as though they were operating a partnership. However, this act of grace by Congress has been severely limited. Such a corporation cannot be used, for example, if it has more than 10 stockholders. This is typical of so many absurdities found in our tax laws. If there are 11 stockholders, they must suffer corporate income tax on their corporation's income, as well as personal income tax on dividends received. But if there are only 10 stockholders, they

can escape corporate income tax. Is there any good reason why double taxation should be imposed merely because of the number of stockholders!

Logic (in which the Internal Revenue Code does not always engage) could demand that either dividends be received tax-free or that a corporation be taxed only on the net profits it does not pass on to the taxpayer. I see only one ground for opposing such a reform. It would deprive the Government of what is perhaps the easiest tax to impose, one on corporations, but the easy way is not always the most equitable.

GO-SLOW IN THE SENATE?

It would take many pages to point out all the fallacies and absurdities in The Tax Reform Act of 1969. Hope lies in the possible willingness of the Senate to apply a scalpel to the present bill. Is it even possible that the Senate may conclude that no legislation of such gravity should be rushed through to enactment?

What is most discouraging about the prospect is that the most vital objective of tax reform, reducing the aggregate tax burden, is rarely given adequate support. Many of those who blame our excessive taxation on the cost of the war are the same who are constant advocates of more and greater Federal spending. Our Government has lived beyond its means for so long that we have a national debt so large that the interest on it alone is over $15 billion per year. That $15 billion or more must be extracted from the general public in taxes, superimposed on (and indeed taking priority over) the taxes required for all other purposes.

Loophole closing will not materially relieve the long-suffering public, nor will any kind of tinkering tax "reform" in itself. Only good sense in Congress and sound Federal housekeeping can do it. Said Congressman Rarick, in a release commenting on the Act: "Honest tax relief from high taxes—and the reversal of inflation as well—can only be brought about by curtailment of runaway Federal spending."

The CHAIRMAN. Now, our next witness will be Professor Saulnier, from Columbia University. Welcome, Professor.

STATEMENT OF RAYMOND J SAULNIER, PROFESSOR OF ECONOMICS, BARNARD COLLEGE, COLUMBIA UNIVERSITY

Professor SAULNIER. Thank you, Mr. Chairman. This proposed legislation is so long—368 pages—so complex—26 major sections with 63 subsections—and so deeply affected by loophole emotionalism that there is a danger of it being enacted without an adequate evaluation of its potential overall effects. Yet it should be clear even to a casual reader of press summaries that, as it is found in H.R. 13270, the Tax Reform Act of 1969 would be seriously counterproductive.

The object of H.R. 13270 is to correct certain inequities in the Federal tax code but, whatever it would do in that connection, it would have seriously adverse side effects on two other matters that must be coordinate in importance with equity in the design of our tax laws; namely, the Nation's capability for achieving vigorous economic growth and the balance between private and public effort in our society.

Specifically, the bill would impair the Nation's capability for achieving vigorous economic growth by a number of provisions that would reduce incentives to save and invest, including the proposed treatment of capital gains and the reduction of incentives to invest in real estate and in minerals resources. It would further inhibit growth by reducing—in some cases eliminating altogether—ways in which business concerns reward management achievement under present tax law. And the balance of its revenue effect, which would become increasingly negative between 1970 and 1972, would favor consumption at the

expense of investment, thereby weakening Government efforts to overcome inflation as well as impeding economic growth. The Treasury estimates that, under the bill as it stands, the net long-term shift in the tax burden would be to raise taxes on corporations by $4.9 billion while lowering taxes on individuals by $7.3 billion.

In addition, H.R. 13270 would have a number of unfortunate effects on the structure of American institutions. It would impair the ability of State and local governments to finance public facilities independently and, in so doing, weaken their position in our present governmental structure. It would seriously impair the ability of private nonprofit institutions—colleges and universities, museums, hospitals, et cetera—to obtain the private gifts on which they rely heavily, in some cases entirely, for the extension and improvement of their activities. And as this memorandum will show, it would weaken the enterprise system—the means through which this country has achieved a standard of living unparalleled elsewhere in the world and through which America, from its beginnings, has offered opportunity for personal development and improvement unmatched anywhere.

In doing all this, and more, some of the bill's major provisions offend one's sensibility by being in a number of instances seriously, unnecessarily and punitively retroactive; violating the long-respected distinction between capital and income in their treatment by the tax laws; deviating from the established principle of taxing income when it is actually received; deleting a whole series of still valid and justifiable incentives on the ground, apparently, that yesterday's incentive is today's loophole.

The justification for this wholesale rewriting of the tax code is that a small group of individuals in the $200,000-and-over income bracket—154 in number—had no Federal tax liability in 1966. Whatever the merits of the case against these individuals, it must be recognized that they represent only 1 percent of the taxpayers in this income class. Yet in order to reach 154 individuals, H.R. 13270 would adversely affect the tax status of hundreds of thousands of taxpayers, corporate as well as individual, would affect every citizen through higher prices and rents, would imperil every nonprofit, gift-supported institution in the country. It is hard to imagine a bill from which the fallout threat would be greater.

As for the 154, how much Federal tax they paid in other years is typically overlooked, as is the taxes they paid over the years to State and local governments. Typically, no account is taken of the income these individuals chose to forgo in achieving tax exemption, nor the amount of capital or income they gave away, et cetera, et cetera. Nor is there an adequate evaluation in the public dialog on these questions of what it will cost the Nation in the impairment of its productive institutions to correct such genuine inequities as exist under present tax law by the methods proposed. There surely must be a better and fairer way to do it. One is impressed again and again that what we have here is a massive example of throwing the baby out with the bathwater—in this case a whole family of babies, with a few cups of bathwater.

Although H.R. 13270 has been described as a milestone in tax legislation by the Secretary of the Treasury, there are valid objectives of tax reform—long recognized inside and outside of government—that

it does nothing to achieve. Notable among these are simplification of the tax code and revisions to promote growth. Value-added taxation, a major subject of tax discussion these past few years, is nowhere in this bill. Nor is fiscal responsibility a part of it. The fact that the bill would burden the finances of the Federal Government—in amounts estimated as high as $4.1 billion in 1972—by tax cuts that more than offset the increased revenue involved in tax reform and in repeal of the investment tax credit, has already been commented on. In short, H.R. 13270 deserves not a mere patching up but a thorough overhaul. One thing is certain: if it is passed, even with the changes proposed by the Secretary of the Treasury—many of which go in the right direction but others, in the opinion of this writer, do not—no true tax reformer need fear he has been done out of a job. Actually, the tax reform problem would be rendered more difficult.

It would be impossible for any one individual—and certainly not in one brief memorandum—to present a full critique of this lengthy and complex bill. The fact that many provisions are not commented on here is not to be construed as meaning anything, one way or the other, pro or con, with respect to their specific merits. Limitations of space, time, and energy have required concentration on only a few of the bill's major provisions. It is hoped, however, that the selection is of those most in need of critical comment.

Let us begin with certain of the bill's provisions that affect capital investment and thus the Nation's potential for economic growth.

1. PERMANENT REPEAL OF THE INVESTMENT TAX CREDIT

Permanent repeal of the investment tax credit, as H.R. 13270 proposes, would remove an incentive to capital expansion and improvement that from its inception has been a constructive provision of the tax code. There may be abuses here and, if so, they should be corrected, but not by the wildest stretch of the imagination can the investment credit be regarded as a loophole in any meaningful sense. Its permanent repeal would have to be regarded as a blow at the ordinary, everyday business of improving the Nation's productive plant. Certainly, if this provision is enacted the Congress should find some means—presumably through depreciation liberalization—to make the volume of investible funds generated internally by businesses more nearly consistent with what is required for capital investment. Otherwise, the productivity and international competitiveness of American industry will suffer a damaging setback.

Finally, although an on-again off-again handling of the investment credit deserves, in my opinion, no place in stabilization policy—planning for capital expansion and improvement needs and deserves a more stable framework of taxation—the anti-inflation purpose—for which there is a reasonable argument—would be better served by suspension than by permanent repeal, if that has to be the choice.

2. LIMITATION OF ACCELERATED DEPRECIATION PRIVILEGES IN REAL ESTATE INVESTMENT

Despite the well-known tendency for investment in new construction—notably, new residential construction—to lag behind other types of investment, and despite the widely-recognized and increasingly

critical shortage of residential facilities, H.R. 13270 would reduce certain incentives which Congress on earlier occasions deliberately incorporated into the tax law to encourage construction and rehabilitation of real property under the House bill:

(*a*) Accelerated depreciation—previously allowed on all new construction on the 200 percent declining balance and sum-of-the-years digits methods—would henceforth be restricted to the recovery of capital invested in new residential building.

(*b*) Despite the fact that the incentive to invest in new construction depends heavily on an active market for used structures, straightline depreciation would be required on the latter—residential and nonresidential—in place of the 150 percent declining balance method presently allowed.

(*c*) Although new nonresidential construction is crucial to the creation of a satisfactory total environment, it would be allowed a slower—150 percent declining balance—depreciation in place of the accelerated rate presently allowed.

(*d*) The excess of accelerated over straightline depreciation would be recaptured as ordinary income on the sale of real property of any type, with no amelioration of this effect—as provided in present law—depending on how long the property was held, thus aborting the initial effect of fast writeoff.

(*e*) The right to depreciate rehabilitation expenditures on a straightline basis over 20 months would be restricted to projects where the additions or improvements have a useful life of 5 years or more, where they constitute low cost housing for nontransient use—declared eligible for such treatment by HUD—and where rehabilitation cost per unit is not less than $3,000 or more than $15,000.

These proposals—which treat accelerated depreciation as if it were a device for nonpayment of taxes rather than a deliberate, congressionally designed arrangement for the deferral of taxes—are almost certainly destined to result in (i) a smaller increase in total housing supply than would be produced by wider availability of faster depreciation; (ii) a reduced availability of housing for low- and middle-income families; (iii) inadequate nonresidential facilities need for a balanced total neighborhood environment; (iv) less rehabilitation of existing housing, further limiting total supply; and (v) increased rents. There must be a way to prevent the tax-shelter uses of real estate—by what must be a very limited number of individuals—without these adverse and untimely effects on the whole construction and real estate industry.

3. HEAVIER TAXATION OF CAPITAL GAINS

It is a long established feature of tax law everywhere to tax capital gains less heavily than current income. In so doing, legislators have had in mind that if there is a gain from capital in terms of appreciation of principal value, it is (i) a gain from investment of income already taxed to the individual before it could be saved and invested; (ii) that it often reflects in whole or in part, the plowback of undistributed profits already taxed to the corporation; (iii) that the income from capital is also fully taxed as received; (iv) that capital gains are built up over time—frequently over a long time—and, with tax

rates typically rising, an equitable and proper averaging process should put the capital gains tax at a lower level than the tax on current income; and (v) that a capital gains tax is levied, in any case, against an increase in principal value which, the world being what it is, is typically a result largely of inflation. No tax code can deal severely with investment gains without discouraging the investment process itself, either by lowering potential return or limiting liquidity, or both—and to discourage investment is to inhibit growth and everything that growth means for the creation of jobs and the enhancement of well-being for everyone. Yet H.R. 13270 would make present taxation of capital gains more severe by—

(*a*) extending the holding period required to distinguish between capital gain and income from ordinary transactions from 6 months to 1 year;

(*b*) eliminating the alternative tax rate for long-term capital gains, thus raising the upper limit of the effective tax on such gains for taxpayers with a marginal tax rate above 50 percent from the present 27½—including surtax—to 38½ or by 40 percent;

(*c*) raising the alternative rate for corporate taxpayers to 33 percent—including surtax—from the present 27½; and

(*d*) permitting only 50 percent of an individual's net long-term capital losses to be offset against ordinary income, up to the $1,000 limitation, in place of the full deductibility presently allowed.

In addition to making invested funds more illiquid and discouraging both saving and investment, H.R. 13270's proposed treatment of capital gains would be clearly retroactive in effect, constituting an unanticipated capital levy not just on the 154 but on many thousands of unsuspecting Americans.

4. REDUCTION OF DEPLETION ALLOWANCE AND OTHER PROPOSALS AFFECTING MINERALS INDUSTRIES

One of the most capital-intensive and risk-affected industries in the United States—oil, gas and other mineral resources—would be dealt with especially severely by H.R. 13270. Apart from the adverse effect on these industries from repeal of the investment tax credit and the heavier taxation of capital gains, the proposed legislation—in the case of oil and gas—would (i) reduce percentage depletion allowances from 27½ to 20 percent on domestic properties; (ii) eliminate depletion allowances altogether on overseas properties; and (iii) treat production payments as loans.

Among the likely effects of these proposals are the following:

(*a*) The cost to U.S. companies of oil development would be increased substantially and, if there is anything at all to the shifting of taxes—and there must be in this case, since the profitability of oil companies in 1968 was only about the same as that of manufacturing concerns generally—the cost of gasoline at the local gas pump would be increased.

(*b*) The cost to U.S. companies of oil development conducted overseas would be increased: (i) in all probability without increasing U.S. tax revenues; (ii) with predictably adverse effects on the strategical position of the United States in world affairs;

and (iii) with adverse effects, certainly in any long-term perspective, on the U.S. balance of international payments.

(*c*) With a lower after-tax cashflow, oil-producing companies would need to depend more heavily on external financing for oil development, a necessity that would be felt most severely by individual developers and small companies.

REDUCED OPPORTUNITIES TO REWARD MANAGEMENT ACHIEVEMENT

The opportunity to reward a business executive for making a success of a company's affairs cannot possibly be anything but constructive in promoting economic growth. In this respect, the proposed 50 percent upper limit on taxation of earned income moves in the right direction; on the other hand, those provisions of H.R. 13270 that would limit opportunities to provide rewards other than by current income would be an obstacle to growth. Specifically, this criticism applies to—

(*a*) The bill's treatment of deferred compensation payments, a type of forward income-averaging which, under these proposals, would be taxed not at the rate applicable to the taxpayer in the year the income was actually received but at a rate calculated, ex post, as what would have been applicable in the years in which the income was earned;

(*b*) Allowing the deduction of interest only to the extent of investment income and longterm capital gain—plus $25,000—for the acquisition of stock—for example—under a stock option program, even though the interest is a cost incurred to make an investment, the income and capital gain from which—if there is any—will be taxable in due course;

(*c*) Taxing as compensation the value of stock received in lieu of salary under restricted stock plans—except where the employee's interest is subject to substantial risk of forfeiture—despite the fact that in many instances the stock continues under restriction which prevents its sale to raise funds to pay the tax.

6. REDUCING TAX EXEMPTION OF INTEREST ON STATE AND LOCAL (MUNICIPAL) BONDS

H.R. 13270 would reduce the tax exemption accorded interest paid on State and local government securities—municipals—an exemption going back to the introduction in 1913 of the federal income tax and grounded in constitutional considerations, by—

(*a*) Allowing an individual to count as tax preference income—in the limited tax preference—LTP—rule—an amount not to exceed 50 percent of total income—adjusted gross income plus tax preference income—regardless of the actual proportion of taxable to nontaxable income, thus treating some tax-exempt income as taxable;

(*b*) Requiring that deductions be allocated to nontaxable income in the allocation of deductions—ADR—rule—in the proportino ofnontaxable income to total income, thus making some part of the deductions ineffective in the role for which they were originally granted.

Also, the bill would further restrict the availability and raise the cost of municipal debt financing by—

(c) Making capital gains on debt securities held by financial institutions taxable at the income tax rate rather than—as now—at the capital gains rate.

Having thus taken away with one hand at least part of the tax exemption explicity offered with the other, and having reduced the incentive for financial institutions to continue investing in municipals—commercial banks hold nearly 40 percent of the outstanding supply—the bill then says that if a State or local government chooses to finance on a taxable basis the Federal Treasury will provide a subsidy calculated to offset the higher cost of borrowing without benefit of tax exemption.

Quite apart from the constitutional questions raised by these proposals—which have to do with reciprocal tax immunity as a principle essential to desirable Federal-State-local relations—there are a variety of important economic questions involved. Thus—

(a) Again if there is anything at all to the shifting of taxes, this proposed erosion of tax exemption will raise the cost of financing to State and local governments and require an increase in tax rates at the State and local level; a measure of this effect can be judged from the fact that in recent markets tax-exempt securities sold at yields as much as 2 percentage points below those obtainable on taxable securities;

(b) To the extent that an erosion of the tax-exemption privilege induces State and local governments to elect the alternative of issuing taxable securities, the proposed legislation will require the Federal Government to undertake a new and conceivably large and growing function in administering interest rate subventions;

(c) The market for municipal securities is bound to be dislocated, indeed is already seriously dislocated, at a time when—most would agree—capital improvement programs at the local level are needed more urgently than ever before; already, the yield spread between taxable and nontaxable securities has narrowed by close to one third of a percentage point.

Again, all this is done apparently to cut back on the use of tax-exempt municipal bond income to avoid tax liability, when the evidence indicates that this type of income is of major consequence to only a small minority of all high-income individuals.

7. TREATMENT OF CHARITABLE CONTRIBUTIONS

Finally, there are the provisions of H.R. 13270 that would significantly alter the balance of private versus government effort in various sectors of our society. It would do this by hampering the gift-raising capability of private nonprofit institutions on which every community in the Nation, in one way or another, depends heavily for educational, cultural, medical, and other facilities. It is especially serious that this would be done at a time when these institutions, with few exceptions, are operating under increasingly serious financial difficulties and when demands on them by the community are heavier than ever before.

The proposed increase from 30 to 50 percent in the general limitation on an individual's charitable contribution deduction would be a constructive and important change, but in a number of other provisions H.R. 13270 would be so technically complicated and so severe in its treatment of acts of charity and philanthropy that prospective

donors would likely withdraw in bafflement if not in anguish as fund-raising personnel attempt to explain the tax implications of prospective gifts. Features of the proposed legislation that would make life more difficult for gift-supported institutions include:

(*a*) eliminating the unlimited charitable contribution deduction now available to donors, thus making it more difficult to obtain the large gifts that frequently are the events that make a success of ambitious fundraising programs;

(*b*) treating as taxable the appreciation—unrealized, at that—of charitable contributions of appreciated property;

(*c*) placing what appear to be severe limitations on the deduction available to donors in charitable remainder trusts, and charitable income trusts the remainder of which goes to a beneficiary other than a charity;

(*d*) requiring that in so-called bargain-sales to charitable organizations costs be allocated between the portion sold and the portion given, rather than allowed in full as a charitable contribution deduction;

(*e*) eliminating the rule that made possible the so-called 2-year charitable trust;

(*f*) eliminating the presently unlimited set-aside deduction available to nonexempt trusts and estates; and

(*g*) disallowing charitable deductions for gifts less than the donor's full interest in the property involved.

CONCLUSION

Without attempting to evaluate all the possible effects of H.R. 13270, the conclusion must be that, as it stands, it would: impair the Nation's capability for achieving economic growth and improvement; reduce in particular the incentive to invest in new construction, in all probability doing little if anything to promote investment in new low-income housing; raise rents; raise the price of gasoline and mineral products generally; raise local taxes; create the need for a new Federal program to help State and local governments finance public facilities; create the need for new Federal programs to aid private gift-supported institutions; and hamper the fight against inflation.

THE TREASURY'S SEPTEMBER 4, 1969 PROPOSALS

The maleffects of H.R. 13270 would be ameliorated in part but not entirely by proposals made September 4, 1969, by the Secretary of the Treasury, in particular by his proposals for—

cutting the estimated 1979 revenue shortfall from $2.4 to $1.3 billion;

reducing the corporate tax rate by one percentage point in 1971 and an additional point in 1972;

retaining the 6-month holding period for capital gains and, with some exceptions, retaining the maximum 25-percent rate on such gains;

excluding charitable donations of appreciated property from LTP and ADR;

reducing the proposed tax on foundations from 7½ to 2 percent of income;

excluding tax-exempt municipal bond interest from LTP;

eliminating that section of H.R. 13270 that puts a limit on the deductibility of interest on indebtedness incurred to purchase or carry investment assets; and

deleting that provision of the bill—section 331—relating to deferred compensation.

However, the Secretary's proposals would leave unchanged or make even more severe certain sections of the proposed bill which, in the judgment of this writer, would have a counterproductive economic effect. Specifically, the Treasury's proposals would, among other things—

leave the treatment of real estate investment as in the House bill, except for the suggestion that commercial banks, mutual savings banks and savings and loan associations be allowed a special tax deduction of 5 percent against gross income from loans to finance residential construction—also for guaranteed loans to college students and loans guaranteed by the Small Business Administration;

accept the reduction of percentage depletion for the minerals industries—though not a part of the administration's initial recommendations—and the inclusion of both depletion and intangible drilling costs in ADR—as initially suggested to the House—but would go beyond H.R. 13270 by proposing—as the administration did initially, but as the House did not—that both depletion and intangible drilling costs be included in LTP, though the latter not for taxpayers deriving 60 percent or more of their income from oil and gas operations;

continue the limitation—as originally proposed by the administration—on restricted stock plans;

accept the House proposals regarding charitable contributions, except the inclusion of donations of appreciated property in LTP and ADR;

include tax-exempt interest in ADR—as does the House bill—but—with potentially damaging effect—without the 10-year phase-in which the bill provides;

apparently employ an arrangement—to be disclosed later—such as an urban development bank in lieu of interest subsidies to State and local governments that elect to issue taxable securities;

retain the retroactivity of any change in the taxation of capital gains.

Clearly, there is a great deal still to be done to make H.R. 13270 consistent with all the goals of constructive tax reform.

Senators, nothing I said is meant to disparage in the least the importance of efforts to check genuine abuses of the present tax code. No one can make a case for retreating from that task. The point is we must be sure that in the cleaning-up process it is bathwater and not babies that is thrown out, and that there is no exchange of new inequities for old ones. We need a tax code that is fair and equitable. But we also need a code that bolsters incentive to work, to save, to invest, to take risks—and heavy risks at that—and a code that will have the kind of effect on the institutional structure of our country—the place of private enterprise in the production process, the balance of State and local versus Federal power, and the role of private nonprofit, gift-

supported institutions—that will strengthen, not weaken, the democratic qualities in American life.

The CHAIRMAN. Thank you very much, Professor.

Now, the next witness will be Mr. J. T. Higgins, chairman of the American Textile Manufacturers Institute, Tax Committee.

STATEMENT OF J. T. HIGGINS, CHAIRMAN OF THE TAX COMMITTEE, AMERICAN TEXTILE MANUFACTURERS INSTITUTE

Mr. HIGGINS. Thank you. I hope I shall do as well. My name is John Higgins. I am a vice president of Burlington Industries of Greensboro, N.C. I am appearing before you today in this capacity as chairman of the Tax Committee of the American Textile Manufacturers Institute. I am accompanied by Mr. Roland Kirks, general counsel of ATMI, and Mr. Jay Glasmann of Ivins, Phillips & Barker, the firm that represents our committee in tax matters.

Our association represents some 300 corporations which have about 85 percent of the capacity of the textile industry. That industry employees 984,000 people in 42 States. It has an annual payroll of some $4 billion, and last year had shipments of more than $21.5 billion.

This statement is directed to the various provisions of H.R. 13270. It was the unanimous decision of our committee to make the following representations to you with respect to some parts of the House passed bill. They are nine in number. First, with respect to private functions, we sincerely believe that enactment alone of section 4942—that is the provision entitled "Taxes on Failure to Distribute Income"—enactment of that section into the code in conjunction with existing code sections 503(c) through 503(j), would constitute a practical deterrent to the tax abuses which have been considered to justify the fundamental sweep of title I of the bill.

Referring to section 231, we approve of the extension and more liberal treatment of moving expenses deductions. When an employee is moved at the request of the employer and incurs expenses in that move, reimbursement to him by the employer should not be treated as taxable income to the employee so long as the reimbursement is reasonable.

We think, however, that the present 20-mile limitation contained in section 217 of the code should be retained. The question of enlarging the moving expense provisions of the code has been before Congress actively for several years. We see no reason therefore why it should not be made applicable to taxable years beginning after December 31, 1969. We think the overall limitation of $2,500 is too restrictive. And we would suggest removing the dollar limitation entirely and limiting the expenditures to reasonable allowances, or if budgetary reasons compel the retention of the $2,500 limitation at this time, that the statute itself should provide that the $2,500 limitation will automatically be dropped at the end of the 2-year period and a reasonable allowance concept established at that time.

With respect to section 331 of the bill, deferred compensation has been found appropriate and most helpful in obtaining the services of talented scientific, technical, and other highly specialized personnel

as well as general executives. The prospective employee who has demonstrated such ability often would sacrifice or forfeit pension or profit-sharing credits established in present employment to accept a new and more constructive employment. On the other hand, he may have attained a sufficiently advanced age to bar him from or limit his potential in establishing corresponding credits in the comparable qualified plans of a new employer. We therefore have used deferred compensation plans as a means of affording such talent and adequate and reasonable retirement benefit. It has worked well, and we see no reason why the method should be abolished.

If, however, you become satisfied that the deferred compensation provisions have been abused, we then suggest to you that the bill be amended to provide that the new provisions should apply only to deferred, annual deferments of $10,000, the present provision of the bill, or 50 percent of the earned income in the highest 5 years of the last 10 years of the employment period. We believe section 802 of the bill dealing with the maximum marginal tax on earned income should be amended to provide that deferred compensation be considered earned income.

I refer to sections 413 and 414 of the bill. Under section 414 of the bill there is a provision of our convertible debentures issued and repurchased by a corporation at a premium. That premium should be divided into the amount that is paid for the cost of the call and the amount that is paid for the convertible privately. Only the call premium is to be deductible by the corporation. Without arguing the point that principle compels such treatment, we would advance for your consideration the thesis that some impressively should be applied. Specifically, it should be recognized in section 413 so that if a corporation issues a convertible debenture, the proceeds it receives are recognized as being in some part attributable to that right or convertibility.

Fifth, with respect to the treatment of stock dividends, section 421 of the bill amends section 308.5 of the code to treat certain types of redemptions as corporate distributions. We object to the broad nature of section 305(c) which delegates powers to the Secretary of the Treasury to prescribe by regulations what transactions shall be treated as distributions within sections 301 and 305. No yardsticks are set forth in the proposed legislation to guide his powers.

With respect to section 452, we see no reason for requiring earnings and profits to be determined through the use of a straightline method for computing depreciation with respect to manufacturing industries. The mere fact that there have been abuses investigated by regulating agencies or in real estate situtations should not compel an abnormal method of computing earnings and profits for all other industry. It unnecessarily adds significant complexities to the tax law.

Seven. With respect to section 461 of the bill, we have two suggestions to make with respect to the capital gain taxation as it relates to corporations. We think it is sound to require half the gains be included in an individual's income and subjected to ordinary tax rates, the same idea should be equally applicable to corporations. We also recommend for both corporations and individuals a graduated rate of tax on capital gains similar to that included in the 1936 act where, as the holding period increases, the rate of tax decreases.

With respect to section 521, real estate depreciation, here again we

believe abuses in the real estate field are no reasons why accelerated methods of depreciation are not generally appropriate and should not continue to be applicable to industry. We have no objection, however, to changing the law so that the recapture provisions of section 1250 are applicable to all disposition of measurable profit. For corporations generally and particularly for those primarily engaged in manufacturing the proposed amendments to the depreciation recapture provisions would appear to take care of any problems that may have arisen with respect to disposition of depreciable property.

Finally, in referring to the repeal of the investment credit and the amortization of certain railroad rolling stock, echoing sentiments which have been expressed previously here, these provisions point up the need for more certain depreciation allowances for American industry. Specifically ATMI recommends the elimination of the Treasury reserve ratio test. Further and continuing modernization is of vital importance to our industry if it is to compete effectively with low-cost imports. The reserve ratio test because of its complexity and its potential for requiring repeated useful live adjustments makes it impossible for taxpayers in our industry to be able to count on definite depreciation deductions when expenditure plans are being made. This uncertainty should be eliminated.

As provided in the bill for railroad rolling stock, taxpayers should be allowed to use specified depreciation lives as a matter of right. Only those taxpayers claiming depreciation life shorter than specified life or lives for their industry should then have recourse to defer complicated rules of revenue procedure 6221 which is the Treasury guideline.

As an entirely personal comment, I realize this committee has undertaken a most arduous assignment in considering this bill, an undertaking which the American people will judge by the degree to which the amended Internal Revenue Code results conforms to their concept of justice and fairness. The complexities already existing in the code have reduced the individual tax return form to a checklist of multiple schedules and other attachments. That complexity is compounded by the provisions of this bill to a degree that I am convinced surpasses the comprehension and the confidence of the taxpayer. It surpasses his ability to comply and the Government's ability to audit and to administer even handedly. Because of this belief I hope that your regard for the practical difficulties of administration will be one of the primary standards by which we will measure and modify this legislation.

Thank you.

The CHAIRMAN. I see you managed to wind up right on your time also. Thank you. Congratulations for a well-timed statement. I would say you are well-advised. And Mr. Glasmann sitting to your right is no stranger to us here.

I suppose if the Republicans must be in power from time to time they couldn't find a better man to help them at the Treasury than Mr. Glasmann. I assume he is in accordance with your views on this matter.

Mr. HIGGINS. I believe he is, yes.

Thank you very much, sir.

(Mr. Higgins' prepared statement follows:)

STATEMENT OF JOHN T. HIGGINS ON BEHALF OF THE AMERICAN TEXTILE MANUFACTURERS INSTITUTE, INC.

My name is John T. Higgins. I am Vice President of Burlington Industries, Inc., of Greensboro, North Carolina. I am appearing before you today as Chairman of the Tax Committee of the American Textile Manufacturers Institute, Inc. I am accompanied by Mr. Rowland F. Kirks, General Counsel of ATMI, and Mr. Jay W. Glasmann of Ivins, Phillips & Barker, which firm represents our Committee in tax matters.

Our Association represents some 300 corporations which have about 85 percent of the spinning, weaving and finishing capacity in the cotton, silk and man-made fiber industry. The textile industry employs 984,000 people in 42 states, has an annual payroll of $5 billion and last year had shipments valued at over $21.5 billion.

This statement is directed to a number of the provisions of H.R. 13270. We had a meeting of our full Committee last month and the unanimous decision of the Committee was to make the following representations to you with respect to several parts of the House-passed bill.

SECTION 101—TAX TREATMENT OF PRIVATE FOUNDATIONS

We understand that many, many other witnesses will appear before you to discuss the implication of each section of Title I of the bill, and therefore I shall not impose upon your time to that purpose.

We do recognize that the major impact of Title I would be to deprive private charity in its established flow of funds, by the application of provisions almost impossible to administer, with consequent primary effect upon the poor and underprivileged among us.

We sincerely believe that enactment of Section 4942, the provision entitled "Taxes on Failure to Distribute Income", into the Code would provide, in conjunction with Code sections 503(c) through 503(j), a practical deterrent to the tax abuses which have been considered to justify the fundamental sweep of Title I.

We are aware that the Ways and Means Committee concluded that it was objectionable for private foundations to be used to maintain control of businesses, particularly small and medium-sized family corporations. On this issue, ATMI is in complete disagreement with the conclusions of the Committee. We believe that retention of control of family business should be fostered rather than curtailed and that if private foundations can be utilized to assist in such retention, such practice is not reprehensible so long as the foundations are distributing to active charities the requisite amount of income or capital required under §101(d) of the bill. We believe that the proposed stock ownership limitations with respect to foundations and so-called disqualified persons under the bill will have a detrimental effect on the continuity of ownership and management of many small corporations in this country without in any way promoting the legitimate interests of charity.

SECTION 231—MOVING EXPENSES

The present deduction for employee moving expenses (transporting the taxpayer, members of his family, and their belongings from the old residence to the new residence, including meals and lodging en route) would be expanded to allow the deduction of expenses for house-hunting trips, living expenses up to 30 days at the new job location, expenses related to the sale of a residence or the settlement of an unexpired lease, and expenses related to the purchase of a residence at the new job location or the acquisition of a lease on property to be used as the new residence. The deduction for these additional categories as moving expenses is subject to the overall limit of $2,500 per move, with the further limitation that the deduction for house-hunting trips and temporary living expenses cannot exceed $1,000. Under present law, a deduction for moving expenses is allowed if the taxpayer's new principal place of work is located at least 20 miles farther from his old residence than was his former principal place of work. The bill increases the 20 mile test to 50 miles. The proposed changes are to apply to taxable years beginning after December 31, 1969.

ATMI supports liberalizing legislation with respect to moving expenses. Reimbursed moving expenses are not in the nature of salary or wages and employees should not be taxed on their receipt. It is patently unfair to tax an employee on reimbursed expenses which would not have been incurred if the employee had

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not relocated to accommodate his employer. Accordingly, ATMI supports the liberalizing changes included in the bill with respect to moving expenses. We believe, however, that the $2,500 limitation for the new deductible moving expense category is grossly inadequate. The proposed ceiling barely covers closing costs, including selling commissions on a $30,000 home, and leaves little or nothing for the other important categories of moving expenses, namely, house-hunting trips, temporary living expenses, and out-of-pocket expenses attributable to the acquisition of the new home. Moreover, with the inflation that has taken place in the last two years, and which appears likely to continue in the immediate future, the overall limit of $2,500 appears unrealistically low. We recommend, therefore, removing the dollar limitation entirely, with the deductible expenses in the new categories being limited to reasonable amounts under all the facts and circumstances. In the alternative, if budgetary considerations compel the retention of the $2,500 limitation at this time, we believe that the bill should provide for the automatic elimination of this limitation at the end of a two-year period, with the reasonable expense concept taking over at that time.

We strongly recommend that the present 20 mile limitation that is contained in § 217 of the Code be retained. We can see no justification for changing the limitation to a 50 mile test which can only generate hardship and ill-feeling for affected taxpayers. For example, assume an employee is working in Washington for the Federal Government and lives 10 miles south of the Capital in Virginia. Assume his employer transfers him to Baltimore, which is approximately 45 miles from Washington. Under the bill, such an employee would not be able to deduct his moving expenses if he attempted to relocate in the Baltimore area. In effect, the bill, as drafted, assumes that commuting to Baltimore from the Virginia side of Washington is a normal pattern of existence. We believe this not to be the case and urge that the bill be changed accordingly.

The question of enlarging the moving expense provisions of the Code has been before Congress since at least 1963. The Treasury Department, in its April 1969 tax reform recommendations to the Congress, proposed that the new rules should have an effective date with respect to years beginning after December 31, 1968. The Ways and Means Committee gave no indication in its report why the Treasury's effective date recommendation was not accepted. At any rate, ATMI recommends, at a bare minimum, that the liberalized moving expense rules should apply to calendar year 1969. Further, we believe that consideration should be given to making the provisions retroactive back as far as 1964 because of the uncertainty and unfairness which have existed with respect to the tax treatment of moving expenses since Congress last considered the subject in connection with the Revenue Act of 1964.

SECTION 331—OTHER DEFERRED COMPENSATION

The bill would change the tax treatment of unfunded, non-qualified, deferred compensation payments in excess of $10,000 a year received by key employees, whether the arrangement giving rise to the payment be a simple contract on an individual ad hoc basis or a complex plan (deferred cash bonus, phantom share, etc.) applying to all or most of a company's executive group. Under present law, an employee does not report income on deferred compensation of this type until it is actually received in cash, frequently after retirement when the employee expects to be in a lower tax bracket.

The bill provides that when a deferred compensation payment in any taxable years ending after June 30, 1969 exceeds $10,000, a "minimum tax" is to be imposed on the excess. The minimum tax would be the lower of two alternate amounts computed under complex formulae, except that if the tax computed under the regular rules should be higher than the minimum tax so computed, the regular rules are to apply.

ATMI believes the proposals to alter the existing rules for taxation of unfunded deferred compensation arrangements are inadvisable for the following reasons:

1. Deferred compensation is a key element in the overall compensatory programs of most corporate employers, large and small. Deferred compensation has been found appropriate and most useful in obtaining the services of talented scientific, technical and other highly-specialized personnel, as well as general executives. The prospective employee who has demonstrated such ability often would sacrifice or forfeit pension or profit-sharing credits established in present employment to accept a new and more constructive employment. He may have

attained a sufficiently advanced age to bar him from, or limit his potential, in establishing corresponding credits in comparable qualified plans of the new employer. Many employers have used unfunded, non-qualified deferred compensation plans as a means of affording such talent an adequate and reasonable retirement benefit. It has worked well, and we see no reason why the method should be abolished.

2. The present taxation of unfunded deferred compensation arrangements is not a loophole. The present rules are based on the simple concept of cash basis taxation. An individual is taxed on income only when he receives it or has a right to receive it. Failure to tax him in or by reference to an earlier year is not a loophole in the law. The proposed change will not have its most important impact on the wealthy, who will usually be in a high tax bracket even after retirement. Instead, it strikes at the middle-income executive who ultimately retires without a business or private fortune to support him in retirement.

3. The proposal would necessarily be irrational and inequitable in operation. Taxation of deferred compensation at rates determined by reference to a year or years other than a year the cash is actually received, may make little sense when applied to any particular arrangement in the broad spectrum of deferred compensation.

4. Administration of the proposal will be extremely complex and burdensome for both the taxpayer and the Government. It is inherent in the proposal that record-keeping will be required for a period of forty or more years. Furthermore, because of the difficulty in many cases of determining when a payment is "deferred compensation" (a term not defined in the bill), enforcement of a proposal of this type will undoubtedly be uneven and fraught with costly litigation.

While ATMI believes the arguments against imposing a new minimum tax on deferred compensation far outweigh the arguments advanced by the Ways and Means Committee in justification of the proposed changes (see Summary, Tax Reform Bill of 1969, prepared by the Staffs of the Joint Committee on Internal Revenue Taxation and the Committee on Finance, August 18, 1968, p. 53), if §331 of the bill should be retained, a number of changes should be made. We suggest, for example, that the Bill be amended to provide the new minimum tax shall apply only to deferred compensation payments received in any year which are in excess of the higher of $10,000 or 50 percent of the average of the employee's earned income in the highest five of the last ten years of his period of employment. Such an amendment would enable small and medium-sized firms in our industry to compete with larger corporations in acquiring executive talent.

We also recommend, in order to avoid an inequity which could hardly have been intended, that §802 of the bill pertaining to the maximum tax on earned income be amended to provide that deferred compensation payments attributable to years beginning after December 31, 1969 be treated as earned income. As drafted, §802 of the bill would provide that the 50 percent limit is not applicable to deferred compensation. If this provision is not changed, it could result in an employee paying a higher tax on deferred compensation than he would have paid had there been no deferral.

SECTION 413—ORIGINAL ISSUE DISCOUNT

SECTION 414—CONVERTIBLE INDEBTEDNESS REPURCHASE PREMIUMS

§414 of the bill provides that where a corporation repurchases its convertible debentures at a premium, the portion of the premium paid for the convertible privilege cannot be deducted as being analogous to an interest expense. Without arguing the point that principle compels such treatment, ATMI, on behalf of several of its members, submits that this principle of viewing the conversion feature as separable from the underlying indebtedness should be consistently applied. In other words, convertible debentures should be treated the same as bonds issued with warrants attached, both for purposes of the bond premium provisions of the bill (§414) and the bond discount provisions of the bill (§413).

We recommend, therefore, that §413 be amended to provide, in effect, that a corporation issuing a convertible debenture shall be treated as having issued an "investment unit" as is now provided under the bill when debt is issued with stock warrants. Thus, it should be recognized in §413, in the case of a convertible debenture issue, that the stated interest rate should be adjusted upwards to reflect the effective interest rate after attributing a portion of the issue price to the convertible feature of the bond.

SECTION 421—TAX TREATMENT OF STOCK DIVIDENDS

Section 421 of the bill amends § 303 with respect to nontaxability of stock dividends. The bill goes on to provide specifically that a stock dividend shall be treated as a taxable dividend if the distribution, or series of distributions, results in receipt of property by some stockholders and in an increase in the proportionate interest of other stockholders in the assets or earnings of the corporation. The bill also provides that, by regulations to be prescribed by the Secretary or his delegate, a change in a conversion ratio, a change in redemption price, a redemption treated as a taxable dividend, or any similar transaction, will automatically be treated as a dividend to other shareholders whose proportionate interests in the assets or earnings of the corporation are increased. Thus, a redemption which results in a taxable dividend to the redeemed stockholder would appear to result (under regulations to be prescribed) in constructive dividends to the other stockholders whose proportionate interests have in any way been increased.

Under the effective date provisions, a grandfather clause protects distributions of stock, including distributions which result in a receipt of money for property by some shareholders and an increase in the proportionate interests of others with respect to stock outstanding on January 10, 1969, or issued pursuant to a contract binding on that date. The grandfather clause covers distributions of stock (or rights to acquire stock) made prior to January 1, 1991, but the grandfather clause is not made specifically applicable to changes in conversion ratio, redemption prices, etc., which are to be covered under regulations to be prescribed.

ATMI objects strongly to the legislative powers delegated to the Secretary or his delegate to prescribe, by regulation, transactions not described in the statute which shall be treated as dividends under the bill. No yardsticks are set forth in the bill to guide the exercise of the Secretary's discretionary powers. The difficulty we see in such delegation of powers can be illustrated by the following:

Under §101 of the bill, dealing with private foundations, the foundation must dispose of stock in a corporation if the combined ownership of the corporation's voting stock held by the foundation and all disqualified persons amounts to more than 20 percent. In many instances, the only place this stock can be marketed is to sell it back to the corporation itself. Thus, §101 of the bill compels a redemption of the stock and §421 (under regulations yet to be issued) may impose a dividend tax upon the remaining stockholders because of the redemption.

Finally, there is an effective date problem which should be corrected. There are many convertible debenture issues which were outstanding on January 10, 1969, which provide for changes in the conversion ratio with the passage of time. Certainly the grandfather clause applicable to outstanding stock as of such date should be expanded to cover holders of rights or convertible securities which were outstanding as of January 10, 1969.

SECTION 462—EARNINGS AND PROFITS

Under the heading "Depreciation Allowed Regulated Industries; Earnings and Profits Adjustments for Depreciation", the bill would require all corporations, not just regulated utilities or real estate corporations, to use the straight-line method of depreciation for purposes of determining the earnings and profits of the corporation. The justification for the proposed change is that for a number of companies, especially among utilities and those investing heavily in real estate, distributions of tax-free dividends are permitted where accelerated depreciation methods are utilized in determining earnings and profits.

ATMI is opposed to the general requirement that earnings and profits of all corporations be determined by the use of the straight-line method of depreciation. This adds an unnecessary complexity to the tax law for the great bulk of corporations (probably in excess of 99 percent) which have not been and will not be, in a position to distribute tax-free dividends merely because their earnings and profits are computed through the use of the accelerated depreciation methods permitted in determining the taxable income of the corporation.

Furthermore, while not announced as a foreign tax credit modification, the proposed amendment requiring corporations in years beginning after June 30, 1972, to use the straight-line method of depreciation in computing earnings and profits, could have a significant effect on the determination of Subpart F income of controlled foreign corporations, as well as upon the computation of the "deemed paid" foreign tax credit under §902 of the Code. If §451 is not limited to utilities and real estate corporations, the bill should be amended to make it clear that the earnings and profits changes are not to apply to all of the various provisions of the Code dealing with foreign corporations which use as their starting point earnings and profits of the foreign company.

SECTION 461—CAPITAL GAINS

We have two suggestions to make with respect to the capital gain tax as it relates to corporations. We think that if it is sound to tax 50 percent of the gain to an individual at ordinary income tax rates, the same idea should be equally applicable to corporations. Accordingly, instead of a 30 percent tax rate with respect ot corporate capital gains, we suggest that 50 percent of the gain be taxed at the regular corporate tax rate. This would have the effect of giving relief to small corporations with respect to capital gains. We also recommend for both corporations and individuals a graduated rate of tax on capital gains similar to that included in the 1936 Act where, as the holding period increases, the rate of tax decreases. This could be done by providing that 50 percent should go into taxable income for holding periods of one to three years, 40 percent from three to five years, 30 percent from five to ten years, etc.

SECTION 521—REAL ESTATE DEPRECIATION

On the ground that the present tax treatment of real estate has been used by some high-income individuals as a tax shelter to escape payment of tax on substantial portions of their economic income, accelerated methods of depreciation would be denied with respect to new buildings (except in the case of new residential housing) where a construction begins on and after July 25, 1969. The bill also provides for the recapture of the excess of accelerated depreciation over straight-line depreciation on the disposition of depreciable real property to the extent of depreciation taken after July 24, 1969.

ATMI is strongly opposed to any provision which would prohibit manufacturing corporations from using the double declining balance and sum-of-the-year's digits methods of depreciation with respect to new buildings and other depreciable real property. To the extent there are abuses in the real estate field with respect to "some high-income individuals", ATMI recommends that Congress strike directly at the target of the abuse and that it not make changes which are of substantial detriment to corporations generally and to the industrial segment of the economy in particular—where the abuse does not exist.

It is noteworthy that the Tax Reform Act of 1969 proposes a substantial reallocation of the tax burden between corporations and individuals. The largest revenue increase under the bill, for example, comes from the repeal of the investment credit, practically all of the cost of which falls upon corporate taxpayers. Under such circumstances, we urge that the manufacturing segment of our economy not be further penalized by denying it the use of accelerated depreciation methods for new plant, where the primary rationalization for the change is simply to take away a tax shelter for a few high-income individuals.

For corporations generally, and particularly for the manufacturing industry, the proposed amendments to the recapture provisions of §1250 would appear to be adequate to take care of any problems that may have arisen outside the so-called tax shelter area. Accordingly, ATMI approved of the proposed amendments to §1250 of the Code, but objects vigorously to the proposed elimination of accelerated depreciation methods for depreciable real property used by manufacturing corporations.

We would further point out that when the Treasury's depreciation guidelines were promulgated in 1962, the Department indicated that it was not providing for shorter lives than old Bulletin F on buildings because of inadequate depreciation recapture provisions with respect to dispositions of depreciable real property. As a consequence, industry in this country is now confronted with the fact that lives on buildings and other depreciable real property are unrealistically long and we are about to lose the right to compensate in part for this factor through the use of accelerated depreciation methods. We think this is unjust and inequitable.

SECTION 705—REPEAL OF THE INVESTMENT CREDIT

SECTION 705—AMORTIZATION OF CERTAIN RAILROAD ROLLING STOCK

We have combined these two sections together because they point up both the need for and a possible solution to the single most important reform needed in the field of depreciation generally.

We are not objecting to the repeal of the investment credit as such, although we must advise that it accomplished a great deal in the textile industry and

helped considerably in bringing new machinery into our plants which greatly improved our efficiency. This modernization of obsolete plant and equipment was much needed in view of the increasing competition from textile products imported from abroad. However, the investment credit did not last long enough to permit completion of much needed modernization programs. We still have a considerable way to go in order to be better able to compete with low-cost foreign imports. In this connection, one of the problems that is beginning to plague our industry is the application of the reserve ratio test contained in the Depreciation Guidelines of the Treasury Department.

The reserve ratio test is extremely complicated and it is very difficult to apply. We find that there is no uniformity with respect to its application in various parts of the country and no taxpayer knows just where he stands with respect to his depreciation allowance. It is, of course, very important that taxpayers in our industry be able to plan on definite depreciation deductions in order that they can know what they can spend for new machinery. We think the answer to this problem is indicated by § 705 of the bill dealing with depreciation on railroad rolling stock. The bill specifies a set period of years over which such rolling stock can be depreciated by the railroad industry. The Guideline rate of the railroad industry is 14 and the bill reduces this period to 7 years.

We are not necessarily asking that our Guideline Life of 12 to 14 years be reduced to 7 years, but we are asking that we be allowed to count on the 12–14 year life with accelerated methods of depreciation. We do not want our depreciation to be subject to repeated adjustments through the use of the reserve ratio test. We ask Congress by legislation to allow taxpayers to use the guideline lives of their industry as a matter of right. Under this recommendation, the reserve ratio test of Revenue Procedure 62–21, and the various administrative procedures for adjusting lives if the test is not met, would be dropped, except for the case of taxpayers who use depreciation lives which are shorter than the applicable guideline life.

CONCLUSION

This concludes our written statement. I wish to thank the Committee for giving ATMI an opportunity to be heard.

The CHAIRMAN. Next we will hear from Mr. James B. Irvine, Jr., who is president of the Association for Advanced Life Underwriting.

Mr. Irvine, you have a good salesman in Baton Rouge, La., a classmate of mine in college, who called me to direct my attention to the fact that you were going to be here today. He wanted me to ask about something or other. I cannot recall what it was. We will just have to count on you to tell it.

STATEMENT OF JAMES B. IRVINE, JR., PRESIDENT, ASSOCIATION FOR ADVANCED LIFE UNDERWRITING; ACCOMPANIED BY GERALD H. SHERMAN, COUNSEL

Mr. IRVINE. Thank you, sir. I am delighted.

Mr. Chairman, we very much appreciate the opportunity to appear here today. My name is James B. Irvine, Jr. I am a charter life underwriter from Chattanooga, Tenn., and appear before you today as president of the Association for Advanced Life Underwriting (AALU).

I am accompanied by Gerald H. Sherman, our counsel.

AALU is an organization of more than 500 of the United States leading life insurance agencies including your friend, sir, who because of the large——

The CHAIRMAN. That is Bob Bowlus that I am thinking of. You know him?

Mr. IRVINE. Bob Bowlus. Yes, indeed.

The CHAIRMAN. A pretty good salesman. He made me buy a lot more than I should have bought I think.

Mr. IRVINE. The members of AALU because of the large amounts of insurance with which they are concerned, tend to utilize the more complex income planning arrangements. AALU's larger parent organization, the National Association of Life Underwriters (NALU), will be appearing before you today to present its views on a number of current tax reform proposals. We fully support the position set forth in the NALU testimony.

Now, our testimony today will focus solely on the subject of deferred compensation, section 331 of H.R. 13270, and its close relative restricted property, section 321.

Section 331 as passed by the House attempts to remove the possibility of shifting income to taxable years after retirement when the marginal tax bracket is expected to be lower—a shifting of income that heretofore has been available to employees who are in a position to bargain for a deferred compensation average amount.

Now, we believe that the Ways and Means Committee has overstated the case for its suggested change and that such a change will be detrimental to the public policies of encouraging retirement programs and reducing current inflation. Assuming however that the section 331 proposal can find support in its broad application, we would like to direct the committee's attention to a number of considerations that were inadvisably treated. Perhaps the major ommision of section 331 is its failure to contain a definition of the term "deferred compensation."

The mere fact that income is received in retirement years should not be conclusive on the question of whether it qualifies as deferred compensation as contemplated by section 331. This is because employers often insist that a certain portion of compensation be paid only in retirement years. This income is deferred at the employer's pleasure, not the employees. Such deferral of compensation is not "bargained for" in the words of the Ways and Means Committee report.

We, therefore, recommend to the committee that deferred compensation should be defined so as not to penalize involuntarily deferred income.

Section 331 was not promulgated to impede supplementary pension benefit plans that are designed for middle-income employees. Rather it was intended to eliminate jumbo transfers of compensation by high bracket executives to their lower bracket retirement years. A totally ontarget satisfaction of this purpose was, in our opinion, not achieved.

For example, there seems little purpose in legislating tax strictures on disability benefits which are often a part of deferred compensation arrangements. The receipt of disability benefits never represents a deliberate attempt to manipulate the graduated tax rate structure.

The disability benefit reasoning is similarly applicable to death benefits, or at least that portion of death benefits which exceeds the funded or putatively funded amount. Although the language of the House-passed bill seems to encompass death benefits within its scope, the Ways and Means Committee Report speaks solely in terms of retirement benefit. We again here suggest that the statutory language be amended to limit the provisions of the bill to deferred compensation which is received as retirement income by the employee who

earned it. Death benefits, for widows and orphans, as well as disability benefits, should be removed from the legislation's coverage.

We can appreciate the tax equity of excluding an annual amount of deferred compensation from the reach of section 331. However, we strongly suggest that the $10,000 annual amount is inadequate to the task.

We have recommended to the committee in our written statement a number of possible alternative approaches. A reasonable increase in the $10,000 annual exclusion would not constitute an interference with the bill's purpose of eliminating tax motivated deferral of compensation.

In concluding our remarks directed solely to the section 331 treatment of deferred compensation, we would urge the committee to continue to seek a mechanically more simple means of solving the tax rate manipulation problem. There will be a substantial number of deferred compensation recipients who will have to deal with what to them will simply be nonintelligible computations.

"The failure to define "deferred compensation" or "deferred compensation arrangement" leads us back to a dependence on existing law which itself constitutes a thicket of conflicting rules, the application of any one of which is difficult to determine.

The Ways and Means Committee seemed to recognize this situation in promulgating a special new provision for so-called restricted property arrangements.

Having faced the issue that restricted property arrangements are merely another form of deferred compensation, the House failed to reach the logical conclusion that similar tax rules should apply to both situations. As the bill now stands taxpayers can still pick and choose, free of relative economic considerations, from among similar arrangements in order to reach the tax result which is more beneficial.

Furthermore, the bill does not provide us with clear guidance in the situation of funded deferred compensation which does not quite fit into the restricted property category.

To eliminate these close and not totally relevant distinctions between the tax treatments of various types of deferred compensation, we would urge the committee to apply to restricted property arrangements whatever rules it finally decides upon for deferred compensation.

For some reason, not fully articulated in the Ways and Means Committee report, H.R. 13270 imposed substantially more onerous tax consequences to the holdings of nonforfeitable property, that is, restricted property, than it does to the holding of a nonforfeitable promise, that is deferred compensation. Such a forfeiture standard is essentially immaterial if we are faced with a situation in which the employee cannot in any significant way realize upon his nonforfeitable rights. If he cannot transfer the property, his possession of it is simply not worthy of taxing. Drawing fine distinctions between restricted property and deferred compensation bears no consequential relationship to tax equity.

If we start with the assumption that the rules respecting deferred compensation as decided upon by this committee are equitable, why not bring those rules to all forms of deferred compensation including restricted property.

We would suggest further additions to the legislation. The bill refers to restricted property while the Ways and Means Committee

report speaks primarily of restricted stock. It should be made amply clear that the restricted property provisions encompass all manner of property and not merely stock.

There are many forms of property including the insurance policies with which members of my organization concern themselves on a daily basis. We ask this committee to eliminate any inference that would support an unduly limited definition of the term "property."

In addition, the legislation should further clarify that funded deferred compensation plans are to be treated no differently than unfunded plans. This is, of course, simply an a priori conclusion from the premise that restricted property should be treated under normal rules applicable to deferred compensation.

And lastly, we urge that employers should be permitted a deduction at the same time and in the same amount as the employee's income must be recognized.

Mr. Chairman, we appreciate very much the opportunity to appear here today and make our views known, and we hope that we have been of some assistance to the committee.

The CHAIRMAN. Thank you, sir, for a good statement. It seems to me that if we would try to work out somehow in the legislation that the average person making a substantial amount of money, when he is paid 50 percent, could settle for that unless he makes a great deal beyond that, if we could stop all this foolishness of people trying to fiddle and change and go into businesses for which they are not eminently qualified, all that sort of thing, all this deferral and changing and shifting; in other words, if a person was going to pay about 50 percent—and I am talking of a person making a substantial income and those are the people who can afford to buy a big life insurance policy from you—there would be very little incentive for people to try to defer their income for 10 years or 15 years or something of that sort because in all probability they would still be paying 50 percent whether they did eventually receive the income. That kind of thing it would seem to me might have some merit.

In any event, what you said about deferred income at least to a considerable degree had the support of the Secretary of the Treasury. Are you aware of that?

Mr. IRVINE. Yes, sir. We would make one clarification, Mr. Chairman, in that we would not disagree strongly with the statements that you just made. For the most part, however, they apply to the large-income man as opposed to the large number of middle-income people for whom we are making a plea here today.

There are many deferred compensation arrangements that are employer oriented as opposed to being employee oriented. As such they do not represent deferred compensation along the lines that apply to the big taxpayer.

The CHAIRMAN. Well, we got both me and you on your 10 minutes. How about Senator Anderson.

Senator Williams?

Senator WILLIAMS. No questions.

The CHAIRMAN. Thank you very much, sir.

Mr. IRVINE. Thank you, sir.

(Mr. Irvine, Jr.'s prepared statement follows:)

STATEMENT OF JAMES B. IRVINE, JR., C.L.U., ON BEHALF OF ASSOCIATION FOR ADVANCED LIFE UNDERWRITING

My name is James B. Irvine, Jr. I am a Chartered Life Underwriter from Chattanooga, Tennessee, and appear before you today as President of the Association for Advanced Life Underwriting (AALU). I am accompanied by Leonard L. Silverstein and Gerald H. Sherman, our counsel.

AALU is an organization of more than 500 of the leading life insurance agents in the United States. By the designation "leading life insurance agents," we mean agents who, because of the large amounts of insurance with which they are concerned, tend to utilize the more complex and sophisticated financial planning arrangements.

AALU's larger parent organization, the National Association of Life Underwriters (NALU), a 100,000 member group of life insurance agents, will be appearing before you today to present its views on a number of the current tax reform proposals—those to which we will specifically refrain from speaking. Our failure to join NALU in a detailed consideration of such proposals does not indicate our disinterest in them, but rather it reflects our deference to the Committee's request that duplication of testimony be kept to a minimum and, if possible, eliminated. We would like, however, to assure the Committee that we fully support and commend to the Committee, the positions set forth in the NALU testimony.

Our testimony will focus solely on the subject of deferred compensation (section 331 of H.R. 13270) and its close relative, restricted property (section 321). We in the life insurance industry devote our entire working lives to assisting others to provide adequate financial protection for themselves and their families after their normal working lives have been concluded, whether by death, disability, or old age retirement. In a sense, then, our entire focus is on the provision of deferred compensation in one form or another. At the very least, the establishment of deferred compensation arrangements constitutes a major activity of the life insurance industry. We, therefore, are greatly interested in the manner in which deferred compensation is subjected to our taxing system.

A. Deferred compensation (§ 331)

Section 331 of H.R. 13270, as passed by the House and submitted to this Committee for consideration, attempts to remove "the possibility of shifting income to taxable years after retirement when the major tax bracket is expected to be lower"—a shifting of income that has heretofore been "available to employees who are in a position to bargain for deferred compensation arrangements." [1] We believe that the Ways and Means Committee has overstated the case for its suggested change in the treatment of deferred compensation. Further, such a change will be detrimental to the imporant public policy of encouraging economically secure retirement programs. However, we can sympathize with the attempt (as a function of tax equity), to limit the possibilities for the otherwise economically fruitless activity of shifting income between years in order to minimize the effect of our graduated income tax rate structure.

Assuming, then, that the section 331 deferred compensation proposal of H.R. 13270, as submitted to this Committee, can find support in its broad application, we would like to direct the Committee's attention to a number of considerations that were either overlooked or inadequately treated in the current legislative draft.

1. DEFINITIONAL PROBLEMS

Perhaps the major omission of section 331 is its failure to contain a definition of the term, "deferred compensation." Neither the Bill nor the Committee Report gives any guidance as to when compensation is deemed to be deferred.

The mere fact that income is received in retirement years (the kind of compensation which seems to have been in the minds of the drafters) should not be conclusive on the question of whether it qualifies as compensation of a deferred kind for purposes of the legislation. Employers often insist that compensation be paid in retirement years so that employees will have little difficulty in maintaining reasonable standards of living during those years. In this way the employer is protected from having to make difficult decisions respecting which employees should receive the benefit of *ad hoc* assistance during retirement. In effect, the employer relieves itself of a pastoral function for which it is normally ill suited.

[1] H.R. Rept. No. 91-418 (Part 1), 91st Cong., 1st Sess. 90 (1969).

The employee must accept the compensation after retirement and can, in no event, receive it during the normal working years. The income is deferred at the employer's pleasure, not the employee's. The deferral of the compensation is not "bargained for" in the words of the Ways and Means Committee report.

Another definitional problem arises from the fact that compensation can and often is, deferred as between different years during which the employee is working and receiving other taxable compensation income. The statutory language would appear to reach this kind of arrangement, although it can be questioned that this was or should have been the intention of the House.

We, therefore, recommend to the Committee that a workable definition of deferred compensation be developed for inclusion in the legislation. Such a definition would recognize that involuntarily deferred income should not be penalized.

2. OVERREACHING OF THE PROVISION

The deferred compensation which appears primarily to have been in the minds of the legislative draftsmen is that type which defers large amounts of income of high bracket taxpayers. The provision for a $10,000 annual exclusion seems clearly to be in pursuance of this legislative purpose. Another way of stating the same thesis is that section 331 was not promulgated to impede supplementary pension benefit plans that are designed for middle income employees. Rather, it was intended to eliminate "jumbo" transfers of compensation by high bracket executives to their lower bracket, retirement years. A totally on-target satisfaction of this purpose was unfortunately not achieved.

(a) *Disability benefits.*—For example, there seems little purpose in legislating tax strictures on disability benefits which are often a part of deferred compensation arrangements. The carefully conceived tax rate deferral approach upon which a specific, retirement motivated, deferred compensation arrangement may have been based is not even germane to the taxation of disability benefits. Although, by some lights, it can be argued that all disability benefits constitute deferred compensation, it is doubtful that the disability benefit paid to a given employee is ever fully funded in amounts that might otherwise have been reported in income in earlier years. The major portion of disability benefits arises through insuring arrangements that entail the sharing of costs and risks among many persons.

Additionally, irrespective of considerations involving the technically accurate measurement of the extent of deferral, the receipt of disability benefits never represents an advertent attempt to manipulate the graduated tax rate structure. Little purpose can be served by making it more difficult for a man to use the benefit to its fullest and most efficient extent during the period of disability. The new rules of section 331 should specifically be made nonapplicable to disability benefits.

(b) *Death benefits.*—The disability benefit reasoning is similarly applicable to death benefits, or at least that portion of death benefits which exceeds the funded or putatively funded amount. Although the language of the House-passed bill seems to encompass death benefits within its scope, the Ways and Means Committee Report speaks solely in terms of retirement benefits. We again here suggest that the statutory language be amended to limit the provisions of the bill to deferred compensation which is received as retirement income by the employee who earned it. Death benefits, for widows and orphans, as well as disability benefits, should be removed from the legislation's coverage.

(c) *Annual exclusion.*—We can appreciate the tax equity of excluding an annual amount of deferred compensation from the reach of section 331. However, we strongly suggest that the $10,000 annual amount is inadequate to the task. It is always difficult, probably impossible, to arrive at a total equitable, objectively stated amount. However, in lieu of the $10,000, we can recommend to the Committee the utilization of other standards employed elsewhere in the Bill. For example, under section 221, taxpayers may deduct annually $25,000 of investment interest before being concerned with disallowances resulting from lack of investment income. Another approach might be the coordination of an absolute dollar amount exclusion with a fifty percent test, such as that utilized in the tax preference limitation provision of section 301. To illustrate, the recipient of deferred compensation might be entitled to a stipulated annual minimum amount, but in no event less than an amount equal to fifty percent of the deferred compensation received.

Yet another approach to this problem would be to focus on the amount of retirement benefit needed to provide middle echelon executives with reasonable

amounts of retirement benefits. For example, in the major American metropolises, such as New York, Chicago and Los Angeles, minimum monthly deferral compensation of $1000 to $1500 would not seem unwarranted, i.e., $12,000 to $18,000 per year. Middle management executives, who during their working lives earned $25,000 to $30,000 per year, would currently have difficulty managing on retirement benefits of less than $12,000 to $18,000 annually. In numerous cases the deferred compensation is the employee's only source of retirement benefits. Many employers have no pension plan, have pension plans providing limited benefits, or, with respect to newly-hired older employees, provide minimal benefits because of years of service-based formulas.

A reasonable increase in the $10,000 annual exclusion would not constitute an interference with the Bill's avowed purpose of eliminating tax-motivated deferral of compensation from one year to another.

3. COMPLEXITY

In concluding our remarks directly solely to the section 331 treatment of deferred compensation, we would urge the Committee to continue to seek a mechanically more simple means of solving the tax rate manipulation problem—a means that would not have recourse to the kinds of tax return complexities which are inherent in section 331, which the average citizen will not understand, and to which he will have no sympathy. Granted that the concept of a minimum annual exclusion will eliminate the problem for many taxpayers, there still will be a substantial number of deferred compensation recipients who will have to deal with what to them will simply be nonrelevant and nonintelligible computations.

B. Restricted property (Section 321)

As we previously stated, the failure of H.R. 13270 to contain a definition of the term, "deferred compensation," presents certain serious problems. In addition, this failure, or more particularly the failure to define the phrase, "deferred compensation arrangement," a liberally used term throughout the Ways and Means Committee Report, leads us back into a dependence on existing law which, itself, constitutes a thicket of conflicting rules. The varying approaches of the judicial decisions and the Revenue Service administrative positions are often contradictory and irreconcilable.

There are a series of different consequences that could arise, depending upon whether the deferred compensation arrangement is funded or unfunded, utilizes the intercession of a trust, or reflects the actual delivery to the employee of property subject to restrictions having an effect on value. Under existing rules it is difficult to determine the appropriate set of legal consequences. One might have recourse to such a divergent group of rules as section 72 respecting annuities, section 404(a)(5) respecting deduction aspects of certain funded plans, Regs. sections 1.61-2 and 1.421-6 respecting restricted property, and Rev. Rul. 60-31 respecting certain described kinds of deferred compensation arrangements. In addition, it has been necessary to master (if that is even remotely possible) the doctrines of constructive receipt and economic benefit.

1. RELATIONSHIP TO DEFERRED COMPENSATION

The Ways and Means Committee seemed to recognize this situation, at least in part, in promulgating a special new provision for so-called restricted property arrangements, i.e., situations in which an employee receives property subject to restriction. The Committee Report specifically acknowledged that restricted stock arrangements, one form of restricted property, are not designed as a means of allowing key employees to become shareholders in a business but are more particularly designed as a form of deferred compensation.

Having faced the issue that restricted property arrangements are merely another form of deferred compensation, the Ways and Means Committee and the House failed to reach the logical conclusion that similar tax rules should apply to both situations. Such a conclusion would have substantially assisted in clearing the morass of conflicting rules and would have led the way to an understanding of the common characteristics of almost all forms of deferred compensation. As the Bill now stands, we are left with a situation similar to that under existing law where taxpayers can pick and choose (free of relevant economic considerations) from among similar arrangements in order to reach the

kind of tax result which is most beneficial. Furthermore, although the Bill appears to apply separate rules for restricted property as contrasted to deferred compensation, it does not provide us with clear guidance in the situation of funded deferred compensation which does not quite fit within the restricted property category. Here we are left in the same unfortunate haze as under existing law.

2. IDENTITY OF TREATMENT PROPOSED

To eliminate these close and not totally relevant distinctions among the tax treatments of various types of deferred compensation, we would urge the Committee to apply to restricted property arrangements whatever rules it finally decides upon for deferred compensation arrangements.

H.R. 13270 would now impose tax on the full value of nontransferable property (without consideration of depletion in value by reason of the existence of the nontransferability restriction) simply because the property may not be subject to forfeiture for failure to perform substantial future services or may not be subject to some other substantial risk of forfeiture. Compare this to the Bill's deferred compensation approach where an employee may have a binding and nonforfeitable right to receive the deferred compensation. Despite the nonforfeitability of the right, it is wisely recognized in the Bill that the income should not be taxed until received. Thus, for some reason not fully articulated in the Committee Report, H.R. 13270 imposes substantially more onerous tax consequences to the holding of nonforfeitable property than it does to the holding of a nonforfeitable promise.[2]

3. FORFEITABILITY CONSIDERATIONS

Although the Ways and Means Committee Report suggested no explanation of the meaning of the term "substantial risk of forfeiture", we would assume that the term does not include such commonly used forfeiture provisions as noncompetition clauses and consulting service arrangements. No evidence has been offered, of which we are aware, indicating that such provisions do not represent limitations of subsistence. If such data does exist, it should be made available for public inspection. In any event, the forfeiture standard is essentially immaterial if we are faced with a situation in which the employee cannot in any significant way realize upon his nonforfeitable rights. If he cannot transfer the property his possession of it is simply not worthy of taxing incidence.

The drawing of fine distinctions between restricted property and deferred compensation may demonstrate a virtuosity in close analysis. However, such distinctions bear no consequential relationship to tax equity. If we start with the assumption that the rules respecting deferred compensation as decided upon by this Committee, are founded on equitable underpinnings why not apply those rules to all forms of deferred compensation, including restricted property? The "sauce for the goose, sauce for the gander" analogy is most appropriate and applicable here.

4. RELATIONSHIP TO ALL FORMS OF PROPERTY AND FUNDING APPROACHES

In order to implement a more complete unity in the tax treatment of deferred compensation arrangements, we would suggest further additions to the legislation. The Bill refers to restricted property while the Ways and Means Committee Report speaks primarily of restricted stock. It should be made amply clear that the restricted property provisions encompass all manner of property and not merely stock. There are many forms of property, including the insurance policies with which members of my organization concern themselves on a daily basis. We ask this Committee to eliminate any inference that would support an unduly limited definition of the term property. The intent of the statute is clear. It should be reflected in the legislative language or, at a minimum, in this Committee's Report in order to counterbalance the possible inference to the contrary that might be derived from the Ways and Means Committee Report.

In addition, the legislation should further clarify that funded deferred compensation plans are to be treated no differently than unfunded plans. This is,

[2] There is nothing in section 321 which limits the definition of property to tangible property or to certain types of nontangible property. Why then couldn't the right to deferred compensation be deemed to be property for purposes of that section?

of course, simply on an a priori conclusion from the premise that restricted property should be treated under normal rules applicable to deferred compensation.

Lastly, we urge that the legislation contain specific rules for the coordination of deferred compensation payment deductions with the taxability of deferred compensation receipts. Employers should be permitted a deduction at the same time and in the amount as the employee's income must be recognized.

We appreciate the opportunity to appear and make our views known, and hope that we have been of some assistance to the Committee. Thank you.

The CHAIRMAN. We will hear from Mr. John P. Meehan, chairman of the National Association of Life Underwriters' Committee on Federal Law and Legislation. Is he here?

Well, we will pass his statement and perhaps we will hear from him later.

Is Mr. Leon Kust, the vice president and general tax counsel of Westinghouse Electric Co., here?

Pleased to have you here with us today, Mr. Kust.

STATEMENT OF LEONARD E. KUST, VICE PRESIDENT AND GENERAL TAX COUNSEL OF WESTINGHOUSE ELECTRIC CORP.

Mr. KUST. Thank you, Mr. Chairman and members of the committee.

My name is Leonard E. Kust and I am, as the chairman said, vice president and general tax counsel for Westinghouse Electric Corp.

I have submitted in advance a statement which I request be placed in the record. I would like to present a summary which I trust I can do within the 10-minute limit.

We applaud the effort at tax reform in general. I think there is a need to reexamine the exemptions, deductions, and various special provisions of our Internal Revenue Code for the purpose of making it consonant with present needs and priorities.

However, I wish to point out to the committee that in the preoccupation with the main thrust of reform, we think there are going to be some unintended and undesired results at least as some of the major provisions have impact on our operations. I would like to point these out to the committee.

Also, I would associate myself with the testimony of some of the previous witnesses in their pointing out that there is a need for evaluating the total impact of the House bill, particularly in terms of what I think is a matter of concern—the total effect is a shift in the relative tax burden between corporate business and individuals. I believe that the economic implications of this deserve careful consideration against a background which is not always recognized.

The 1964 Revenue Act reduced individual tax liabilities by about 20 percent while corporate tax liabilities were reduced only by 8 percent. It is true that the investment credit and liberalization of depreciation was looked to as equalizing the reductions, but on the other hand the acceleration of tax payments really canceled in total the reduction for corporations.

Then, of course, the surcharge was at the full 10 percent rate on corporations in 1968; for individuals only half that rate. Now this year it is equal. But again when the surcharge is discontinued, we will revert to the 20 percent reduction for individuals in the 1964 Act and

only 8 percent for corporations. And this bill would increase the tax liability of corporations by $4.9 billion while it reduces the tax liabilities of individuals by $7.3 billion.

This is a very significant shift in relative tax burdens which has an impact on our economic growth and which is a matter of the welfare of all of the people.

If the investment credit is to be repealed, I urge that there be careful consideration given to some compensatory change in the tax liabilities of corporations such as more liberal depreciation allowances or a reduction in the corporate rate.

Now as to some specific reform proposals which we think may have either inadequate impact or unintended results, I would call attention to the problem of moving expenses of employees.

While the House bill does contain provisions that are designed to recognize that the costs of transferring employees when reimbursed to the employees should not be taxable income, such costs are inadequately recognized, particularly where there is a sale of a residence at the old location.

The overall limit of $2,500 on moving expenses is less than the commissions and closing costs incurred by the average transferred employee in connection with the disposition of the home. There would be nothing left for the other expenses that are intended to be covered. And the expenses of disposition are too restricted.

They should cover such carrying charges as insurance, taxes, utilities, and maintenance which are duplicated in circumstances which are quite frequent, that is, where there are two homes owned during the period of the move before the old house is sold.

With respect to the depreciation of real estate, while there is unquestionably some need for reform in this area, we think the House bill is too sweeping and that it reaches not only the abuse but would repeal desirable and needed depreciation allowances for taxpayers who have to invest in buildings as a necessary adjunct to their manufacturing or commercial pursuits.

I would recommend that the present depreciation methods continue to be applicable to owner-occupied factories and commercial buildings.

With respect to restricted stock and deferred compensation, I think it should be recognized that while there is the potential, and in some cases a realized tax benefit to the employee, tax considerations are not the sole motivation. Indeed from the point of view of the employer they are the lesser part of the motivation for most of these compensation schemes.

Deferred compensation, particularly that kind which is issued in the form of restricted stock of the employer or is measured by the employer's stock, enables the employers to induce their key employees to remain with the company and to provide them a proprietary interest in the company.

Now, these are valid employer purposes which predate the income tax and are not motivated by tax considerations. The proposed amendments in the House bill dealing with deferred compensation in our judgment would destroy these methods as a means of achieving these valid employer purposes. We urge that this be restudied as the administration proposes, and our suggestion is that it be studied within the context of the qualified stock option rules, which are the provisions

that have been designed to permit the creation of a proprietary interest in key employees, but which in our judgment do not really adequately serve that purpose.

One of the main reasons why in recent years there has been a shift to deferred compensation and restricted stock is the inadequacy of the qualified stock option in serving the employer purpose of creating adequate proprietary interests in their key employees.

With a single controlling framework such as the present qualified stock option provisions, modified to permit the use of restricted stock, taxed however at ordinary income rates when the restrictions lapse, which would be a departure from the present practice of taxing the appreciation as a capital gain, and the permission to use outright awards of employer stock or awards measured by employer stock with taxation at ordinary income rates, when either the restrictions lapse or an award measured by stock is distributed, there would be an appropriate recognition of the need for employers to have access to these devices for their employer purposes without creating any undue tax preference to the employer.

I would like again to commend the Congress and this committee for their determination to proceed with the difficult task of tax reform. I appreciate this opportunity to present views in behalf of Westinghouse, and I trust that the suggestions will be taken not as opposing reform but as an effort to keep reform from having in certain respects unintended and undesired results.

Thank you very much.

Senator ANDERSON (presiding). Senator Williams?

Senator WILLIAMS. No questions.

Senator ANDERSON. Thank you very much for a fine statement.

(Mr. Kust's prepared statement follows:)

STATEMENT OF LEONARD E. KUST, VICE PRESIDENT AND GENERAL TAX COUNSEL, WESTINGHOUSE ELECTRIC CORPORATION

My name is Leonard E. Kust and I am Vice President and General Tax Counsel of Westinghouse Electric Corporation.

It is my purpose to testify in behalf of Westinghouse on four of the specific areas of tax reform included in H.R. 13270: Moving expenses, depreciation of real estate, restricted stock plans, and other deferred compensation. I will cover a fifth item, the capital gains rate applicable to corporations in some general remarks with which I would like to begin.

May I say that at the outset that we applaud the effort to reform our federal income tax structure. There is need for reassessing exemptions, deductions and special provisions with the purpose of making the tax system consonant with present needs and priorities, providing equity where inequities have become evident and broadening the base of the tax in order to permit a reduction of rates.

There will, of course, be disagreement over what specific reform proposals serve these purposes best. Moreover, enthusiasm for tax reform should not be permitted to add layers of new complexity to the tax laws or to create new imbalances in the tax structure.

The momentum for tax reform should not be dissipated through prolonged deliberation but measured consideration of so important a matter as broad-scaled reform in our income tax is certainly necessary.

IMBALANCE BETWEEN BUSINESS AND INDIVIDUAL TAX BURDENS UNDER H.R. 13270

I am concerned that in the overall the structural and rate reform measures of H.R. 13270 result in a shift of the total income tax burden between corporate business and individuals. This needs to be carefully evaluated. I do not believe such a shift is wise.

The 1964 Revenue Act reduced individual tax liabilities by 20%. But corporate tax liabilities were reduced by less than 8%. Corporations did have the benefit of the investment credit and new depreciation guidelines of 1962, but these benefits and the 1964 rate reduction were more than offset through 1967 by speed-up of tax payments. Then the surcharge increased corporate taxes by 10% in 1968 while individual taxes were increased by only 5%. The surcharge extension increased both corporate and individual taxes by 10% for 1969 and both will revert to previous levels in 1970, i.e., individuals will again enjoy the 20% rate reduction of 1964 while corporations will receive only the 8% rate reduction. Yet H.R. 13270, when fully effective, would provide additional individual tax reductions of approximately $7.3 billion while the tax burdens of corporations would increase about $4.9 billion.

It is in this context that I question the advisability of increasing the corporate capital gains tax to 30% and repealing the investment credit.

There should be thorough consideration of the economic desirability and justification of the shift in relative tax burdens between corporate business and individuals inherent in H.R. 13270. A statement on behalf of Westinghouse, in opposition to repeal, was filed with the Ways and Means Committee and I will not repeat our arguments here. But if the Finance Committee should deem repeal of the investment credit desirable, I urge that some compensatory adjustment be made in corporate tax liabilities, such as more liberal depreciation allowances or a reduction in the corporate tax rate to keep the relative tax burdens of corporate business and individuals from shifting to the disadvantage of corporations. It is always tempting to shift taxes to business but the economic wisdom of submitting to the temptation must be questioned if our long-term national interest is to be served.

I should now like to follow these general comments with comments on some specific structural changes in H.R. 13270 affecting our operations.

MOVING EXPENSES OF EMPLOYEES

The first is moving expenses of employees. The reform bill quite properly addresses itself to the inadequacy and confusion of existing law.

Thus, proposed new section 231 recognizes that the transfer of employees between company locations is a common business practice, and the reimbursement of expenses of relocation a business expense of a non-compensatory character. However, under the provisions of the Bill the expense is non-compensatory only if it falls within certain prescribed classes of expense and certain dollar limits. For practical reasons in order to prevent tax avoidance some limitations are necessary, no doubt, but they should be broad enough to permit recovery of the costs and expenses involved in the average move.

It may be thought that only the more highly paid employees are transferred by an employer. Several years ago in an effort to provide background data for legislation, we analyzed the moves made within our Company. We found 70% of the transferred employees earned under $15,000 and 20% between $15,000 and $20,000. Only 10% had income exceeding $20,000. We do not have a similar breakdown for subsequent years but we know the number of transfers has more than doubled, testifying to the growing urgency of the problem.

I have in mind two classes of expense inadequately covered in this Bill which I submit that this Committee should consider. The first is that miscellaneous group of expenses which are inevitable in every move, such as connecting and disconnecting utility services, disconnecting and installing appliances, altering rugs, re-registering automobiles, etc. Collectively these represent a significant item to the average employee. I suggest that a catch-all category be established to include such common miscellaneous items. An over-all limitation with respect to deductible moving expenses should be adequate protection against abuse.

The other class to which I refer is the costs and expenses incurred in connection with disposition of a house at the old location. While commissions and closing costs incurred are covered by the new section, often there is delay in the sale which involves "carrying charges" such as taxes, insurance, interest, utilities and maintenance being incurred simultaneously on both the old and the new home. In 1968 expenses in connection with the disposition of homes of transferred Westinghouse employees averaged about $3,000 per employee, of which the "carrying charges" described are about $1,000.

The over-all limitation of $2,500 with respect to "indirect" moving expenses is not realistic when the sale of a home is involved. The costs and expenses in connection with selling a home will generally exceed that amount, leaving noth-

ing for the other expenses incurred. Since a demonstrable inadequacy exists where the sale of a residence is involved, I suggest that the over-all limitation on "indirect" moving expenses be enlarged in such a case to at least $4,000 and the allowable expenses expanded to include all the costs and expenses of home disposition, other than loss on the sale.

DEPRECIATION OF REAL ESTATE

The proposed reform of depreciation of real estate to prevent abuses by high income individuals is too sweeping. It not only reaches the abuse but would repeal desirable and needed depreciation allowances for taxpayers who do not utilize investment in real estate for tax avoidance but who must invest in buildings as a necessary adjunct to their manufacturing or commercial pursuits.

For many years prior to the Revenue Act of 1954 the business community had complained persistently about the inflexible and inadequate tax depreciation rules. The Revenue Act of 1954 was the first step toward recognition of the need for relief from those rules and was followed in 1962 by an administrative liberalization, commonly referred to as the new depreciation guidelines. The latter, however, had little or no application to real estate. Thus, the only depreciation reform with respect to real estate has been the 1954 Act permitting the adoption of the double declining balance and the sum-of-the-years digits methods for new buildings.

Admittedly, the use of the double declining balance and sum-of-the-years digits methods of depreciation by high income individuals investing in real estate ventures has resulted in tax avoidance. The proposed solution is to eliminate the accelerated depreciation methods enacted as part of the 1954 depreciation reform with respect to all buildings, except residential housing.

Owner-occupied industrial or commercial properties tailored to the requirements of specific manufacturing or commercial pursuits do not, however, lend themseleves to tax avoidance. Such properties are usually occupied during their full economic life by the operator of the business. There is no established market for such properties and they rarely change ownership. They do not serve to generate losses to offset other income and then yield capital gains on sale when rents begin to exceed the depreciation. Furthermore, investment in new productive facilities should not be discouraged as drastically as does H.R. 13270, by eliminating the investment credit on new equipment and the accelerated methods of depreciation on the associated new building.

It is recommended that double declining balance and sum-of-the-years digits methods of depreciation be denied only to real estate held primarily for rent where the income is predominantly from rents, permitting the abuse against which the House legislation is aimed. Present depreciation methods should continue to be applicable to predominantly owner-occupied industrial and commercial buildings. The proposed changes in the recapture provisions are adequate in the case of such property to prevent any abuse of double declining balance or sum-of-the-years digits depreciation.

RESTRICTED STOCK AND OTHER DEFERRED COMPENSATION

H.R. 13270 contains three amendments having a direct effect on deferred compensation payments. In industry, these payments typically are awards of money to executives which are to be paid at some future date, either over an immediately succeeding number of years or over some period after retirement. They may be paid in cash or converted into stock which is issued to the executive subject to restrictions, in which case the award is termed "restricted stock", or may be so converted without issuance of the stock, in which case the award is sometimes referred to as "phantom stock". Many variations are possible, but in substantially all cases the awards are initially forfeitable, being contingent upon the continuation of employment for some number of years.

The amendments referred to are new section 85, which taxes as ordinary income the entire market value of restricted stock at the earlier of the time when restrictions lapse or when the stock is no longer subject to a substantial risk of forfeiture; new section 1354, which imposes a throwback rule on the computation of tax applicable to deferred compensation payments; and new section 1348, which excludes deferred compensation payments from the 50% maximum rate limitation on earned income.

The intention behind the restricted stock provision is to end the capital gain benefit available with respect to appreciation in restricted stock under current

Treasury regulations, and behind the throwback rule, to prevent the obtention of lower tax rates by deferral of income into lower income post-retirement years of the employee. The intention behind the exclusion of deferred compensation from the 50% limitation is not disclosed by the Ways and Means Committee Report or House debate, but presumably is to induce employees to take current income.

We agree with the Administration that these proposals require further study. We would be happy to work with the Administration and the Congress toward a reasonable solution of the problems involved. The following comments are offered to this end.

In the concern for ending preferences to employees the proposals in the House Bill go too far and impair the valid objectives of employers. Deferred compensation, particularly that issued in the form of capital stock, serves two legitimate business purposes of employers. First, through deferral coupled with forfeitures it enables employers to induce employees to remain with the company. Second, deferred compensation in the form of stock awards serves to give the employee a proprietary interest in the company. These business interests predate the income tax and have been accepted as valid by the Congress in the past. They are still valid today. I believe that it should be possible to serve these valid business purposes and prevent any undue tax preference to employees.

Yet, if compensation paid currently is subject to a 50% maximum tax rate and, at the same time, the tax on deferred compensation is not so limited, the result clearly discriminates against the legitimate business purposes involved. If, in addition, it is remembered that the recipient of a deferred compensation payment is, under the throwback provisions, henceforth burdened by the necessity either of recomputing income tax liabilities for all years subsequent to 1970 for as many as perhaps twenty-five years or else paying tax at an even higher rate under the new section 1354, it becomes apparent that deferred compensation simply cannot be used any longer.

Since restricted stock is probably deferred compensation within the meaning of sections 1348 and 1354, although this is not clear, the foregoing comments apply to it as well. In addition, restricted stock is rendered useless by the proposed subjection to tax when no longer forfeitable even though still subject to restrictions on sale. Although most restricted stock issued by employers in the last few years has contained restrictions lapsing only after retirement, generally it has not been subject to forfeiture longer than five years after issuance. If taxation is accelerated to the time when forfeiture terminates, restrictions on sale of the stock cannot really extend beyond that time for then the consequences to the employee would be worse than under the present qualified stock option rules.

But qualified stock options are not an adequate alternative to restricted stock and deferred compensation measured by stock, for purposes of developing a proprietary interest. Although offered by the Treasury and accepted by the Congress as "the appropriate means by which key employees could be provided with a stake in the business," the qualified stock option must be declared at best only a qualified success. It is the failure of the qualified stock option to serve adequately as a means of creating significant key employee proprietary interests that has shifted emphasis to restricted stock and deferred compensation measured by stock. We have not used qualified stock options widely and with good reason. Requiring the employee to pay 100% of the market price at the time the option is granted and then to hold the stock for three years imposes too much strain on the many people who must borrow in order to exercise the option. Thus, with respect to the Westinghouse qualified stock options which have now expired under the 5-year limit on exercise, 31% of the grantees receiving options in 1964 have already made disqualifying dispositions of their stock. It is clear to us that qualified stock options are unlikely to serve significantly as a device for creating long-term equity participation by key employees. Neither can restricted stock, nor deferred compensation measured by stock, under the proposed rules.

I suggest that qualified stock options, restricted stock and deferred compensation measured by stock should all be viewed as serving a legitimate corporate purpose which should not be destroyed by the tax treatment in the hands of the employee accorded to these compensation-with-a-proprietary-interest devices. Undue tax preference for the employees can be eliminated without frustrating the legitimate desire of the employer company to use compensation devices which will deter key employees from leaving and give such employees a proprietary interest.

Since qualified stock options do not adequately serve these purposes and since restricted stock and deferred compensation, while serving these purposes, are

thought to confer an undue benefit on the employees, I suggest a modification of the qualified stock option rules to serve as the controlling statutory framework and to permit:

(1) the issuance to an employee of an option to purchase stock of the employer at 100% of current market value with taxation of the full gain on the sale of stock held for more than 3 years after exercise of the option as capital gain, as at present.

(2) the issuance of a similar option to purchase at a price below the current market price stock subject to restrictions on sale, with taxation of the difference between option price and market price on date of grant as ordinary income when restrictions on sale lapse. Any appreciation above market price at date of grant could be taxed in whole as capital gain upon disposition if the stock is held for more than three years or could be partially taxed as ordinary income, measuring such additional income by the percentage by which the option price was discounted from market value on the date of grant. The first alternative would be simpler but the second would perhaps be more appropriate.

(3) the outright grant to an employee of stock of the employer subject to restrictions on sale or the award of deferred compensation to an employee measured by stock of the employer with taxation in either case of the market value of the stock as ordinary income when the restrictions on sale lapse or the deferred compensation is distributed.

All other present restrictions on qualified stock options would continue to apply, bringing a desirable unity of applicable rules to the whole area of stock options, restricted stock and deferred compensation measured by stock.

Such provisions would remove any undue preference to employees but permit the employer flexibility in serving his purposes of deterring his employees from leaving and motivating them with a proprietary interest to maximize the performance of the business.

It should be evident that exclusion of deferred income falling within the categories described from the 50% maximum rate limit on earned income is incompatible with the aims sought to be served. While such deferred income will serve the interests of the employer, employees will be reluctant to accept it in place of current income if current income is subject to the 50% maximum rate but deferred income is not. With the safeguards which I have suggested it is unnecessary to exclude deferred compensation from earned income subject to the maximum rate. Indeed, if it is not included in earned income the employer's purposes served by deferred compensation will be frustrated. If the 50% maximum rate is applicable then I submit that the throwback rule is unnecessary, obviating the incredibly complex and burdensome record-keeping rules involved.

As a final suggestion with respect to deferred compensation it should be clarified that bonuses payable over no more than five years and subject to earn-out should not be considered deferred compensation. Since such bonuses are forfeitable unless earned-out through continuance of employment they are in fact income only as earned out. Moreover, such forfeitable bonuses really serve the employer's purposes of retaining key employees and rarely provide the employee any benefit over current compensation.

In closing, may I again commend the Congress and this Committee for their determination to proceed with the difficult task of tax reform. I appreciate this opportunity to present views on behalf of Westinghouse and I trust that the suggestions made will be viewed not as opposing reform but as an effort to keep reform from having unintended and undesired results.

Senator WILLIAMS. The next witness will be Miss Vivien Kellems.

Senator ANDERSON. Is Miss Kellems here?

Senator WILLIAMS. Is Miss Vivien Kellems here?

If not, the next witness is Mrs. Caryl Terry.

STATEMENT OF MRS. CARYL TERRY, REPRESENTING PARENTS WITHOUT PARTNERS, INC.

Mrs. TERRY. Mr. Chairman and members of the committee, I am Caryl Terry. I am here as a representative of Parents without Part-

ners, which is an organization of single parents, who are divorced, widowed and separated.

We are here to comment on four reforms which we urge this committee to include in the bill as passed by the House.

Basically we ask that parents providing homes for children be treated equally without regard to whether or not the parents be married, widowed, divorced or separated. In accordance with this, we request that the joint rate taxation which the House bill 13270 extends to widowed parents be equally extended to divorced parents and separated parents who maintain homes for dependent minor children.

In addition, we ask that parents living apart maintaining separate households in accordance with separation agreements be treated for tax purposes as though they were divorced.

We also request that medical and child care deductions be made available to those parents who pay the expenses, without regard to whether or not that parent deducts the children as dependents within the meaning of the Internal Revenue Code.

In many cases one parent provides more than half of the child's support while another parent actually is paying out medical expenses and child care expenses. Neither person can take the deductions as the code is now written.

In addition, we ask that the current discrimination against divorced and separated fathers as opposed to widowed fathers be removed from the child care deduction section. Child care is something that divorced fathers with young children must provide in order to work since they must leave their children at home. There is really no rational basis for the discrimination as it now exists.

That is a summary of our suggestions. I request that our statement be made a part of the record. We are grateful for the opportunity to have testified.

Senator WILLIAMS. I certainly want to thank you for your statement, for a well-prepared statement and the points you have raised merit our consideration and will be considered by the full committee and we thank you for them.

Mrs. TERRY. Thank you, Mr. Chairman.

Senator ANDERSON. Are you a national organization?

Mrs. TERRY. Yes, sir. There are over 400 chapters in all the States. Thank you.

(Mrs. Terry's prepared statement follows:)

TESTIMONY OF MRS. CARYL TERRY,* PARENTS WITHOUT PARTNERS, INC.

Parents Without Partners is an international organization whose sole criterion for membership is that each member be a single parent. Over 50,000 widowed, divorced, or separated parents belong to more than 400 chapters of our organization throughout the United States. We have requested permission to testify concerning H.R. 13270 because of certain tax inequities and related matters affecting single parents and their children. In March of 1967, 2.4 million widows and 2.9 million divorced and separated women were employed in the United States.[1] Of these 5.3 million employed women, 1.7 million had children 17 years of age or younger.[2] There were 819,000 families headed by employed males which

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*Mrs. Dorris Palmer, International President, Kansas City, Mo., Mrs. Joan Kushnir, Legislative Liaison Committee.

[1] United States Dept. of Labor, Bureau of Labor Statistics, Special Labor Force Report No. 94, Marital and Family Characteristics of Workers. March 1967, p. A–5. Table A.

[2] Ibid., p. A–12. Table G.

were not husband-wife families.[3] The tables from which the latter figure was obtained unfortunately do not contain data about children in such families.

We wish to emphasize that none of these figures reflect the total number of single parent homes in the United States. These figures do suggest, however, that millions of children live in single parent homes.

Although we support H.R. 13270's adjustments in the taxation of individuals, such as the increased standard deduction and maximum standard deduction and the provision of intermediate tax status for single individuals over the age of 35, we urge this Committee to amend H.R. 13270 before reporting the Bill to the Senate.

We seek amendments in four basic categories: (1) To equalize the tax treatment of divorced, separated and widowed parents; (2) To supplement this equal treatment by permitting persons living apart pursuant to separation agreements to elect to treat themselves as widowed, divorced or legally separated persons for tax purposes; (3) To permit parents to deduct medical and child care expenses without requiring the children on whose behalf such expenditures are made to be the taxpayer's "dependents" under Section 152 of the Internal Revenue Code of 1954; and (4) To liberalize the child care deduction available to fathers.

Section 803(b) of H.R. 13270 amends Section 2(b)(1)(A) of the Internal Revenue Code of 1954 to tax widows and widowers who maintain homes for dependent children at the joint rate applicable to married couples, while divorced or separated parents maintaining homes for dependent children continue to be taxed at the higher intermediate rate. The responsibilities and financial problems of all such single parents, regardless of the cause of their single status, are substantially identical. In many cases, divorced or separated parents are confronted with the necessity of supporting two households from the income which previously supported a single household, without the insurance, pension or annuity benefits often available to widowed persons. Most divorced and separated mothers work in order to provide decent homes for their children. In fairness they should not have to contend with a tax burden larger than that placed upon a parent in comparable economic circumstances who has lost a spouse through death. We urge this Committee to amend Section 803(b) to avoid its present discrimination against divorced and separated parents, and to provide joint-rate taxation for all single parents who reside with dependent children. Parents Without Partners urges that all *de facto* single parents, regardless of the circumstances which cause their single status, should be treated equally for tax purposes, and that single parents who maintain households for dependent children should not be discriminated against vis-a-vis married taxpayers.

We also recommend that Sections 2(b)(1)(A) and 214 of the Internal Revenue Code be amended to equate taxpayers maintaining separate households under a separation agreement, often during a statutory waiting period prior to divorce, with taxpayers who are already divorced. This would, of course, require such separated individuals to forego their current privilege to file tax returns jointly with their separated spouses, as they can under Section 6013. In many cases this privilege is illusory as emotional considerations and other factors make it actually impossible for such persons to file joint returns. There is no distinction between the situation of such separated persons and divorced, legally separated or widowed individuals. However, the law now imposes a higher tax burden on such persons during this difficult waiting period.

We request this Committee to amend Sections 213 and 214 of the Internal Revenue Code of 1954 so as to permit a parent who actually pays for medical or child care for minor children to deduct medical care payments and child care payments made for such children whether or not the children are that parent's "dependents" under Section 152 of the Code.

Section 213 fails to permit a parent who bears the responsibility for a child's medical expenses but does not claim the child as a dependent for tax purposes to deduct medical expenses paid on behalf of the child. We believe that a parent who spends more than three percent of his adjusted gross income on medical expenses for himself and his children should be permitted to deduct the excess expenses whether or not his children are his "dependents" pursuant to Section 152.

Similarly, Section 214 provides a deduction of up to $900 for child care expenses incurred so that a woman, widowed father or certain married persons

[3] *Ibid.*, p. A–22. Table T.

can be gainfully employed only if such expenses are paid for children who are the taxpayer's "dependents." This deduction is not available to divorced or separated fathers who have custody of their young children, nor is it available to the many women who must work and must pay out substantial sums of after-tax dollars for child care who do not claim their children as dependents for income tax purposes. We recommend that Section 214 permit any single-parent taxpayer having custody of children under 13 to obtain the benefit of the child care deduction without regard to the child's status as his "dependent" under Section 152. Incidentally, we suggest that the Committee consider raising this age limitation.

In addition, we urge this Committee to amend Section 214 to permit parents who are separated but who have not yet received a decree of final divorce or legal separation to benefit from the deduction for child care if such parents maintain separate households and do not file joint income tax returns.

Unfortunately, we are unable to estimate the revenue impact of our suggestions. However, there is no reason to anticipate a very large revenue decrease from these suggested amendments. Whatever are the relevant revenue considerations in equality of treatment among taxpayers who are similarly situated is undesirable. Single parents should not bear a disparate tax burden, a tax burden which inevitable affects their children.

George Eliot wrote that ". . . children are still the symbol of the eternal marriage between love and duty." Members of Parents Without Partners love their children and want to do their duty. With your help we will!

Senator WILLIAMS. The staff has just called to my attention that we passed by Mr. John P. Meehan. He was not called. Is he here?

Next is Miss Dorothy Shinder.

Please proceed, Miss Shinder.

STATEMENT OF MISS DOROTHY SHINDER, DIRECTOR, WAR SINGLES (NOT WAR WIDOWS), AND PRESIDENT, SINGLE PERSONS TAX REFORM

Miss SHINDER. Mr. Chairman and members of the committee, my name is Dorothy Shinder. I am director of War Singles (Not War Widows), and president of Single Persons Tax Reform, both volunteer national service organizations, duly registered in Washington, D.C.

Mr. Chairman and members of the committee, may I ask that both the oral testimony which I will give today and the dialog between you gentlemen and myself and the prepared statement and the summary also be included in the record.

Senator WILLIAMS. It will be included as a part of the record.

Miss SHINDER. Thank you.

May I also ask that this statement and the summary and the dialog be prepared in a separate little pamphlet such as the seed catalogs and all the other catalogs because that is something of vital importance to the members and every American taxpayer?

Senator WILLIAMS. Under the committee rules——

Miss SHINDER. Pardon me, sir?

Senator WILLIAMS. Under the committee rules all testimony has to be printed in the same document.

Miss SHINDER. All right. It was a request, however.

Forgive me for stepping forward at the first part of the testimony, the hearings. You forced me to do this in protest. I have with me a wire in which I specifically requested to be placed on the agenda either first or second on the committee rather than being relegated to the end.

This was done under the "Bill of Rights." I have traveled a great and long distance from a far-off city, across the country, San Francisco, Calif., to speak for millions of people here. It was a protest. I also protest the fact that on the calendar, on the agenda there is no notation made of the fact that these are national groups.

In addition to that, gracious gentlemen, I protest that not one member of the committee is a woman, not to mention a war single.

Senator WILLIAMS. Perhaps the inequity could be corrected if you ran for Senator and got elected.

Miss SHINDER. Thank you, kind sir.

I also protest that there is——

Senator ANDERSON. The Members of the Senate would have a job to change their sex.

Miss SHINDER. I also protest that this is not a full committee sitting for the hearing.

Senator ANDERSON. How would you get the rest of them here?

Miss SHINDER. Pardon me, sir?

Senator ANDERSON. How would you get the rest of them here?

Miss SHINDER. I can register the protest. This is the point.

Senator WILLIAMS. Yes, you have a right to protest but as I pointed out earlier a member of the committee passed away recently. His funeral is this afternoon and many of our members are in attendance. Perhaps this member, knowing his usual concern for his constituents, would have changed the date of his death had he been able to do so.

Miss SHINDER. That is a very astute come-back, sir, and I compliment you, Senator Williams.

You honor me by permitting me to speak before you. My appearance here is in the interest of human rights, social justice, and equity of the law. It is for a cause which is very dear to the hearts of every American—taxation without representation.

War singles—not war widows—have never been recognized or ackwnowledged by our Government, and are now asking for representations comparable to what war widows receive and for other benefits. Other single, widowed, and divorced persons also should be included in the new reform tax laws.

You wonder who the war singles are. War singles are over 35, heterosexual, single or briefly married women whose chances of marriage or remarriage were spoiled by the wars.

Welcome! It is nice to meet you, Senator Long.

War singles have worked in respectable jobs, Senator Long.

The CHAIRMAN. Well, I think our jobs are respectable. Go right ahead.

Miss SHINDER. Yes, sir—all the while paying the highest rate of tax with very little, if any exemptions. War singles have provided for themselves, been their own wageearners and have assumed the entire economic responsibility and burden of maintaining their own households, where they live.

War singles are as much an aftereffect of the wars as are war widows, yet only the war widows have received compensation in the amounts between $32,000 and $39,000 since 1945. All tax exempt war singles have had grevious suffering socially, emotionally, economically, financially, physically, biologically, all affecting their health and welfare.

War singles deserve reparations in the amount of $35,000, plus interest. This money can be obtained from the billions of dollars more than was necessary, appropriated for defense, from plugging up the existing loopholes such as tax exempt foundations, 27½ oil depreciation. Why, Senator Long? Real estate loopholes, accelerated depreciation, and establishments of religion which have gone into businesses, and other areas such as farm subsidy which was intended to help the small farmer, not Senators who have ranches and farms and thus get a tremendous amount of depreciation.

The CHAIRMAN. I do not know what Senator you are referring to. I got out of that business because I lost, really lost money at it.

Miss SHINDER. This is good to hear. If you lose money, Senator Long, you could take it as a loss off of your income tax, gracious sir!

The CHAIRMAN. Well, I pay a lot of taxes anyway I regret to say.

Miss SHINDER. All right.

The CHAIRMAN. May I say that with regard to my situation, I lost so much that even the tax saving did not do me any good.

Miss SHINDER. You know it is nice to have this dialog with you. I have looked forward to meeting you. This is not on a personal basis as you will see afterward.

You know the three times I have been here in Washington, D.C. I have tried to see you. That is why this is truly a revelation.

The CHAIRMAN. Thank you very much.

Miss SHINDER. When the war singles receive their $35,000 just compensation it would be barely comparable to what war widows have received. You, the men in Government, took the men, sent them to wars, then actually punished these war singles for not having husbands. They have been humiliated. Everything was taken from them. It not only gave them nothing in return but made them pay, and made them pay more than their share, at that, draining their incomes and violating their human rights, denied them their equal opportunity and freedom of choice.

To make further amends to these war singles, additional benefits should include retirement at age 50 with full widows social security benefits, including the provision to work whenever they wish, for additional income.

You probably ask why. This is because 57 percent of the married women have gone back into the working area. This means that we have come into a double and triple income economy. Not only that, when the married women do come into the working field, they not only flood the market but they come into the working field not because they need to work, some of them; they want a change of scenery, to fill a vacuum in their lives.

War singles work because they are forced to provide for themselves.

And what we have proposed here is a change of scenery for the war singles, also, who have worked 20, 30, 40, 50 years, and yet the legislative laws have indicated that only men are providers. These war singles have been providing for themselves. They deserve a change of scenery and to be able to have financial security in the form of social security which they have paid for in full.

Remember social security is an insurance policy. War singles would then be in a position comparable to a married woman's, to work whenever they wish, 3 or 4 days a week and for an unlimited income. This

would do a great deal to open up the labor market for the youth, and for these married women who go back into the labor market. When war singles retire, we would like them to retire at age 50. Then they would also be eligible for medicare. (Right now millionaries qualify for it over 65).

War singles should also have tax deductible rents on their living quarters. You probably ask why. Because when they live in an apartment, it is their home. They are home renters, not homeowners. And because the men have made the laws so that women with a low income cannot buy property to live in. Not only that, war singles are more secure living in a bigger building.

And most important of all, if one person, one legislator, voted for redevelopment, which has increased the value of property, and because it was not regulated as it should have been to prevent inflation, then it was because of a special interest; they increased their own wealth if they owned real estate or apartment buildings.

Also, two $600 exemptions as is given to those who retire over 62 or 65. We have discovered that the social security benefits given to single women are atrocious. War singles have been excluded completely. If war singles became deceased before they retire, they lose everything and receive only the small sum of $255 for burial. War singles have paid a large portion for 4,500,000 survivors' benefits to which they have never objected and therefore war singles should be treated fairly and squarely and receive the same amount as a widow does because the cost of living for war singles is the same, their extra expenses are the same as a widows.

Reference is now made to the Secretary of the Treasury's recent statement given before this honorable committee on September 4, 1969, page 23, at the top of the page, wherein the Secretary has stated: "Further, the selection of age as a dividing line for preferential treatment seems arbitrary and bears no relationship to actual ability to pay." This is the crux of the entire situation.

Over the past 7 years I have corresponded with the Office of the Treasury, and I have received their opinions, and I would like to point out at this point when Senator Eugene McCarthy introduced head of household legislation for over 35 it was referred to as "the working girl's bill." (Time magazine, Feb. 14, 1964.)

This was intended to aid and assist unmarried women, be they single, widowed, or divorced because there were 13 million unmarried women as compared to 6 million unmarried men. These women worked, were alone, supported themselves in most instances, had extra expenses and all the while no one even thought about them.

It was a working girl's bill for those over 35. So you see, this contradicts the reasoning and points out the lack of thought of the Secretary of the Treasury pertaining to the legitimacy of the age element involved. It is because of what had happened 20 and 25 years ago. This was why, Senator Long, it was so cruel and unchivalrous of you, sir, to slander and poke fun at so many deserving, respectable unmarried women by saying "In my State that kind of relationship is recognized as a situation in which two people have 'took up.' The amendment would give better tax treatment for those who just 'took up' than married people would receive under law." (Time magazine, Feb. 14, 1965).

A Miss McDonald from San Francisco wrote you a letter and she

sent me a copy, and I wrote an article on it entitled "The Rape of Single Women by our Government," published in the California magazine, Les Gals, and I would like to point out that since that article it seems that the rape incidences have gone up; in San Francisco, alone, 110 percent.

This is a very serious matter—no doubt people on the outside think if the men in government can rape our American women, why can't they. Now, this must cease. You gentlemen must stop crucifying the American single woman.

The CHAIRMAN. Well, how about the American single man?

Miss SHINDER. Pardon me, sir?

The CHAIRMAN. How about the American single man? If we are going to benefit you, why shouldn't he benefit? Why shouldn't it work both ways?

Senator WILLIAMS. She is talking to you.

The CHAIRMAN. But the House bill, as I understand it, would try to benefit both the men and women.

Miss SHINDER. Very good, sir. I am glad you posed that question. At the time Senator Anderson, when the debate was taking place in 1964——

The CHAIRMAN. May I ask you this question. Can you explain to me why we ought to have some tax benefits for two people who are living together in a house without the benefit of wedlock which you deny to two people who are married living in this same house?

Miss SHINDER. Well, this is what the advisory committee on the status of women should look into and they have completely overlooked the war singles who are respectable working girls, women, but the commission has not included them. This is why, gracious sir, it is necessary to have a war singles commission to look into these things, to do research and investigate and get down to the nitty-gritty, to find out just exactly what goes on.

You no doubt have reason to say what you are saying, but I know what I am talking about because I am a woman, and you are a man, I hope.

Now, split income—now here is the answer to your question, sir. Split income for married persons serves as an incentive for marriage. Heterosexual unmarried women desire marriage, love, and companionship with heterosexual unmarried men. They would gladly forego any tax break as an unmarried person, but the odds are against these women who are now over 35 years. And why? Because there were 15 million casualties in World War II, and the foreign marriages right and left to our American men stationed in other countries. In Australia alone there have been an estimated 30,000 war brides, leaving 30,000 American women without husbands in this country, not to mention the other countries.

Does the Department of Defense, will it publish the number of marriages our American GI's make overseas to foreign women in all other countries where they are stationed? This is another item that could be a part of the war singles commission under the Department of Defense.

Also, because of the increased number of male homosexuals, which further depletes the supply of available men. For statistical purposes, these men are listed as male but they are not. And this is why it is so

shocking for the gracious Senator McCarthy to introduce S. 2794 which would allow income splitting for single people.

In the name of God, this must not be. This is destructive legislation. It tends to further ruin the chances of marriage for heterosexual women. Mind you, the odds are against them over 35 as a result of the wars. It will condone and accept homosexuality. Is this what you want? It will induce a greater degree of permissiveness which tears down a heterosexual society. Is this what you want? This is truly legislation without a conscience.

The CHAIRMAN. It seems to me——

Miss SHINDER (continuing). And not in the best interest of our heterosexual society.

The CHAIRMAN. It seems to me that you and I seem to be in agreement on this point that we do not see any point in providing a tax advantage to a homosexual that you would not provide to somebody that is not a homosexual.

Miss SHINDER. But on the other hand, they are taxpayers. And as I say here certainly all unmarried persons deserve a tax break for fairness and equity of the law. This can be accomplished in the form of two $600 exemptions for those who maintain their own households, or even head-of-household legislation. It could also be accomplished by the tax rate changes for all unmarried persons which I notice, are being effectuated in this legislation, for all.

I am speaking right now for war singles legislation which you have overlooked all of these years.

Now, I would like to present a brief summary of the activities of how I have gone about doing it, but before that, would like to mention that in 1964 Senator Albert Gore said the 1964 omnibus tax bill was a bill without a conscience. Senator Anderson at the time said this should come in separate legislation.

Didn't he realize that it applied to so many more women than it did men, the war singles? Wasn't that what he meant? He also said it would cost $300 million. Senator Jennings Randolph——

The CHAIRMAN. I regret to say that you have now consumed 20 minutes and I believe we are going to have to ask you to put the rest of your statement in the record, but we will be glad to put any additional information that you want before that.

Now may I say to the witness——

Miss SHINDER. I have just one other item, sir. This will be very brief. I must get this in.

The CHAIRMAN. One more minute. Go right ahead.

Miss SHINDER. Yes. Thank you, sir.

When there has been no check or balance between the legislative, judicial, and the executive departments of our country, it is a well-known fact that there has been much conflict of interest, serving themselves, among public officials. The President of the United States has seen fit to disclose his financial statement. The judges through the Federal courts have been asked for the same disclosure. The people are clamoring for the truth. There is only way to get it.

The time has now come to invoke the ninth and 10th amendments of the Constitution of the United States which, when properly interpreted, mean when those in public office indulge in "questionable practices," we the people have the "right to know." Therefore with due

regard and complete respect for the individuals and offices concerned, it is respectfully requested that all Senators and Congressmen and Cabinet members of the United States make known their financial statements, thereby disclosing what their interests are and their wealth, and the amount of tax they pay thereon.

This must be done to preserve the national security of our country, revive the faith and confidence in our Government and put our public officials back on the right track.

In addition, before our country becomes a church state which can ultimately destroy the principles of our Government, the financial statements of all establishments of religion (refer to the first amendment and the 16th amendment) some of which are corporations, and the amount of tax they pay thereon, should also be made known to the general public.

Gracious Senators, the time is past for recriminations. This is a direct confrontation and I challenge all of you. Is it not time to make amends, to make it up to us, the people? You have the glorious opportunity of setting a precedent for the entire world by recognizing the plight of war singles. We want a war singles amendment, a women's grievance commission, and to recognize that unmarried persons should receive an equitable tax break.

I would like to thank you for letting me speak on a little more and this direct dialog. Good day.

The CHAIRMAN. Thank you, Miss Shinder. Now please do not be too harsh on this committee for not doing something that you have not asked us to do before. I have always felt that if you want something, you ought to come before the committee and ask for it.

Miss SHINDER. I am here.

The CHAIRMAN. And prior to this time we have had no opportunity to vote for your amendments because it has not been offered.

Miss SHINDER. Would you like to introduce it, sir?

The CHAIRMAN. I am not going to introduce it, but I would be glad to give it due consideration.

Miss SHINDER. Senator Long, why didn't you answer my letter I wrote to you after I found out what you said in Time magazine? That was not very gallant, sir.

The CHAIRMAN. I guess I haven't been. I just did not get around to it.

Thank you very much.

Miss SHINDER. Not at all. Good day.

(Miss Shinder's prepared statement follows:)

STATEMENT OF MISS DOROTHY SHINDER

War singles are over-35 heterosexual single, or briefly married women, whose chances of marriage or remarriage were spoiled by the wars. War singles have worked in respectable jobs for 20 years or more, all the while paying the highest rate of income tax with very little, if any, exemptions. They have provided for themselves, been their own wage-earners and have assumed the entire economic burden and responsibility of maintaining their own households, where they live.

War singles are as much an after effect of war as are War Widows, who receive compensation.

War singles deserve war Reparations in the amount of $35,000 plus interest. This would be barely comparable to what War Widows have received. The Government took the men, sent them to wars, then actually punished the War

Singles for not having husbands; humiliated them, took everything from them, and not only did it give them nothing in return, but made them pay, and pay more than their share, at that, draining their incomes and their Human Rights.

Favoritism given women who serve husbands—Because we are in a male-dominated, family-oriented society, there is far too much favoritism given the women who serve husbands—this cruelly discriminates against War Singles. Though all benefits are based on the wife depending upon the husband for support, no thought has ever been given to the War Single who depends upon herself for her own support.

War singles work as long as men—Our laws—the social security and the tax laws are based on the erroneous assumption that women do not work as long as men, and that only the men are providers—the wage-earners. This is a fallacy. War Singles living alone have been self-supporting and their own wage-earners-providers for as many as 20-30-40-50 years. Thus, if the government has assumed this premise, and it is false, then it is up to these men (the majority of legislators are male) to make amends and correct the wrongs.

Millions more unmarried women than men—and why? In 1940 these women were full of promise. Suddenly, World War II. The men had gone off to war. 15,000,000 men were battle casualties; this means 15,000,000 women were bereft of mates. In the United States alone, there were 300,000 casualties. It was only natural that foreign marriages became commonplace. The women were there—the men were ready. The women here too were ready—the best years of their lives—but to marry ghosts was not an "in" thing. Australia alone supplied an estimated 30,000 wives to our American GIs. Thus, there are now approximately 13,000,000 unmarried women as compared to 6,000,000 unmarried men over 35 years of age. An aftermath of War! In addition, the ever-increasing number of male homosexuals has further depleted the supply of available husbands. In San Francisco alone they are a reputed 80,000 strong. And more's the pity, when so many are so handsome—what a waste. For every two men who "go together" there are two of us heterosexual women who are left without husbands. This has a devastating, frustrating and demoralizing effect on the unmarried heterosexual women.

War widows—As far back as the Spanish American War, the widows of veterans received a Dependency Indemnity Compensation, wherein the government pays them for the loss of their providers. This was an effort to "make it up to them." An estimated 117,891 widows received this benefit, but as of 1966, 87,000 were discontinued because of remarriages and the figure dropped to 30,891. The monthly compensation is $4,854,000; or averaging $157.00 per month, each. Since 1963, the benefits were increased to a minimum of $131 and upwards, per month, depending upon the rank of the deceased husband, and the paid regardless of the income of the widow! Since 1945, each has received approximately between $31,200 and $37,000. All Tax Exempt!

War singles deprived--But what about the War Singles? Haven't they suffered an even greater loss? As of 1967, there were 2,721,000 single women over the age of 35. Their "would be" husbands were taken from them before they even had a chance to marry and derive a little happiness. Yes, these women were deprived of the love, security, companionship and family which marriage would have brought to them. They will never have the aid and comfort of children in their old age and have suffered emotionally, socially, economically, physically, biologically and financially. Nothing can ever really replace these losses. To add insult to injury, these American women were not only left without husbands to depend on for love and companionship as well as support, but were forced to pay higher taxes—which frequently went for the benefits paid to foreign born widows who had married their American men.

Human Rights—Despite all this deprivation, the government actually punished these women for remaining single. Our government and society sits in judgment of War Singles when it was the government itself which was responsible for cutting off the male supply. Their equal opportunity for marriage and leading a normal life, their HUMAN RIGHT was taken from them. Yet the Human Rights Commission has failed to include them. In San Francisco there is not a War Single on its Commission. The possibility of marriage decreases as a person grows older—especially for women. Medical authorities claim it is dangerous for a woman to bear a first child after the age of 35; and an older woman is not as flexible as a younger woman and requires more privacy.

The Government looked the other way—And what did the government do about it? NOTHING! The statistics were available. These War Singles have been pun-

ished unjustly for a situation over which they had no control. They were forced to get out and support themselves. The jobs available to women were low salaried and the income was needed to live on with very little, if any, left for investment, which in turn would have provided tax deductions, which in turn would have lowered their income taxes, which in turn would have made it possible to make adequate provisions for old age as do the men with higher salaries. Thus, without deductions, a straight high tax was paid. Example: In the year 1962 on a salary of $4,548, the income tax was $703 leaving $320 per month to live on. (A working WAR WIDOW receiving approximately $157 tax exempt would have $477). In the year 1963 on a salary of $4,868 the tax was $939.12, or $327 per month (a working WAR WIDOW would receive approximately $484) per month to provide for rent, food, clothes, insurance, recreation, upkeep, dental and medical expense, utilities, vacation, miscellaneous. While the married woman's husband was in the enviable position of receiving great benefits for deductions, it was primarily the unmarried women, because of their sheer numbers, who were paying for the rearing of families. The income of War Singles have been drained over the years because they had no deductions or benefits, thus they suffered a wage loss, which when multiplied over a period of 20 years or more, amounts to many thousands of dollars plus interest, which is pure plunder—yes, indeed, they do have a justifiable grievance against the government! They have a rightful claim and deserve every consideration. While these trusting women relied with faith and confidence on the men in government, these same men maneuvered it so that the tax money extracted from them was being used against them. Instead of giving them the benefits which they so richly deserve, and for which they have paid manyfold. The War Single has been forsaken long enough. If society is working towards a goal of permitting each woman to find herself, then society and the government must turn back the clock and return the men taken from these women. If this cannot be done, then it must make amends to those who have suffered great loss.

Recommendation—It is recommended that these War Singles receive the sum of $35,000, plus interest, IN REPARATIONS for having been deprived of their human rights, for mental cruelty and the grievous suffering emotionally, socially, economically, physically, biologically and financially, because they also had no provider—lost a provider and husband, and were in a SIMILAR SITUATION as a War Widow. This is a glorious opportunity for you gracious gentlemen to set a precedent for the entire world. (The Doctrine of Equality of Treatment to Taxpayers Similarly Situated).

Discrimination against War Singles nonproperty owners—Thus, these War Singles migrating to the big cities for their jobs, working for years on low salaried jobs, while paying the highest rates of taxes, could not even afford to purchase a home because of discriminatory stringent loan relations, or because there was no need for this, and ended up living in apartments which were THEIR HOMES. Yet the government, without compunction, used War Singles' tax money for redevelopment and then turned around and said because you don't own property, you don't count . . . and these helpless women were forced to clean their apartment-homes at their own expense without being able to deduct for these expenses. Because there were no guidelines to protect these apartment homerenters, they were constantly hounded with unjustified rent increases and evicition through unfair practices, at great expense which affected their health and welfare, all due to conflict of interest of government officials who owned apartment buildings. Conflict of interest means the men in government cannot serve two masters; they are supposed to serve the people and not make laws to use the people's income tax money or their influence for themselves.

Recommendation—a. Tax deductible rents because their apartments are their homes and their property taxes are paid through their rents, which they have never been allowed to deduct because our country still has the Old English Property Laws (which England itself no longer has) and which is UN-American and UN-constitutional. Their situation would then be similar to homeowners who can deduct their interest and taxes while enjoying the developing of an equity, which a renter cannot do. Landlords have been receiving far too much favoritism—example an owner of both an office building and an apartment building can deduct depreciation and expenses, but it is only the office renters and not the HOME RENTERS who can deduct expenses. It was never the intent of the 1913 16th Amendment to the Constitution to permit "lording" it over a homerenter. b. for War Single Homeowners: Tax deductible depreciation and expenses yearly because they pay the same rate of property tax as do income property owners.

Medi-Cal discriminates against war singles—Yet, if these respectable, deserving taxpayers of long standing, these war singles working women become ill in the State of California, Medi-Cal discriminates against them because they do not OWN but pay rent for their home. A widow, who has been sheltered and provided for by a husband, or an individual with a private home valued at $25,000, plus $5,000 in real property, plus $1,500 in fluid cash, or a wealth of $31,500, would be eligible. However, a War Single through aforementioned circumstances, with no wealth except possibly a couple of thousand dollars scraped together from her meager earnings intended for her old age, whose apartment has not been recognized as her home, must first be reduced to a minimum of $1,500 IN CASH WEALTH, as compared to a property owner widow or other individual with $31,500 in wealth. This despite the fact that these single women have been paying the highest rate of income tax for 10–20–30–40 years.

Recommendation—It is recommended that apartments be recognized as homes for these War Singles, which they are; therefore a homerenter would be in the similar situation as a homeowner. It is further recommended that the actual wealth of both a property owner and a non-property owner be taken into consideration before allowing this discriminating practice to continue .

Social security as affecting war singles—Social Security is an insurance policy which when paid up in full, that is, the necessary quarters, is supposed to give FULL BENEFITS. Congress thought that the monthly benefit build up over a woman worker's lifetime would be enough to provide security for her. This assumption was based on the theory that she lived with relatives or shared. But she didn't as pointed out in previous paragraphs, but instead maintained her own dwelling-household for years, thus incurring the same initial expense as does a widow in the same kind of household. The basic purpose of social security is to provide protection for the individual and the home. Since this program is determined on need and not based on actual contributions to the system, why should a widow receive more than a War Single, when they both have the same basic household expenses? Or the average monthly retirement benefits be lower than that of a widow? Or why should widows be eligible for social security benefits at age 60 and not the War Single working woman? Especially since the War Single has DONE HER OWN CONTRIBUTING? Fair? Absolutely not! It is the War Single who has the least protection under public programs; it is the widow who receives protection under group life insurance or other types of husband's insurance.

Intensification of discrimination against War Singles—It is intensified for a War Single who out of her meager salary, pays the same rate of tax, receiving only the basic retirement benefits, while married workers not only receive this benefit but also dependents receive additional benefits. These benefits were designed to prevent workers from becoming dependent when the breadwinner retires, thus an individual's security grows out of their own work. What about the War Singles security when she has been her own breadwinner all of her working adult life?

Recommendation—If the original intent and purpose of the social security laws is to be adhered to, then social security benefits should be immediately provided to a self-supporting wage-earner-provider War Single in like amount as to a widow—their costs of living are the same—their situations are the same.

Social security disability discrimination against War Singles—War Singles work for 20–30 and more years and are their own wage-earner providers. They acquire their own necessary quarters to qualify for Social Security benefits. However the 1967 Amendment grossly discriminates against them! This amendment is based on the false assumption that only widows and certain divorcees depend on a wage-earner-provider, i.e., their husbands. War Singles have no husbands and when they cannot work as a result of a disability, they lose their wage-earner-provider, (themselves). When a spouse with the necessary quarters, regardless of when they were acquired, becomes deceased, the disabled widow and certain divorcees automatically become eligible for disability benefits, yet the provisions of necessary quarters regardless of when they were acquired, do not apply to War Singles.

Recommendation—Social Security laws should be amended so that qualified self-supporting wage-earner providers, the War Singles, can also receive disability benefits regardless of when the necessary quarters have been acquired, and receive the same treatment as women who have served husbands, under the doctrine of equality of treatment to taxpayers similarly situated.

Survivor benefits—4,544,785 receive survivors benefits, but even though War Singles have the necessary quarters for Social Security, they are never eligible for this benefit. And, if they become deceased before retirement, they receive nothing except $255 burial expense and lose everything else, plus interest. When women come to work for the State of California, after having completed their necessary SS quarters in private industry, which already includes one survivor benefit play, they are again forced to pay for another survivor benefit even though they will never use either one.

Recommendation—It is recommended that War Singles be given comparable benefits to compensate for not having any survivors—a bequest to a beneficiary, for the sake of justice and equality.

The advisory commission on the status of women—When the President's Commission on the Status of Women was formed in 1961, it was with the intention of doing away with the "prejudices and outmoded customs which act as barriers to the full realization of women's basic rights which should be respected and fostered as part of our nation's commitment to human dignity, freedom and democracy." To this effect, the California Advisory Commission on the Status of Women was created in 1965, to look into "The effect of social attitudes and pressures and economic considerations in shaping the roles to be assumed by women in the society." There was not a one War Single on it! It is absolutely shocking, that by their many omissions, the reports rendered have themselves discriminated against and excluded the War Singles. Instead the reports were completely enamored with wives, dependents, widows, survivors. The needs, the pressures and emotional voids of War Singles were completely overlooked.

Why a war single works—What with 57% of married women in the working field, we have drifted into a double and triple income economy. With an oversupply of employable women over 40, this has a disastrous effect on the War Single by holding the salaries down. The War Single works because she is forced to be her own provider and needs the income to LIVE ON, not because she wants to get out of the house, or for a change of scenery, or a lark, or something different to do. She is not as fortunate as the married woman entering into the business world for what is called a "second career" opportunity. It is a new life for the married woman, but for the War Single it is a continuation of the old life, thus there has been no equal opportunity.

Doctors prescribe a change for married women when they go through menopause. What about a change for the War Singles who also go through this period, and alone at that. They do not have the warmth and security and love of a husband and a family to help tide them through the rough spots. If there is a new life for the married woman, there should also be one for the War Single. She should also have a change. If the married women have two incomes, that is, the support of a working husband, and can work whenever they wish, then shouldn't these War Singles receive relief in kind? They deserve it after having paid more than their share of taxes for so many years.

Recommendation—It is recommended that War Singles, that is, women who have worked for 20 years or more, acquired the necessary quarters in social security, regardless of when acquired, have been their sole provider-wage-earner, have assumed the entire responsibility of maintaining their own household, their dwelling where they live, and have reached the age of 50 years be permitted: Full retirement, Social Security benefits, and in addition, be permitted to work whenever they wish and for unlimited income.

Not only would this partially make amends for all the past sufferings and multiple injustices inflicted on these innocent, helpless women—and give them some semblance of security and peace of mind, but would also create openings in the labor market for the unemployed and evergrowing youth.

TAX INEQUALITY FOR UNMARRIED PERSONS WHO HEAD THEIR OWN HOUSEHOLDS

Split income—The 1948 Amendment to the Internal Revenue Code gave a benefit to married persons by allowing the "split income." It was designed to equalize the tax treatment of married couples residing in community property states and in noncommunity property states. Also, at this time, two $600 exemptions were allowed for over 65 years, regardless of income. The rationale being that those over 65 have a decreased earning power, but greater expenses, such as medical expenses.

Medicare—Medicare now takes care of medical expenses for over 65s. Still, millionaires and other wealthy persons are presently benefitting not only from the double exemption, but also qualify for Medicare which defeats the original intent and purpose of this legislation.

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Recomemndation—If the rationale is based on a decreased earning power, there should be a "means" gauge to be eligible for this benefit, and the tax saving could be applied towards a more equitable tax for the unmarried persons.

Head of household—In 1951, special "Head of Household" rates were added to the Internal Revenue Code as an extension of the split-income benefit . . . the rationale being to give a portion of the split income benefit to taxpayers who maintain households for dependents, because, in effect, they SHARE INCOME with the person for whom the household is maintained, in a manner SIMILAR to the way a husband shares his income with his wife. The Internal Revenue Code, Sec. 1, reads in part "an individual shall be considered as maintaining a household only if OVER HALF of the cost of maintaining the household during the taxable year is furnished by such individuals." (emphasis added)

It was believed that taxpayers not having spouses but nevertheless required to maintain a household (home, dwelling) are in a somewhat similar position to married couples who share their incomes, thus incurring extra expense. It should be noted that these benefit provisions are because the recipients maintain a home (dwelling) and incur extra expense (plus two $600 exemptions).

Unmarried persons ignored—However the code never mentions an individual whose entire cost of maintaining the household during the taxable year is furnished by ONE individual. No thought was given to EQUALIZING the benefits for unmarried persons. The assumption here being that these persons either lived with parents or other persons and shared the expenses of a household. This is not true. It has become the custom for millions of Americans to live alone.

Head of household properly defined—As applied by the IRS, the term "Head of Household" is a misnomer. A household is a dwelling, regardless of the number of people who live in it. At issue here is a household, a dwelling and the cost involved in maintaining it regardless of the number of occupants. A married couple live only 1⅓rd times as expensively as one person, and a family of four generally lives on only twice the average of a single person.

An individual living alone bears the complete responsibility, the financial burden, visually and socially. This consists of rent, property taxes, food, utilities, taxes, clothes, insurance, medical bills, car expenses, gasoline, laundry, recreation; the very same basic items as a married couple. Thus the fixed costs for an unmarried householder and a married couple or a family of four are known to be comparable, even identical.

Surely, this gracious Committee and the Congress can recognize the difference between one type of unmarried person who does not maintain a home but lives with parents or others, and thus does not incur extra expense, and the other type of unmarried person who is required to maintain a home and does incur extra expense.

The doctrine of equality of treatment to taxpayers similarly situated—Under this doctrine, unmarried head of householders should receive equal tax treatment accorded others in similar situations, under the equal protection of the tax laws, under the XIV Amendment.

The Congress has made adjustments for married persons and head of households (as defined by the IRS) because they were both in similar situations, that is, had extra expense. Unmarried Heads of Households also have extra expense as compared to unmarried persons who share, thus this is a similar situation to the married persons and the present IRS Head of Householders.

The following is an equal tax exemption (without the unmarried person)

Exemptions plus Head of Household:	
Unmarried	$600
W/Dependent	600
Exemptions plus Split Income:	
Husband	600
Wife	600
Exemptions plus Sharing Expense:	
Unmarried	600
Father	600
Mother	600
Exemptions plus Nothing: Unmarried, living alone	600

Recommendation—It is recommended that two $600 exemptions as is allowed in the above cases also be enjoyed by the unmarried householders over 35 years of age. It would be a matter of equity for all. It would be a tax exemption benefit

equitable to what the others receive in similar situations, regardless of income. Not only would it cost the government less, but those who need it the most would receive a greater benefit and more spending power, which they need so badly. The saving is substantial for those with high incomes, who are also in a position to invest for tax deductions but the lower income person needs all his money, all his income to live on.

	Present tax 1 $600 exemption	Proposed tax 2 $600 plus exemptions	Saving
Income:			
$5,000	$667	$553	$114
$50,000	21,630	21,270	360

Note: 2 $600 exemptions would make it an equal tax exemption benefit for all incomes, which actually lowers the cost to Government and gives a substantial benefit to the lower and also higher income.

Straight "Head of Household" legislation benefits the rich-higher incomes! it would allow the $5,000 income only approximately $55 as compared to $114 through two $600 exemptions. It must be kept in mind that the lower salary cannot afford tax exemptions, while higher incomes can invest.

Dorothy Shinder vs. Commissioner of Internal Revenue No. 21, 942—In the case of Dorothy Shinder vs. Commissioner of Internal Revenue, No. 21942, appeared as counsel for herself. Although she was well aware of the existing laws, the purpose and intent of her action before the U.S. Court of Appeals for the 9th Circuit was to obtain a judicial opinion. Petitioner respectfully suggests that a just opinion has not been rendered and that the opinion and decision does not follow the Court's own Federal Rule of Civil Procedure Rule 39, 28 U.S.C. 455, "substantial interest," and that the District Court's withholding of information constitutes a denial of her constitutional rights and power.

Petitioner states in her petition for a rehearing: "When there is cause to believe that there is no check and balance between the legislative, executive and judicial departments of our government, then it is incumbent on the people to check and balance those in government who are suspect. Petitioner, a citizen and taxpayer, is *one of the people*, and has retained the 'Right to Know' and the *power reserved to her*, to be informed of any questionable 'Substantial interest' of any one in public office. (The enumeration in the Constitution, of certain rights, shall not be construed to deny . . . others (rights) *retained by the people. U.S. Const., IX Amend.*) ('The powers not delegated to the United States by the Constitution . . . *are reserved . . . to the people.*' U.S. *Const.*, *X Amend.*) (emphasis added).

"Thus, when those who preside over the Court, place themselves above and beyond the law, this, in effect, deprives Petitioner of her liberty, of her right to effectually share and conduct her government and in *her equality before the court.* In essense Petitioner is deprived of her *due process of law.* (*U.S. Const.* V *and XIV Amend.*)

The Court's opinion states, in part, 'The classifications of the law that adversely affect petitioner are within the range of classification that traditionally have been held constitutional.' The Court's use of the word "traditionall" *perpetuates the oral transmission* of beliefs from ancestors who *had no written* memorials and harks back to biblical times and the dark ages. While we live in the present the Courts cling to the past.

"And the Court's ruling on 'constitutional' is purely a matter of interpreation, which can be influenced by "substantial interest" reasoning. It appears a matter of bias and prejudice that the Court, in rendering its opinion, has not used an open mind, and has totally ignored the original *intent* and purpose of our *Constitution which is a WRITTEN MEMORIAL* (replacing any non-written memorials) with built-in guidelines, when interpreted with an open mind, *to serve and protect Petitioner*, as well as members of the Court.

The opinion of the Court with regard to the need of money for Government disregards the wanton waste, squandering, and abuse of petitioner's tax payments, and the corruption of members of our Government.

"In its opinion, the Court states 'As the tax court said, and we must say, this unfortunate woman can only hope for relief from the legislative branch of the government. And, on her facts, it may be a slim hope, given today the government's ever increasing need for money.'

Need for money for whom?? Petitioner at this time would like to point out and query how many Senators like Senator Eastland are actually receiving Petitioner's tax money and approximately $167,000 per year for farm subsidy when the intent and purpose of that legislation was to aid the small farmers? Or, how many judges like Judge Fitzgerald Ames of San Francisco actually received nearly $50,000 of petitioner's tax money, on speculation on redevelopment property in San Francisco when there should have been regulation. Or, Federal Judge Alphonse Zirpoli, and perhaps others, merrily profiteering with Petitioner's tax money? Or how many Senators like Senator Allen Ellender actually receiving Petitioner's tax money for his personal hobby of movie-making. And why did the House of Representatives actually authorize more billions of dollars than was necessary for defense?

"Surely the Court can readily see that actions of these and other public officials reflect on the integrity of all, which is destrictive to our government, and tears down other kinds of law and order." Witness the rioting!

And where will the money come from—The answer is easy. Plugging up the existing loopholes.

1. War Singles reparations can come out of the billions appropriated for Defense.
2. Tax Exempt Foundations which have become distorted into loopholes for tax avoidance, so that others have to pick up the tab.
3. 27½% Oil Depletion allowances could be permitted to recover the original cost of risk.
4. Real Estate Loopholes.
5. Church Businesses. Why does Congress constantly veer from the subject of taxing wealthy churches? The First Amendment to our Constitution states in part: "The Congress shall make no law regarding an establishment of religion." There is nothing, however, which states that Congress shall make no law regarding an establishment of business.

It is a well known fact that the establishments of religion are now in businesses, even corporations, yet escape the 52% Corporation Tax—Corporations reveal their financial statements, shouldn't religious establishments do the same?

It has been said that if one church alone paid its share of tax, it would amount to approximately $300,000,000 in revenue to our treasury. Coincidentally, that is the same amount that Senator Anderson of New Mexico stated it would take to give Unmarried Persons a fair tax.

There is a great danger that if present practices continue, with land and properties being bequeathed to Churches, our country in a matter of 50 or 75 years could become a Church State.

Will history repeat itself, as in the French Revolution, wherein the Church owned ¾ths of the land; the Nobles ¼th, and the people were heavily taxed, as they are today in this country.

Now is the time for men of vision to take action to prevent any future holocaust.

The CHAIRMAN. Now the next witness will be Mr. Richard Walton Edwards, Jr., of Washington, D.C.

Mr. Edwards, will you proceed, sir?

STATEMENT OF RICHARD WALTON EDWARDS, JR., WASHINGTON, D.C.

Mr. EDWARDS. Mr. Chairman and members of the Committee on Finance, my name is Richard Walton Edwards, Jr. I am a resident of the District of Columbia.

I want to express my appreciation for the opportunity to testify, particularly considering the many requests the committee has received. Unlike the ohter witneses you have heard this morning, and many you will hear throughout these hearings, I represent no organization. I speak simply as a citizen, in this case a married citizen.

I have been permitted to testify on two points: (1) the low-income allowance, and (2) the taxation of single persons. If you will permit me, I will speak on the taxation of single persons first.

This past Monday I gave to the office of the committee a supplemental statement commenting upon the Department of the Treasury's proposals for the taxation of single persons. I believe that you gentlemen have that supplemental statement, do you not?

Senator WILLIAMS. Yes. Did you want to put it in the record?

Mr. EDWARDS. Yes, I would.

Senator WILLIAMS. Yes.

Mr. EDWARDS. I would also like to make a correction on page 234 of the printed statements. The sentence in parenthesis about halfway down the page should read:

> Department of Labor statistics show that in March 1967, 10,320,000 married women in the age range 35 through 64 were in the labor force. This was 41.3 percent of married women in that age range.

The citizens of the United States should be told—they should clearly understand—that the special lower tax rates for single persons, if enacted either in the form passed by the House of Representatives or in the form recommended by the Department of Treasury, would mark the effective repeal of the split-income provisions for married persons as we have known them.

Since 1948 married couples have been permitted to split their incomes 50–50 and pay taxes at individual rates as though they were single.

Parenthetically I might say, as you gentlemen know, that there are two ways to effectively repeal a law. One is to do so directly. The other is to pass another piece of legislation which undercuts the effect of the original law and reduces it to a formality.

This is what the Department of the Treasury proposal would do in the case of section 2 of the Internal Revenue Code. It would establish a rate schedule for maried persons filing separate returns which is higher than the rate schedule for single persons. On the basis of this higher schedule, the rates for maried persons filing joint returns would be computed.

The House version does the same thing as to persons over 35.

Four out of ten (40 percent) of married women age 20 to 65 work, and the percentage is slightly higher among married women 35 to 65. These statistics ought to dispel the illusion that husbands make all the money, wives have no income, and marriage is a great way to reduce your taxes.

In many cases, in the tens of millions, the income of a married couple is in fact earned by two people; and in any event it must support at least two people, and typically more. This should be kept in mind when you ponder the charts that Assistant Secretary Edwin Cohen presented to you on Friday which compare the income of one person, a single person, with the combined income of two, a married couple.

For many families, particularly when children are young, one income must support an entire family, and because the wife must be home with the children the parents are in reality a team. And the income they produce, although it comes in the name of say the husband-father, is in reality the income of both and is used for both.

The provisions of the House bill and the alternative proposal advocated by the Treasury severely discriminate against married persons.

I wonder if you could look at the table in my supplemental statement. Do you have it before you?

The table shows various examples under the proposed rates for 1972, of (1) present law under which married persons filing joint returns pay taxes on their split incomes at the same rates as single persons, (2) under the House bill which treats single persons over 35 as "heads of households," and (3) under the Treasury proposal that sets up a special schedule for single persons.

You will note that in example No. 2 a man and a woman each have taxable incomes of $6,000. Under the House version they would pay $140 more in taxes a year if they are married than they would if single.

The same two people under the Treasury proposal would pay $40 a year more if married than if single. I should point out that $40 may not seem like a lot of money in relation to a tax of $2,000 but it would hit many, many persons.

As the incomes go up, the discrimination becomes greater. For example, in example No. 3 a man has a taxable income of $16,000 and a woman has a taxable income of $12,000. Under the House proposal they would pay a total tax of $6,000, if single. If married, they would pay a tax of $6,700, which is $700 more. The same couple under the Treasury proposals if single would pay a tax of $6,140, and under the Treasury proposals if they were married they would pay a total tax of $6,700, or $560 more.

Neither the House bill nor the Treasury proposals in their present form allow married persons filing separate returns to use the new lower rates proposed for single individuals. If special lower rates are made available to single persons, fairness requires as a minimum that those rates also be made available to married persons who elect to file separate returns.

Alternatively, the principle of section 2 of the Internal Revenue Code should be preserved intact as a reality and not reduced to a formality. In that case special lower rates for single persons, which in their effect mean higher rates relatively for married persons, would not be established at all.

The present provisions of the Internal Revenue Code (the sec. 2 split income provisions together with a common rate schedule for single and married persons) make sense. These provisions, permitting persons who have agreed to share their lives together, to share their income and deductions on a 50–50 basis, are sound.

The theory is that in the marital partnership income and expenditures may be so co-mingled that it does not make sense to require that they be segregated between husband and wife, and the income of one partner is in fact the income of the team. And, if you review the legislative history, back in 1948 these split income provisions were enacted because of the problems between the community property States and those without community property laws and because many families had set up very complicated legal devices so that they could legally clearly show that the income was shared equally.

It was to avoid these complications and to simplify the law that the provisions were enacted in 1948 permitting married couples filing joint returns to split their incomes. The provisions for sharing income and expenditures, the so-called split income provisions, do not repre-

sent any special concession. And please keep in mind that the couple's income is split between two real human beings.

In 1951 a fiction was introduced into the Internal Revenue Code. Special rates were established for "heads of households." The idea was that a widow with children to support was entitled to a fictional "half a husband." This was based on the premise that the same or less income must support almost the same family.

There are not even decent fictions to support the House bill's intermediate tax rate provisions.

Let us get one thing clear with regard to the House bill which would give head-of-household treatment to single persons over 35. When the Internal Revenue Code now talks about head of household it is not talking about real estate or the cost of keeping a house in repair or the difference between a house and an apartment as Miss Dorothy Shinder tried to make out. It is talking about persons who share their incomes with others, such as children or parents who live in their house or apartment.

I am afraid that the original principle of income and expense sharing between husband and wife which section 2 of the Internal Revenue Code recognizes will be lost. And why should two persons, both working, have to pay taxes at higher rates when they get married?

The effect of the new rules if enacted would be to penalize married couples and particularly those where each partner has income. They would be far better off to pretend that they were single.

Do you have any questions on this part of my statement before I go to the other?

Senator WILLIAMS. No questions.

Senator ANDERSON. No questions.

Senator WILLIAMS. Have you completed your statement?

Mr. EDWARDS. I have another statement on a different subject, on the low-income allowance; but I think it might be better if I could take questions on what I have said first if that is all right.

Senator WILLIAMS. There are no questions, but you better proceed because we do not have much time.

Mr. EDWARDS. No one should quarrel with sharply reducing the taxes of low-income persons, particularly those who live in or on the edge of poverty. I am not in a position to pass judgment on the exact formula of the low-income allowance, incorporated into section 801 of the tax bill and how effective it will be. I do not question the formula.

My concern is a broad, indeed a philosophical concern. Is not the obligation to pay taxes about as basic as the right to vote? Should not every adult citizen of our country have a responsibility to pay at least something toward the cost of the government from which he benefits?

I believe it is unwise to say to millions of persons—the low-income allowance would take 5.2 million persons off the tax rolls—that they have no responsibility at all to financially support their government.

In my prepared statement I have suggested that a minimum tax be established which all adult citizens would be required to pay. The level might be set at $50 a year, less than $1 a week, or if this seems high, a lower figure.

The tax would be intended to preserve a principle, not raise large amounts of revenue, although the revenue should be substantial since the number of taxpayers will be large.

I have suggested statutory language in my statement. We can discuss it if that seems desirable.

I want to thank both of you gentlemen very much for your attention, and I appreciate the privilege of testifying before you.

Senator ANDERSON. Thank you.

(Mr. Edward's prepared statement with attachment, follows:)

STATEMENT OF RICHARD W. EDWARDS, JR., WASHINGTON, D.C.

My name is Richard W. Edwards, Jr. I am a resident of the District of Columbia. I wish to express my appreciation for the opportunity to testify. I speak as an individual citizen. I represent no organization. I have been permitted to testify on two points: (1) the low-income allowance, and (2) the establishment of a class of "intermediate tax rate individuals." I shall speak on the latter point first.

INTERMEDIATE TAX RATE INDIVIDUALS

Sections 803 and 804 of H.R. 13270 establish special lower tax rates for single persons over the age of thirty-five and widows and widowers. *If* special rates are to be given to "intermediate tax rate individuals," the rates should also be made available to married persons over age 35 who elect to file separate returns. One way to accomplish this purpose would be to draft the definition in amended Section 1(b)(2) of the Internal Revenue Code to read as follows (changes from H.R. 13270 in italics):

"(2) Definition of intermediate tax rate individual.—For purposes of this subtitle, an individual is an intermediate tax rate individual if, and only if, such individual is not married at the close of his taxable year, *or if married does not file a joint return with his spouse;* is not a surviving spouse (as defined in section 2(b)); and—. . . ."

The purpose of the proposed change is to alleviate the discrimination against married persons that would otherwise result. Let me demonstrate. [A blackboard will be used if available.]

Example No. 1.—Suppose a single man over age 35 has a net taxable income of $8,000 and a single woman has a net taxable income of $4,000. The man's tax for 1971, using the 1971 rates in the bill, would be $1,460. The woman's tax would be $640. The total is $2,100.

Now suppose these same persons were married. Their total taxable income would be $12,000. Applying 1971 regular rates to a joint return, their tax would be calculated as follows: They would divide the $12,000 by 2. The tax on $6,000 would be $1,100 which in turn would be multiplied by 2 giving $2,200. Their tax if married would thus be $100 more than if they were single.

I have used proposed 1971 rates in this and the following examples because they are easier to use in making calculations. The discrimination would actually be more striking if the higher 1970 rates together with a surtax were used.

Example No. 2.—The discrimination is greatest when the incomes of the man and the woman are equal, and applies even in relatively low brackets. Suppose the man and woman each have a taxable income of $6,000. For 1971 they would each pay a tax of $1,030, or a total of $2,060, if single. If they were married and filed a joint return the tax would be $2,200; or $140 more.

Example No. 3.—The "price for wearing a ring" gets higher as the incomes go up. Suppose the man has a taxable income of $16,000 and the woman a taxable income of $12,000. As single individuals the total tax would be $6,170 ($3,690 plus $2,480). As a married couple the tax would be $6,900; $730 more.

Example No. 4.—One final example: A man and a woman with high taxable incomes of $20,000 a year each. The "cost of the ring" to them is $1,640 a year at 1971 tax rates. (If they were single their total tax would be $10,160; if married and filing a joint return it would be $11,800.)

DISCUSSION

As demonstrated by the examples, Sections 803 and 804 of H.R. 13270, as presently drafted, discriminate against married persons where both have income. Only in cases where one marriage partner has no income or the taxable income is less than one-fourth of the taxable income of the other partner (the exact proportion may vary slightly) is there no discrimination.

The amendment which I suggested at the beginning of my statement will alleviate the discrimination by permitting married persons over 35 years of age to file separate returns as "intermediate tax rate individuals."

ALTERNATE PROPOSAL

Another alternative, and in my view a better one, would be to delete Section 803 from the bill and make corresponding changes in Section 804(b) to make those rates only applicable to heads of households. The novel provisions for "intermediate tax rate individuals" have no solid rationale.

The present provisions of the Internal Revenue Code permitting married persons to share their income and deductions on a fifty-fifty basis make sense. The theory is that in the martial partnership income and expenditures may be so comingled that it does not make sense to require that they be segregated between marriage partners. The provisions for sharing income and expenditures, the so-called "split income" provisions, do not represent any special concession at least for families where both marriage partners work or have income—a common, not a rare, occurrence. (Department of Labor statistics show that in March 1967 10,320,000 married women in the age range 35 through 64 were in the labor force. This was 41.3% of married women in that age range.*) Even if one of the marriage partners has no income, at least the couple's income is "split" between two real human beings.

In 1951 a fiction was introduced into the Internal Revenue Code. Special rates were established for "heads of households." The idea was that a widow with children to support was entitled to a fictional "half a husband." This was based on the premise that the same or less income must support almost the same family.

Now with the terms of H.R. 13270 establishing "intermediate tax rate individuals," we are completely in the realm of fiction; the original principle of income and expense sharing between husband and wife has been lost. The effect of the new rules, as demonstrated above, is to penalize married couples where each partner has income. They would be far better off to pretend that they were single.

Finally, why favor persons over 35? My personal observation is that persons under 35 have a harder time living on their incomes. The only thing that I can see is that persons over 35 earn more and the progressive tax rates "bite" harder. If this is the problem, it should be corrected by reducing the steepness of the progression of the basic rates (which the bill also does), not by creating a class of privileged persons.

LOW INCOME ALLOWANCE—PROPOSAL FOR MINIMUM TAX

Section 801 of H.R. 13270 provides for a low-income allowance which is in effect a larger standard deduction for persons with low incomes. The Committee on Ways and Means of the House of Representatives estimated that the provisions of Section 801 will remove 5.2 million taxpayers from the tax rolls in 1970 and an additional 600,000 taxpayers will become non-taxable in 1971. The Committee estimated that in 1971 38.1 million taxpayers will benefit to some degree from the low-income allowance.**

I have no quarrel with sharply reducing the taxes of low-income persons, particularly those who really live in or on the edge of poverty. I am not in a position to pass judgment on the exact formula incorporated into Section 801 and how effective it will be to "screen out" persons living at poverty levels. I do not question the formula.

My concern is a broad, indeed a philosophical, concern. Is not the obligation to pay taxes about as basic as the right to vote? Should not every adult citizen of our country have a responsibility to pay at least something toward the cost of the government from which he benefits? I believe it is unwise to say to millions of persons that they have no responsibility to financially support their government while they continue to have the right to receive government services. The removal of over five million persons from the tax rolls may increase the potential size of groups pressuring for larger government spending programs which they have no responsibility to finance.

*The figures were calculated from the statistics in Table B on page A-6 of "Marital and Family Characteristics of Workers, March 1967", Special Labor Force Report No. 94, United States Department of Labor.

**House Report No. 91-413 (Part 1), page 207.

If Section 801 is enacted in approximately its present form, I wish to suggest that a minimum tax be established which all adult citizens would be required to pay. The level might be set at $50 a year (less than $1 a week). The tax would be intended to preserve a principle, not to raise large amounts of revenue, although the revenue should be susbtantial since the number of taxpayers will be large.

The addition of a new subsection to Section 1 of the Internal Revenue Code would, I believe, accomplish the result. Its language might be as follows.

"In the case of a taxable year beginning after December 31, 1969, there is hereby imposed on every individual who is a citizen of the United States of America, is over twenty-one years of age, and whose tax as determined in accordance with subsections (a), (b), and (c) is less than $50, an additional tax which when combined with the tax as determined in accordance with subsections (a), (b), and (c) equals $50." *

SUPPLEMENT TO THE STATEMENT OF RICHARD W. EDWARDS, JR.**

The citizens of the United States, both married and single, should be told in language that they can clearly understand that the proposals for lower taxes for single persons, if enacted either in the form passed by the House of Representatives or in the form recommended by the Department of the Treasury, would mark the effective repeal of Section 2 of the Internal Revenue Code which now permits married couples to split their incomes between the two partners and pay taxes at individual rates.

The Treasury proposal makes this perfectly clear. It would establish a rate schedule for married persons filing separate returns which is higher than the rate schedule for single persons. On the basis of this higher schedule, the rates for married persons filing joint returns would be computed. The House version, although more subtle in its drafting, does the same thing as to persons 35 years of age or older.

39.7% of married women ages 20 through 64 work. In the age range 35 through 64, 41.3% work.*** These statistics ought to dispel the illusion that husbands make all the money, wives have no incomes, and marriage is a great way to reduce your taxes. As I pointed out in my principal statement, to which this is a supplement, even when one marriage partner has no income the couple's income is "split" between two real human beings.

The provisions of the House bill and the alternative proposal advocated by the Treasury both severely discriminate against married persons, particularly where both marriage partners have income. In my principal statement I gave four examples. The attached table shows the taxes for 1972 in these four cases under H.R. 13270 as it was passed by the House, under the Treasury proposal, and if single persons continued to pay at "regular" rates.

If special lower rates are made available to single persons, fairness requires as a minimum that these rates also be made available to married persons who elect to file separate returns. Alternatively, the principle of Section 2 of the Internal Revenue Code should be preserved and special lower rates for single persons should not be established.

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*A provision to accomplish the same result would also be added to Section 3 of the Internal Revenue Code.

**This supplement comments upon the Department of the Treasury's proposal of tentative tax rate schedules for single persons dated September 4, 1969.

***The figures were calculated from the statistics in Table B on page A-6 of "Marital and Family Characteristics of Workers, March 1967," Special Labor Force Report No. 94, United States Department of Labor.

TAX FOR 1972 [1]

	Present law [2]	H.R. 13270—Intermediate tax rate individual provisions [3]	Treasury proposal of tax rates for single persons (tentative)
Example No. 1:			
Man: $8,000	1,530	1,420	1,490
Woman: $4,000	650	620	650
Total single	2,180	2,040	2,140
Total married	2,140	2,140	2,140
Example No. 2:			
Man: $6,000	1,070	1,000	1,050
Woman: $6,000	1,070	1,000	1,050
Total single	2,140	2,000	2,100
Total married	2,140	2,140	2,140
Example No. 3:			
Man: $16,000	4,090	3,580	3,650
Woman: $12,000	2,670	2,420	2,490
Total single	6,760	6,000	6,140
Total married	6,700	6,700	6,700
Example No. 4:			
Man: $20,000	5,730	4,940	4,970
Woman: $20,000	5,730	4,940	4,970
Total single	11,460	9,880	9,940
Total married	11,460	11,460	11,460

[1] The incomes in the illustrations are "taxable incomes." The total tax for married couples is calculated on the bais of a joint return. Neither H.R. 13270 nor the Treasury proposals in their present form allow married persons filing separate returns to use the lower rates available to single persons.
[2] Regular individual rates of H.R. 13270.
[3] It is assumed that the persons are over 35 years of age.

Senator WILLIAMS. Well, thank you for your testimony to be considered by the committee.

Until 10 o'clock tomorrow morning, the committee is adjourned.

(Whereupon, at 1:50 p.m., the committee was recessed, to reconvene at 10 a.m. Friday, September 12, 1969.)

TAX REFORM ACT OF 1969

FRIDAY, SEPTEMBER 12, 1969

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 Clinton P. Anderson, presiding.

Present: Senators Long (chairman), Anderson, Talmadge, Ribicoff, Byrd, Jr. of Virginia, Williams of Delaware, Bennett, Curtis, Miller, Jordan of Idaho, and Fannin.

Senator ANDERSON (presiding). The meeting will be in order.

This morning the general topic before the committee is the proposed treatment of tax-exempt organizations.

In this segment of the hearing, testimony will be received regarding such features of the House bill as: (1) Extension of the unrelated business income tax to churches and other exempt organizations which today are not subject to that tax; (2) treatment of debt-financed acquisition business assets by a tax-exempt organization; (3) the tax treatment of membership organizations and their relationship with their members and the information returns required to be filed by tax-exempt organizations.

We will also take testimony on that portion of the bill repealing separate surtax exemption for multiple corporations.

The committee is honored to have as its first witness this morning the Honorable Mortimer M. Caplin. Mr. Caplin served for several years as Commissioner of Internal Revenue Service. He served with high honor and did an excellent job.

Mr. Caplin, you are recognized.

STATEMENT OF MORTIMER M. CAPLIN, NATIONAL TAX EQUALITY ASSOCIATION

Mr. CAPLIN. Thank you, Mr. Chairman and Senator Williams. It is a pleasure to appear before this committee.

Today I appear in a private capacity as a member of the law firm of Caplin & Drysdale, and we are testifying on behalf of the National Tax Equality Association.

The association represents approximately 8,000 businessmen, and they are concerned over the unfair competitive advantages that tax-free and tax-exempt organizations have when they engage in commercial endeavors.

With marked frequency, and plain inequity, the tax-exempt organizations are entering the marketplace. The tax exemption is being

33-865 O—69—pt. 2——11

stretched to shelter the earnings of ordinary commercial endeavors operated in straightforward competition with fully taxable businesses. And you know how much a businessman chafes under that sort of unfair competition. In the last analysis, the general taxpayer is being asked to subsidize these commercial encroachments of those who have been granted by the Congress the unique privilege of tax exemption.

Although the problem of commercial involvement exists among private foundations it is not, I am sorry to say, confined to that class of tax exempt organizations. A broad range of tax-exempt and tax-favored organizations has undertaken vigorous and large-scale business competition. For example, the multimillion-dollar industrial enterprises operating tax-free as cooperatives; the university-owned department store, euphemistically called a "bookstore"; the church-owned girdle factory; the trade associations advertising business; and many others.

I would like to for a moment survey some of the facts.

This year, a private foundation's tax exemption was upheld by the Tax Court despite the fact that it had acquired 24 businesses during the 9-year period that the Tax Court examined its operations. Included were a plastic manufacturing business, three sand, gravel, and concrete businesses, three dairies, a foundry, a hotel, a printing establishment, and businesses manufacturing windows, oil burners, rubber treads and locks. All were operated under arrangements designed to provide a complete tax shelter for the income received by the foundation; and yet its tax exemption was continued.

One foundation described in the Treasury's 1965 report on private foundations held a controlling interest in 26 separate corporations, 18 of which were operated as going businesses. One was a large and highly competitive metropolitan newspaper with assets valued at $35 million and with gross receipts of more than $17 million in 1962. Another corporation operated the largest radio broadcasting station in the State. A third corporation, sold to a national concern at the beginning of 1965, carried on a life insurance business, with total assets reported at book value of more than $20 million. And that again was back in 1962. Among the other businesses controlled by the foundation were a lumber company, several banks, three large hotels, a garage, and a variety of office buildings.

Cooperatives afford yet another and extreme illustration of the intrusion of tax-free organizations into the marketplace. Only a limited class of these cooperatives are technically tax exempt. But the present tax rules available to other co-ops accord them the practical effect of tax exemption. The tax advantages of co-ops evolved at an early stage in our tax law, in a period when these co-ops consisted of a small band of farmers forming simple associations for marketing farm produce or purchasing farm supplies.

The cooperative today bears little resemblance to their predecessors of 50 years ago. No longer do they consist primarily of the small group of farmers operating at the local level. Rather, with accelerating rapidity, cooperatives have moved into fields of processing and manufacturing, as well as wholesale and retail distribution of non-agricultural commodities. Upon a major scale they produce fertilizer, refine oil, manufacture paint and agricultural chemicals, process citrus fruits, produce dairy goods, sell at wholesale such products as hard-

ware, lumber, drugs, groceries, and operate consumer retail stores. One co-op reported assets valued at $246,599,000 in 1967, with sales of over $500 million for that year. Another had 1967 sales of more than $350 million. A third reported sales of $246,500,000, and five co-ops even appeared in Fortune's latest list of the 500 largest businesses of America.

There are still other classes of tax-free organizations which have embarked on this broad-scale commercial activity—churches, trade associations, fraternal beneficiary societies, and others. They operate advertising businesses, department stores, drilling companies, trailer manufacturing plants, insurance businesses, dairies, et cetera. The Supreme Court in 1965, in the famous *Clay Brown* case, stimulated many of these acquisitions because the Court upheld in that case capital gain treatment in something known as a "bootstrap" sale to a charity. The Court permitted the tax-free organization to acquire the business totally on borrowings, using the earnings of the business to pay for the acquisition; and yet the transaction was treated as a purchase and sale, with no tax to the charity.

The real problem is, first, the fact that this tax immunity involves a great deal of lost revenue to the U.S. Government; and, secondly, and perhaps more seriously, the unfair competition that this represents to the business community of this Nation.

The exempt organization pays no taxes and is competing side by side with fully taxable businesses. I don't have to elaborate on its ability to cut prices, to be able to use its earnings for enlargement and capital improvement, to use its funds for all sorts of fringe benefits for employees. It is extremely difficult for the fully taxable businessman to compete side by side with these organizations under such circumstances.

The prepared statement which I have submitted to the committee, and which I understand will be made a part of the record, describes the technical problems in detail and analyzes the House provisions and the Treasury recommendations. I do not want to go over all the material, but I would like to briefly touch on some of the highlights.

First is the extension of the unrelated-business income tax. The House bill, with only a single limited exception, would extend the unrelated-business income tax to all classes of exempt organizations, including churches. The National Council of Churches and the U.S. Catholic Conference and similar organizations have endorsed the House proposal, and I think that it deserves your full support.

Second is the taxing of debt-financed acquisitions. That relates to the *Clay Brown* situation I mentioned a few minutes ago. Section 121 of the House bill strikes directly at this problem, and it would tax the exempt organization to the extent that it earned income based upon borrowed money. This is the approach that the Treasury Department has supported, and the House bill amply takes care of this problem. I would hope that this committee would give it its support.

Third relates to the taxation of co-ops: Under present law all that a co-op has to do to avoid tax is to pay 20 percent of its earnings to the patrons and give them paper for the rest. All of the earnings are then taxed to the patrons. If he is an ordinary farmer, for example, he has to pay the full tax. Even though the co-op retains 80 percent of the earnings, it pays no tax—unlike an ordinary corporation which

would pay full tax even though it distributed half or more of its earnings.

Now this, of course, is where the unfair competition becomes sharpest: the co-op's retention of earnings without tax as compared to a corporation paying full tax.

The proper solution here should be the normal two-tier tax system applicable to ordinary corporations. Co-ops are corporations, and they should be taxed like other corporations. They should be taxed at the entity level, without any deduction for distributions; and then when their distributions are made there should be taxation on the patron-owners like any other shareholders of corporations.

This past year my law firm completed a rather extensive legal study of the whole area of cooperative earnings. I think this study, which has been published, demonstrates that co-ops are corporations, that their owner-patrons are shareholders, that co-op activities are properly viewed as earning income under established income tax principles, and that the co-op-patron relationship has no special legal features which justify failure to tax.

Senator Ribicoff recently introduced a bill, S. 2646, which incorporates precisely that approach. It is a very simple approach: Tax co-ops like any other corporation, and give them the same tax advantage of any other corporation. But he does one thing which gives an extra advantage, which I would not oppose, to the small farmer-patron who might be involved. The first $300 of dividends paid by the co-op to this farmer would be tax free, and if husband and wife were patrons, up to $600 tax free for a joint income tax return.

I think this is the approach that should be followed. If the Ribicoff bill isn't followed, I think the committee should adopt the position originally suggested by the Ways and Means Committee in its announced tentative decision: require that 50 percent of the earnings of the co-op be distributed currently if the co-op is to be tax free, and require that within a 5-year period the co-op distribute the remaining 50 percent. The latter would be a compromise position.

Unfortunately the House when it released its final bill, watered down the 50 percent distribution some, and in addition, provided that the remaining 50 percent must be paid out in 15 years instead of 5.

The Treasury the other day, for some unknown and unfathomable reason, said we shouldn't even have the initial 50-percent payout. I just don't understand its position. The Treasury said there were certain administrative difficulties under the 50-percent rule, and thus that we should continue with the 20-percent payout.

I submit that if Internal Revenue can cope with the 20-percent payout it certainly can cope with a 50-percent payout administratively. A simple drafting change in the House bill would take care of any administrative problem.

Fourth is the divestiture of foundation business holdings. I believe that the involvement of private foundations in business ownership gives rise to a number of serious problems, even where the business income is subject to tax. I feel that the Treasury recommendation, which is backed by the House's bill, is a proper approach to the problem: that the foundation and related parties should not own more than 20 percent of a business. They should be given liberal transition rules to permit them to get below the 20-percent mark, but they should

not be permitted to own over the specified amount. Business ownership is diversionary. It does create unfair competitive situations. Foundation management becomes related to the business management and diverse opportunities for self-dealing arise. So I do think that the divestiture rule ought to be adopted.

I feel that most of the Treasury recommendations are sound on self-dealing, disgorgement of income, taxing business activities, making sure that the charity really sticks to its knitting.

Once all of this is done, however, I do not think that it is sound to impose a $7\frac{1}{2}$-percent tax on the foundations. I would favor the Treasury's approach of a supervisory fee. I appreciate the costs and difficulties of administering this program. There has been great interest by the Congress in tax administration so far as foundations are concerned and Internal Revenue is putting more people on it. I think a supervisory fee, which is related to the cost of administering this field; would be the sound approach, and I would hope that the $7\frac{1}{2}$-percent tax would be dropped.

Fifth is the advertising income of exempt publications. I think that Treasury regulations are sound and that the legislation of the House to tax this advertising revenue is a proper approach. I would urge that you support it. However, there is one change that I would recommend: the Treasury should be given the power to adopt legislative regulations, to control possible manipulation to avoid tax. There has been a rash of articles by tax advisers of some of these exempt organizations telling how through special reporting techniques and accounting adjustments they can eliminate any tax here. I think you do have to give the Internal Revenue Administrator the opportunity to cope with this.

Sixth, and finally, let me mention the taxation of "related" businesses of exempt organizations. The 1950 legislation placed a tax on the unrelated-business income of certain exempt organizations. But related business, too, can become a problem. Take a map-publishing business or a book-publishing business of a so-called educational institution. It competes side by side with fully taxable publishers. Yet, the institution uses the umbrella of tax exemption to avoid income taxes—by claiming that it is operating in its exempt or "related" field. But when it goes out in the marketplace and behaves like a business, advertises like a business, and solicits sales like a business, then the so-called "related" business income is not what Congress has envisaged as being protected from tax. I would suggest that the committee and the Congress direct the Treasury to conduct a detailed review of this type of business and submit legislative proposals for the correction of any competitive inequality which is found to exist.

I strongly recommend that this committee take prompt and effective action to resolve these problems. I also want to thank the committee for its kind attention.

The CHAIRMAN (presiding). Mr. Caplin, I want to thank you for the support that you gave me some years ago with regard to my efforts to try to simplify our complicated tax structure, so as to provide a simple way where people could pay at a lesser rate, claiming very few deductions.

I am sorry we were not able to accomplish that endeavor.

Mr. CAPLIN. I still feel that way.

The CHAIRMAN. We ought to provide a simple way for a person to pay taxes. Why put them through all the machinations that they go through hiring all these lawyers and accountants and special tax men to find ways to beat taxes. We waste an awful lot of effort needlessly, I think, and that is where the average man would just like to see some improvement.

Take the people in the upper-income bracket. I think most of them would be glad to pay a little more if they could get rid of all the complication and planning that goes along with it.

Unfortunately, we have not been able to work that out.

Mr. CAPLIN. I certainly should like to concur in what you said, Senator, including your last remark about the high bracket people who would be willing to pay some tax if they could be rid of these complications—even those who were fully sheltered from tax. I have encountered that view in traveling around the country. Of course, you get different pictures on how much each would be willing to pay but even a figure of 25 percent doesn't shock some of the people who are able to fully shelter their income today. They recognize the unfairness of the present operation, and many of them are uneasy about the extent of the tax planning that they feel compelled to go through on a competitive basis. They say, "The fellow down the street is doing it, why shouldn't I?"

The CHAIRMAN. Yes.

We appreciate the fine work you have done for Government, and I hope that you are better remunerated now that you are out of Government.

Senator Anderson.

Senator ANDERSON. No questions.

The CHAIRMAN. Senator Williams.

Senator WILLIAMS. Mr. Caplin, welcome to the committee.

It is my understanding that in addition to the recommendations you have made you also have made suggestions that the complete tax exemption of State and municipal bonds be eliminated and that they be a hundred percent taxed. Is that correct?

Mr. CAPLIN. That was not in the context of this testimony.

Senator WILLIAMS. I was reading your recent article.

Mr. CAPLIN. I think you are referring to my article in the Reader's Digest of this month, which referred to an approach comparable to the one mentioned by Senator Long. A simplified approach to the tax law—which would be aimed at taxing more and more types of income alike, fewer exemptions, fewer exclusions, and lower rates—that essentially is the goal.

On tax-exempt bonds I recognize this could not be done without transitional rules, number one, and, secondly, that some substitute would have to be found to take care of the pressing problems of the States and localities for additional financing. The pending recommendation of the House is at least a starting point. The House is not now abolishing tax-exempt interest. It is offering the States and localities the option to declare their bond-interest taxable in exchange for a form of payment from the Federal Government, which would compensate them for any increased interest costs.

I think that the minimum tax—limit on tax preferences—would be seriously deficient if it did not include the interest from tax-exempt

bonds. If we really want to make sure that every American pays some tax we had best include tax-exempt bonds in the minimum income tax, just as the House did. I just do not understand the Treasury in its recent arguments favoring eliminating this from the House bill.

Senator WILLIAMS. I won't pursue it. I was interested in that article and I noticed that you recommend more or less unqualifiedly, as I gather, repeal of the tax-exempt bonds.

Mr. CAPLIN. Senator Williams, there is a footnote in that article in which I point to the need for aid for the States and municipalities, if this exemption is taken away. I wouldn't recommend this to be taken away unless there was some substitute plan, whether we go toward a Federal-State tax-sharing approach or an income-tax credit for State taxes paid, and so forth. There would have to be something to help the States and localities meet their financial needs.

Senator WILLIAMS. I won't pursue it but I ask that Mr. Caplin's article be printed here.

The CHAIRMAN. Without objection, so ordered.

(The article referred to follows:)

[From The Readers Digest, September 1969]

THE TIME FOR LOWER, FAIRER TAXES IS NOW!

A FORMER COMMISSIONER OF INTERNAL REVENUE PROPOSES A PLAN WHICH WOULD CLAMP DOWN ON LOOPHOLES AND SPECIAL PREFERENCES AND, FOR THE MASS OF AMERICAN TAXPAYERS, SUBTANTIALLY REDUCE THE INDIVIDUAL BITE

(By Mortimer M. Caplin)

America's tax system needs major surgery—now. Multimillion-dollar loopholes for certain industries and certain classes of individuals, combined with onerously high rates for the great mass of middle- and lower-income taxpayers, are endangering public confidence in the entire federal tax structure. The system cries out for fundamental, broad-scale reform—reform that *can* be accomplished.

Consider, for example, the markedly disparate treatment the federal tax system metes out to three men living along a typical American street:

Mr. Smith, an artist, made $12,000 last year selling his paintings. He pays tax at ordinary rates. It came to $2,491.85.

Mr. Jones, next door, is an inventor. He earned $12,000 by selling the patent on his new potato peeler. But his income is taxed at capital-gains rates, so only *half* of it is subject to the federal bite. His tax: $1,025.55.

Finally, Mr. Robinson receives $12,000 a year in interest on municipal bonds. Since such interest is entirely tax-exempt, he need not even fill out a return. His 1968 tax: $0.

Disparities like these abound. As I travel about the country, I hear repeated demands for change. Most frequently those complaining are middle-income taxpayers—those who earn from $7,000 to $20,000 a year. This mass of Americans—some 34-million strong—pays over half our individual income taxes. Yet they lack the money to take advantage of the myriads of special provisions that riddle our tax code.

Congress and the Nixon Administration are being bombarded with complaints about the present tax system's unfairness. A recent Gallup poll showed that some 69 percent of the American people consider their federal income taxes "too high." This outcry results from the uneven and unfair way in which our present tax system operates. A variety of special provisions grants favorable tax treatment for certain classes of income, and allows generous deductions for certain kinds of expenditures. In 1967, these loopholes permitted 155 persons with incomes of more than $200,000 to escape federal taxation altogether—21 collecting tax-free incomes of over $1 million.

How have we arrived at this situation? Over its 56-year life, the federal income-tax code—far from perfect in the beginning—has repeatedly been revised to grant special relief to various groups in our society and to provide special incentives for certain types of economic or social activity. Administrative rulings

and court decisions originally thought to be of limited significance have opened major chinks in the tax structure.

The result: today's 1200-page Internal Revenue Code is a patchwork of unjust incongruities. In recent months, scores of witnesses have presented lengthy testimony to the House Ways and Means Committee, which has been considering tax-law revisions. Numerous complex, often confusing, arguments and recommendations are on record. From my own study and experience, let me describe what I believe are the most significant shortcomings of our tax system.

The Untouched. A multitude of special exemptions, deductions and other rules permit the leakage of revenue that would otherwise be collected by the Treasury. A recent Treasury Department analysis showed that a whopping $45 billion is lost to the government *each year* through tax privileges of all kinds.

Consider one major drain. Although the return on corporate bonds is fully taxed, interest paid on state and local bonds is entirely exempt from federal income tax. The advocates of this preference defend it as a method of encouraging the support of hard-pressed state and local governments. But the fact is that this special provision costs the United States almost $2 billion in tax revenue yearly. This $2 billion of unrequired taxes remains in the hands of those who invest in local-government bonds. But local governments do not benefit correspondingly: the lower interest rates that they pay on these bonds save them only about $1 billion in payout compared with the higher rates they would have to pay if they sold taxable bonds.

Tax-exempt local-government bonds have become such a haven for the very rich that four fifths of the interest paid to individuals is pocketed by the wealthiest two percent of the population. One notable example: a wealthy Midwestern widow received a $56-million automobile-fortune legacy in trust which is invested in municipal bonds. For over 40 years she has been getting more than $1,500,000 of tax-free income each year.

Billions more in revenue dollars are siphoned off by the tax advantages available to real-estate operators. Through the use of "accelerated depreciation," for instance, owners of office buildings and apartments can take deductions for the deterioration of their property at a considerably faster rate than it actually wears out. Also, they are permitted to include in the base upon which they figure their deductions loans which they have incurred in constructing the buildings—commonly many times larger than their own investment in the property. While the resultant artificial tax losses shelter the investors' other income from tax, rents are collected and the property usually *gains* in real value.

For example, a real-estate-investment syndicate may put up $50,000 of its own money for a new million-dollar office building, borrowing the remaining $950,000 from a bank. If the building has a 40-year life, it should theoretically decline in value at the rate of $25,000 a year. In fact, the decline is much smaller. However, using accelerated depreciation, the syndicate can deduct *twice* the theoretical decline—$50,000—the first year and slightly smaller amounts each succeeding year. In the first year alone, then, the members of the syndicate can deduct the full amount of their investment. Subsequent years' deductions—and realization of profit on sale, usually at the favorable capital-gains rate—are further icing on the cake.

A case from the Treasury Department files shows how one affluent taxpayer plays the real-estate game. His income was $14 million—mostly profits from the sale of properties. Subtracting the excludable portion of his profits (being long-term capital gains, only *half* were taxable) reduced his taxable income to $800,000. Then, by writing off accelerated depreciation on real estate that he still owned, he produced a bookkeeping loss of almost $900,000. Result: *no* tax whatsoever.

In all, accelerated-depreciation write-offs cost the Treasury $750 million annually in lost revenue. Frequently justified as an incentive for housing construction, it is estimated that they result in but $50 million a year going into urgently needed low-cost housing.

Additional millions of tax dollars are being drained off because many foundations, universities, churches and coöperatives use their tax-free status to prosper in commercial interprises. When such business connections are allowed tax-free profits, they provide unfair competition for corporations which *do* pay taxes. And, in the end, the average taxpayer subsidizes such exemptions by having to pay higher taxes.

Item: A foundation set up by Loyola University of Los Angeles bought 24 separate businesses during a nine-year period. Among its tax-sheltered enterprises were three dairies, a plastics factory, a hotel, a foundry, a printing com-

pany and businesses producing oil burners, rubber treads and locks. The Tax Court upheld the foundation's tax exemptions last January, finding its activities entirely consistent with present law.

Item: Coöperatives were originally granted tax exemption when they consisted of small groups of farmers who had banded together to market produce or purchase farm supplies. Now they have mushroomed into gigantic commercial enterprises ranging from paint manufacturing to oil refining. One coöperative reported business assets valued at $246 million and sales totaling over $500 million in 1967.

Soak the Wage-Earner. The preference arrangements in our tax system result in a man's wages being taxed at a much higher rate than earnings through investments. The major factor: half of all long-term capital gains (profits from the sale of investment property—real estate, stocks—held for more than six months) may be ignored for tax purposes; and the capital-gains tax has an overall ceiling of 25 percent. The heirs of those who can afford to hold appreciated investments until they die do even better: they pay no income tax at all on the appreciation. These major tax preferences cost the government $8.5 billion a year.

In one Treasury Department case study, a man piled up an income of nearly $1.3 million. But $1.2 million of this was in the form of capital gains, half of which—$600,000—was tax-free. Thus his taxable income was reduced to $700,000. Of this amount, another $600,000 was deductible because of interest charges he had paid on money borrowed to finance the investments that brought him the capital gains. With other deductions (some $88,000 in local and state taxes, extraordinary medical expenses, etc.), his taxable income came down to $2386—his eventual tax was exactly $383.

Those who put money in the oil and gas business are granted special benefits, too. The tax code gives the petroleum business (like other "extractive" industries from coal mining to stone quarrying) a percentage depeltion allowance which brings tax immunity to 27½ percent of the income from an oil well for as long as it produces oil. Also, oil and gas investors are allowed to deduct the capital costs which accompany drilling operations *immediately* rather than gradually, as is the case with most other businesses. As a result, high-risk wells are often drilled primarily because the expenses can be deducted at once from profits on producing wells or from other sources. Using such procedures, one oilman avoided paying any taxes over a 12-year period during which he sold $30 million worth of oil.

Wall Street Cowboys. The farm loss is another avenue to tax avoidance. Because farmers are allowed to use special, simplified accounting procedures that are forbidden to most other businesses, paper losses are easily created. Therefore tax-wise upper-income individuals sometimes invest in distant orange groves or cattle herds. While the steers or oranges grow, there is no income—but there are plenty of deductible expenses, which are used to offset the absentee farmer's other income. When the investor sells out, his profit is taxable only at the favorable capital-gains rate.

One such Wall Street cowboy ran up a staggering $450,000 loss on his farming operations. But don't feel too sorry for him. This huge paper loss helped shelter his other $700,000 of income. With capital-gains exclusions, he paid no tax that year.

Unquestionably, such farming is indulged in for tax purposes alone. On Internal Revenue Service study of 1966 tax returns revealed the curious fact that the more money the absentee landlord made away from the farm the more he "lost" *on* the farm. Of all high-income taxpayers who owned farms that year, 88 percent with incomes over $1 million managed to "lose" money on their farming businesses.

A Program for Reform. The people of the United States must come to grips—and come to grips *now*—with the problem of making our tax system fair. To me the answer is clear. We must broaden the base of the federal income tax by eliminating the preferential provisions which enable some people with very large real incomes to pay little or no tax, and some industries to pay tax at far lower rates than others. Our overall objective should be to treat all forms of income alike and to provide equal tax treatment for persons with equivalent real income.

The exemption for interest on state and local government bonds should go. So should the special privileges for the commercial activities of cooperatives, churches and other exempt organizations. The opportunities to turn real-estate investment into tax shelters should be eliminated. The present special advantages accorded capital gains should be dropped; in addition, increases in asset values should be subject to income tax at death. Percentage depletion should be elimin-

ated or, at least, reduced substantially. A tight limitation should be imposed on the use of farm losses by non-farmers. While personal deductions for such items as extraordinary medical expenses, casualty losses and local taxes could be allowed to remain intact, other fundamental, base-broadening reforms like those I have listed should be adopted.[1]

Such loophole-closing would bring at least $12 billion more into the Treasury each year. With this additional money, tax rates could be slashed by *at least 14 percent*. Thus, the top tax rate of 70 percent would decline to 60 percent, while the lowest rate—now 14 percent—would become 12 percent. Here is how my proposal would apply to various types of taxpayers:

A single man who earned a modest salary of $6000 and paid a tax of $930.95 last year would pay $800.62—a $130.33 cut.

A man earning a $12,000 salary would normally pay a federal income tax of $2491.85. Under the plan that I propose, he would pay $2142.99—a $348.86 cut.

A man with an $18,000 salary and $2000 in capital gains must today get up $5286.85 in tax. Under my scheme, even with his capital-gains exclusion eliminated, he would pay $340.78 less.

Finally, consider the million-dollar-a-year man who takes full advantage of today's loopholes and *pays no taxes*. Under my program, all of his special preferences would be wiped out and, after personal deductions, he would pay tax at full rates: $600,083.70.

The path to reform will not be easy. Special-interest groups, from municipalities and exempt organizations to the real estate, securities and oil industries, have a direct financial stake in each of the loopholes. When someone mentions eliminating any of the major tax preferences, these interests fight back—on a year-in, year-out basis. Now, as the tax-reform battle rages in Congress, the question is: Will they win again?

They will—unless the average citizen makes his voice heard. And the way to make it heard is for the great mass of the American people to provide such an outpouring of letters to Congress as has never before been seen.

Senator BENNETT. Mr. Caplin, with respect to your testimony or at least in your submitted testimony, on unrelated-business income of tax-exempt organizations, you feel that each source of unrelated income should be treated separately or do you feel that tax-exempt organizations should have the privilege as a business does of offsetting its losses against its profits from unrelated business income?

Mr. CAPLIN. I feel that operating a business is an anachronism for an exempt organization. I think for that reason that each business should stand on its own footing and that there should not be the ability to mesh them all together, to offset the gain of one against the loss of another.

Actually there are too many possibilities to escape this tax through accounting techniques, by lowering subscription changes, by increasing membership fees and the like. This has all been suggested by representatives of exempt organizations as ways to wipe out any tax—and here I am thinking particularly of advertising revenue.

Senator BENNETT. So you think if a tax-exempt organization does actually incur a loss in one type of unrelated business it should not be allowed to offset that against a profit in an unrelated business even though a corporation which operates one division at a loss is allowed to offset that loss against a profit in another division. You would make a tougher rule for a tax-exempt organization's unrelated business than you would for a private business' separate division?

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[1] Certain of these reforms would have to be accompanied by compensatory legislation. Removal of the exemption for municipal-bond interest, for example, would require the enactment of some program for Federal financial assistance to State and local governments. Deletion of the present special provisions for capital gains would require the adoption of a mechanism for averaging gains accrued over a period of years. In each case, however, the compensatory legislation would cost the Federal Government far less than the present special tax provisions.

Mr. CAPLIN. I would say yes for two reasons: One, that a private coporation is paying full taxes all the way and, No. 2, these tax-exempt organizations really ought to be out of business. Our tax policy should be aimed at discouraging them from engaging in business.

Senator BENNETT. Yes.

What you are saying is that an organzation such as the American Medical Association should not be allowed to have any advertising in its publication?

Mr. CAPLIN. No, if they want to engage in advertising that is up to them, so long as their activities do not jeopardize the magazine's exemptions. But they should pay tax on that advertising.

Senator BENNETT. But you just said they should be out of business. Now, which do you mean?

Mr. CAPLIN. They have a medical magazine which, if it were conducted primarily as an educational matter for the physicians, is justifiable and I wouldn't suggest that that medical magazine automatically lose its exemption.

The exemption issue might arise if the advertising activities become dominant and the educational aspects because secondary or only incidental. Except for the extreme cases where exemption is forfeited, I would favor full taxation of advertising revenue. The Treasury regulations support this and the House now would incorporate those regulations into legislation. But I do think that the taxable activities ought to be separated, and that each advertising function ought to be taxed to the extent it has a profit.

Senator BENNETT. That is all, Mr. Chairman.

Mr. Caplin, in your testimony you refer to a study you made of cooperatives and their functions as corporations, and the taxation of their various activities. Would you be willing to make this study available to the committee?

Mr. CAPLIN. I would be very glad to.

Senator RIBICOFF. Mr. Chairman, I ask unanimous consent that the study be made part of the record of this committee.

(CLERK'S NOTE.—The study entitled "Taxing the Net Margins of Cooperatives: Application of Basic Tax Principles and Analysis of Constitutionality", by Mortimer M. Caplin, dated May 1969, comprising 51 pages, and published by the National Tax Equality Association, is made a part of the official files of the committee.)

Senator CURTIS. May I ask one question at that point. For whom was the study made?

Mr. CAPLIN. For the National Tax Equality Association, whom I am representing today, Senator.

Senator RIBICOFF. You say in your study you conclude that cooperatives' and corporations' earned income should be taxed at the same rates. Did our joint staff and techncians come to the same conclusion in 1951?

Mr. CAPLIN. That is right. There was an imporatnt study made by the joint committee staff back in 1951 which analyzes the taxability of cooperative income and they reached the conclusion that the Congress could properly tax that income.

Senator RIBICOFF. Mr. Chairman, I wonder if the same request, if I could ask unanimous consent that the 1951 study be made part of the record of this committee.

Senator ANDERSON. Without objection that will be done.

(The study referred to follows:)

PART 3

THE POWER OF CONGRESS TO TAX COOPERATIVES ON NET MARGINS

PREPARED BY THE

STAFFS OF THE TREASURY AND THE JOINT COMMITTEE ON INTERNAL REVENUE TAXATION

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THE POWER OF CONGRESS TO TAX COOPERATIVES ON NET MARGINS

I. Congress May Constitutionally Tax Cooperatives As Corporations

The fact that cooperatives are corporations and that Congress has the constitutional power to tax them as corporations may appear so obvious that discussion of the proposition is unnecessary. However, general statements have been made to the effect that the cooperatives are only agents, partnerships, or trusts, with the implication that they are not entities in their own right capable of having income subject to tax. For this reason it is necessary to establish beyond question the fact that the cooperatives are separate corporate entities which are taxable as such.

The most obvious proof that the cooperatives are corporate entities is the fact that in most cases they are organized under corporate charters granted to them by the various States. In some cases they are organized under the States' regular incorporation statutes. In many States there are special statutes for the incorporation of cooperatives. Whether or not the cooperatives are officially incorporated under State law they are treated as corporations for Federal tax purposes, since the definition of a corporation in section 3797 (a) (3) of the Internal Revenue Code includes an association.

So far as is known there has been no instance in the history of Federal taxation since the enactment of the corporation excise tax in 1909 where a cooperative association, other than one which has been specifically exempted from tax, has contended that it should not file tax returns as a corporation. In 1946, for example, the Bureau of Internal Revenue computed that 6,000 exempt farm cooperatives filed information returns on Form 990 and that 2,344 taxable farm cooperatives filed corporate income tax returns on Form 1120. It should also be noted that Congress for many years has considered cooperatives as corporations, since, in exempting certain farm cooperatives from tax, it has exempted them from the corporate tax.

In the light of the fact that the cooperatives are organized as corporations and meet the definition of corporations for Federal tax purposes, decisions by some State courts in which cooperatives have been called agents, partnerships, or trustees, or have been said to be analogous to agents, partnerships, or trustees, are immaterial in an analysis of the Federal taxing power. The courts have held repeatedly that the Federal taxing power is not restricted by definition or status determined under State law. This principle was stated definitely by the Supreme Court in the case of *Burk-Waggoner Oil Association* v. *Hopkins* (269 U. S. 110 (1925)), where it held that Congress had the right to tax as a corporation a "Massachusetts trust" which was technically a partnership under State law. At that time the Court said:

It is true that Congress cannot convert into a corporation an organization which by the law of its State is deemed a partnership. But nothing in the Constitution precludes Congress from taxing as a corporation an association which, although unincorporated, transacts its business as if it were incorporated. The power of Congress so to tax associations is not affected by the fact that, under the law of a particular State, the association cannot hold title to property, or that its shareholders are individually liable for the association's debts, or that it is not recognized as a legal entity. Neither the conception of unincorporated associations prevailing under the local law, nor the relation under the law of the association to its shareholders, nor their relation to each other and to outsiders, is of legal significance as bearing upon the power of Congress to determine how and at what rate the income of the joint enterprise should be taxed.

This same principle has been followed by the Supreme Court in *Commissioner* v. *Tower* (327 U. S. 280 (1946)), *Commissioner* v. *Lusthaus* (327 U. S. 293 (1946)), and *Commissioner* v. *Harmon* (323 U. S. 44 (1944)).

It is also well established that a corporation cannot avoid tax by arguing that it is not an entity for tax purposes but is merely an agent of its owners (*Moline Properties* v. *Commissioner*, 319 U. S. 436 (1943), and *National Carbide Corporation* v. *Commissioner*, 336 U. S. 422 (1949)). In the Moline Properties case the Supreme Court said:

The doctrine of corporate entity fills a useful purpose in business life. Whether the purpose be to gain an advantage under the law of the State of incorporation or to avoid or to comply with the demands of creditors or to serve the creator's personal or undisclosed convenience, so long as that purpose is the equivalent of business activity or is followed by the carrying on of business by the corporation, the corporation remains a separate taxable entity.

II. The Net Margins of the Cooperatives Are Income to Them Within the Meaning of the Sixteenth Amendment and May Constitutionally Be Taxed as Such

A. THE FEDERAL TAXING POWER IS SUFFICIENTLY BROAD TO TAX COOPERATIVES' NET MARGINS

Perhaps the most concise definition of the Federal taxing power was laid down by the Supreme Court in *Steward Machine Company* v. *Davis* (301 U. S. 548 (1937)), in which the Court said:

The subject matter of taxation open to the power of the Congress is as comprehensive as that open to the power of the States, though the method of apportionment may at times be different. "The Congress shall have power to lay and collect taxes, duties, imposts, and excises" (art. 1, sec. 8). If the tax is a direct one, it shall be apportioned according to the census or enumeration. If it is a duty, impost, or excise, it shall be uniform throughout the United States. Together, these classes include every form of tax appropriate to sovereignty.

The power of Congress to tax income of all types without apportionment is derived from the sixteenth amendment:

The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration.

The definition of income has been broad. The leading case defining income under the sixteenth amendment is the case of *Eisner* v. *Macomber* (252 U. S. 189 (1920)). In this case the Supreme Court said:

The fundamental relation of "capital" to "income" has been much discussed by economists, the former being likened to the tree or the land, the latter to the fruit or the crop; the former depicted as a reservoir supplied from springs, the latter as the outlet stream, to be measured by its flow during a period of time. For the present purpose we require only a clear definition of the term "income"

as used in common speech, in order to determine its meaning in the amendment * * *

After examining dictionaries in common use * * * we find little to add to the succinct definition adopted in two cases arising under the Corporation Tax Act of 1909 * * *. "Income may be defined as the gain derived from capital, from labor, or from both combined," provided it be understood to include profit gained through a sale or conversion of capital assets * * *

Congress has an equally broad power to determine, on practical grounds, to whom income should be taxed. This is illustrated by *Burnet* v. *Wells* (289 U. S. 670 (1933)) in which the Supreme Court held that Congress was within its constitutional power in subjecting the grantor of an irrevocable trust to tax on the income of the trust which the trustee used (pursuant to the directions of the trust instrument) for payment of insurance premiums on the life of the grantor. The Court's opinion in this case stated:

* * * Government in casting about for proper subjects of taxation is not confined by the traditional classification of interests or estates. It may tax not only ownership but any right or privilege that is a constituent of ownership. * * * Liability may rest upon the enjoyment by the taxpayer of privileges and benefits so substantial and important as to make it reasonable and just to deal with him as if he were the owner, and to tax him on that basis. A margin must be allowed for the play of legislative judgment.

The only case in which the Supreme Court has passed on a Federal statute which taxes the net margins of a cooperative is the case of *Penn Mutual Life Insurance Company* v. *Lederer* (252 U. S. 523 (1920)). In this case the cooperative organization was a mutual life-insurance company which paid dividends to its policyholders both by applying the dividends against premium receipts due from the policyholders and by actual payment in cash. The mutual insurance company argued that its gross income should have been reduced, under the Revenue Act of 1913, by the amount of the dividends to policyholders which were paid in cash and not used by the policyholders in the payment of premiums. The Supreme Court, in an opinion by Justice Brandeis, held that, while the act permitted a reduction of gross receipts by the amount of any dividends applied by policyholders against premiums, it did not permit deduction of dividends paid in cash and not used in payment of premiums.

The Penn Mutual case deals with a situation where dividends to policyholders represented a mixture of two elements: (1) profit on the investment by the company of the insurance premiums placed with it, and (2) savings on the expense of insurance protection to the policyholders. Congress had chosen to define the latter element (the rebate element) as being limited to the dividends applied by policyholders to reduce their current premiums, and Congress had chosen to treat dividends paid in cash and not so applied as a part of the income element of the mutual company. The Supreme Court said that Congress made this distinction, not because it resulted in a technically perfect measure of the two elements, but simply because the difference between the two types of dividends to policyholders "may well have seemed to Congress sufficient to justify the application of different rules of taxation." The Court said that where the net cost of life insurance proves to be less than the premiums paid, "the difference may be regarded either as profit on the investment or as a saving in the expense of protection." This shows that Congress may use any reasonable standard in measuring the taxable income of

a cooperative, and the mere fact that the corporation is a cooperative does not impose a constitutional restraint on Congress in the measurement of its taxable income. This was true in the Penn Mutual case even though the dividends in question were paid out in cash.

A mutual life-insurance company like the Penn Mutual Co. operates on the same basic principles as an ordinary marketing cooperative. In the case of the marketing cooperative, the patron turns his goods over to the cooperative for processing and resale. He receives the price of the goods he sells to the cooperative plus a patronage dividend which represents the profit margin on the processing of these goods by the cooperative. The policyholder in the mutual insurance company turns over to the company his insurance premiums and eventually these premiums are returned in the form of the face amount of the policy. Meanwhile the policyholder receives dividends which represent a return on the investment the mutual insurance company has made on the premiums the policyholder paid in. The cooperative is under an obligation to pay its net profit margins from the processing of the goods to the patron and the mutual insurance company is under an obligation to pay to its policyholder the return on its investment of his premiums to the extent that this return exceeds the reserve requirements necessary to afford the policyholder insurance protection. The constitutional right of Congress to tax a mutual insurance company on its income before payment of such dividends to policyholders as unquestioned in the Penn Mutual case. In that case, the Court said:

> The fact that the investment resulting in accumulation or dividend is made by a cooperative as distinguished from a capitalistic concern does not prevent the amount thereof being properly deemed a profit on the investment. Nor does the fact that the profit was earned by a cooperative concern afford basis for the argument that Congress did not intend to tax the profit. Congress exempted certain cooperative enterprises from all income taxation, among others, mutual savings banks; but, with the exception of fraternal beneficiary societies, it imposed in express terms such taxation upon "every insurance company."

In *Morrissey* v. *Commissioner* (296 U. S. 344 (1935)), the Supreme Court held that a trust, bearing a fiduciary relationship to its beneficiaries, may be taxed as a corporation if it is created as a medium for carrying on a business enterprise. It has also been held that a research organization established by casualty insurance companies, even though organized for nonprofit purposes, might be subjected to the corporate income tax if it could not meet the statutory requirements for exemption (*Underwriter's Laboratories* v. *Commissioner*, 135 F. (2d) 371 (1943)).

B. THE COOPERATIVES' NET MARGINS ARE INCOME TO THEM REGARDLESS OF PATRONAGE DIVIDEND CONTRACTS

As was pointed out above, a cooperative is a separate legal entity and taxable as a corporation. It is of course possible for a cooperative to act for others as an agent. However, in the typical case of a cooperative dealing with its members, it is not acting merely as their agent. As the Supreme Court indicated recently in the case of *National Carbide Corporation* v. *Commissioner* (336 U. S. 422 (1949)), some of the relevant considerations in determining whether a true agency exists are—

> whether the corporation operates in the name and for the account of the principal by its actions, transmits money received to the principal, and whether receipt of

income is attributable to the services of employees of the principal and to assets belonging to the principal * * *

These considerations appear largely absent in the typical cooperative case. The employees of a cooperative are its employees and not the employees of the alleged principals, the members. Thus in *Lake Region Packing Association* v. *United States* (146 F. (2d) 157 (1944)), it was held that the cooperative was liable for unemployment compensation and social-security taxes. The Court specifically rejected the contention that the cooperative was merely the agent of the members and that the employees were thus in effect the employees of the members:

* * * After all, the stockholders of corporations, whether cooperative or ordinary, intend to, and do, derive advantages from the use by them of the corporate form. It is for Congress, and not for us, to say whether there should be an exemption extended to the one class of corporations and denied to the other. We think it clear that appellant stands exactly in the same case as if it were a corporation organized in the usual way for the distribution of profits to its members.

The legal title to property of the cooperative is ordinarily vested in the cooperative (*Maryland and Virginia Milk Producers' Association* v. *District of Columbia*, 119 F. (2d) 787 (1941)). As the court there indicated—

Even when a cooperative's contracts with its milk-producing members have been phrased clearly in terms of agency, it has been conceded that title to the milk passed to the association * * *.

Moreover, the cooperative sells for its own account and not for the account of the member. The circuit court in the Maryland and Virginia Milk case, above, stated further—

* * * the association, and not the member, was the actual seller of the milk which the distributors bought.

Also, the member does not set the price for which his particular products must be sold, and the sums returned to him are not attributable to profits on sales of his products but to profits on sales on all members' products (*Maryland and Virginia Milk Producers' Association*, supra).

It should also be noted that ordinarily, whether the cooperative is incorporated under the business corporation laws or under a special cooperative provision, the liability of a member for debts of the cooperative is limited, irrespective of whether the cooperative is a stock, nonstock, or membership organization (Packel, the Law of Cooperatives (2d ed.) p. 203).

The incidents of agency which the Supreme Court in the National Carbide case, supra, indicated as controlling thus appear to be entirely absent in the typical cooperative case. Moreover, it seems clear that legal title to the income of a cooperative is not in the members but in the cooperative. In the Maryland and Virginia Milk case noted above, undistributed profits of the year were carried into a revolving fund. The court held that "the fund is the corporation's property, and the member's interest in it is much like the stockholder's interest in the surplus of a stock corporation." At the most, there seems to be an obligation on the part of the cooperative to return to its members some part of the amounts which have been earned by it.

There has been little doubt that where income has been earned by one entity, such income can be taxed to it even though such entity is wholly owned by another (*Moline Properties* v. *Commissioner*, supra).

This proposition is equally true even though there is a binding obligation to pay over such income to another. The Supreme Court in the National Carbide case noted above, held that the mere fact that subsidiaries were required by agreement to pay over all profits in excess of 6 percent of capital did not prevent the imposition of income tax on such profits. A similar result was reached in *Fontana Power Company* v. *Commissioner* (127 F. (2d) 193 (C. C. A. 9, 1942)) where all the net profits of a corporation, paid over to its stockholders, pursuant to a contract, were held to be taxable to it. Finally, it is well established that where income is earned by one entity, an anticipatory assignment of such income, even though such assignment vests title to the income in the assignee, is not sufficient to prevent taxation of such income to the person who earns it (*Lucas* v. *Earl*, 281 U. S. 111 (1930); *Helvering* v. *Horst*, 311 U. S. 112 (1940)). In the Earl case, which dealt with assignment of earned salary income, the Supreme Court said:

> There is no doubt that the statute could tax salaries to those who earned them and provide that the tax could not be escaped by anticipating arrangements and contracts however skillfully devised to prevent the salary when paid from vesting even for a second in the man who earned it.

That a cooperative itself earns income seems difficult to dispute. It has assets and employees, it buys, sells, and performs services. The Supreme Court has recognized that profits derived from activities of this type are the profits of the organization owning the assets, employing the workers, and carrying out the commercial activities, even though another person has a legally enforceable claim to these profits. In the case of *National Carbide Corporation* v. *Commissioner* (336 U. S. 422 (1949)), the Supreme Court held that the corporation was taxable on its profits in spite of its contract to pay to its parent corporation all profits in excess of 6 percent on a nominal amount of capital stock. The recognition by the Supreme Court of the economic realities in such a situation is illustrated by the following quotation from the opinion in the National Carbide case:

> The same fallacy is apparent in the contention that petitioners are agents of Airco. They claim that they should be taxable on net income aggregating only $1,350, despite the fact that during the tax year (1938) they owned assets worth nearly $20,000,000, had net sales of approximately $22,000,000, and earned nearly 4½ million dollars net. Their employees number in the thousands.

Moreover, dividends paid by a cooperative on its capital stock, and amounts placed by it in reserves, stem from earnings resulting from its activities and are taxed at the present time to the cooperative as its income. This could not be the case if the cooperatives were in fact mere agents and earned no income.

There are a number of court decisions which show that taxable income is not necessarily affected by the payment of patronage dividends. In the Penn Mutual case, described earlier, Congress was upheld in its decision to treat certain cash dividends paid by mutual insurance companies to their policyholders as being taxable in the hands of the mutual corporation. In *Cleveland Shopping News* v. *Routzahn* (89 F. (2d) 902 (1937)), the circuit court of appeals for the sixth circuit held a corporation taxable on amounts collected from its patron-stockholders in connection with the furnishing of advertising services, which amounts were distributed to those same patrons in proportion to patronage. The same result was reached by the Tax

Court in *Druggist Supply Corporation* v. *Commissioner* (8 T. C. 1343 (1947)).

The Circuit Court of Appeals for the Ninth Circuit strongly indicated that patronage dividends may not be deductible even under the present law. In that case a cooperative attempted to deduct amounts set aside as reserve funds on the grounds that its earnings belonged to its members. The court denied this deduction, saying:

> * * * petitioner points to no statute authorizing any deduction whatever, and we are in effect asked to hold that a practice of respondent permitting a deduction not authorized by statute, is not liberal enough. We know of no manner in which such liberality may be reviewed in this court * * *. Whether respondent should have allowed the deduction he did allow is a question upon which we express no opinion (*Cooperative Oil Association* v. *Commissioner*, 115 F. (2d) 666 (1940)).

It is important to note that the mere fact that earnings are distributed to shareholders in proportion to their patronage instead of in proportion to stockholdings does not indicate that the distributions are not distributions of income (*Juneau Dairies, Inc.* v. *Commissioner*, 44 B. T. A. 759 (1941)). Distributions to stockholders may be dividends even though they are not proportionate to stock holdings and are not participated in by all stockholders, and even though the formalities of a dividend declaration are lacking (*Regensburg* v. *Commissioner*, 144 F. (2d) 41 (C. C. A. 2, 1944), cert. den. 323 U. S. 783 (1945)).

Congress is not bound by the Constitution to accept, at face value, the terms of a patronage dividend agreement between a cooperative and its members. The parties to such an agreement are not dealing at arm's length (as is the case in an ordinary price rebate). Under these conditions it cannot be stated as a constitutional limitation, that distributions by the cooperative to its shareholders as patronage dividends cannot be, in fact, distributions of profits. The courts have recognized the peculiar nature of transactions between corporations and their shareholders and the fact that their identity of interests may give rise to adjustments which obscure the true income of the corporation. For this reason a bargain purchase (i. e. for less than value) by a stockholder from his corporation is treated as a dividend (*Eastern Carbon Black Co.* v. *Brast*, 104 F. (2d) 460 (C. C. A. 4, 1939)).

The entire argument that the net margins of cooperatives are not income because they are paid or allocated as patronage dividends is based on the implicit assumption that the actual net margin on each article sold to a patron or purchased from a patron for marketing is exactly proportionate to the aggregate net margins on all articles bought and sold by the cooperative during the year. To the extent that this assumption is not correct excessive patronage dividends are paid with respect to some articles and only partial patronage dividends are paid with respect to other articles. For example, if a purchasing cooperative sells an article to a patron for cost and the patron also receives a patronage dividend with respect to this article at the close of the year, this dividend cannot be considered a rebate of a net margin retained by the cooperative with respect to the patron's earlier purchase of the article. The assumption of equal net margins on all articles handled by the cooperative is in direct conflict with ordinary business experience, and it is not believed that Congress is bound, under the Constitution, to accept this contrary-to-fact assumption.

III. Congress May Constitutionally Levy an Excise Tax on Corporations Measured by Their Net Margins Returned by Them to Shareholders and Others Patrons

Before the enactment of the sixteenth amendment, at a time when it was unconstitutional to tax income from property without apportionment, corporations were subjected to an excise tax measured by their net income. This tax was the corporation excise tax of 1909 (36 Stat. 112) which made corporations "subject to pay annually a special excise tax with respect to the carrying on or doing business by such corporation, joint stock company or association, or insurance company, equivalent to one per centum upon the entire net income over and above $5,000 received by it * * *." It was argued that this tax was unconstitutional since a tax levied directly upon income had been held unconstitutional in *Pollock* v. *Farmers' Loan & Trust Company* (157 U. S. 429 (1895)). However, the Supreme Court held the corporation excise tax to be constitutional in *Flint* v. *Stone Tracy Company* (220 U. S. 107 (1911)). There the Court stated that argument on the authority of the Pollock case "confuses the measure of the tax upon the privilege with direct taxation of the state or thing taxed." The Court held this excise tax constitutional even though it was measured by the net income of the corporations from all sources, including income from tax-exempt securities.

A number of States now levy franchise taxes on corporations where the measure of the tax is the corporation's net income. These taxes have also been held constitutional by the Supreme Court even though the net income by which the tax is measured includes income from tax-exempt securities (*Pacific Company* v. *Johnson*, 285 U. S. 480).

It is clear from the Flint case and from the experience of the States with corporate franchise taxes that it would be constitutional for Congress to repeal the present corporate income tax and replace it with an excise tax on the privilege of doing business as a corporation. Such a tax could be measured by the net margins of the corporation, regardless of whether or not these margins represented income. This would be constitutional under the broad powers of Congress to select objects for excise taxation. In *Flint* v. *Stone Tracy Company* the Supreme Court stated:

> In levying excise taxes the most ample authority has been recognized from the beginning to select some and omit other possible subjects of taxation, to select one calling and omit another, to tax one class of property and to forbear another.

The cooperatives could not avoid such a tax by claiming that their net margins belong to their shareholders and other patrons. This argument was rejected by the Circuit Court of Appeals for the District of Columbia in the Maryland and Virginia Milk Producers Association case, noted earlier, where a farm marketing cooperative attempted to avoid the District of Columbia corporation franchise tax (which was measured by gross receipts) by claiming that its gross receipts did not belong to it.

It would be constitutional for Congress to supplement the present corporate income tax with an excise tax measured by the net margins of corporations (including cooperatives) which are not now taxable as income. Such a tax would be based on a reasonable classification

because it would be reasonable for Congress to require cooperative corporations to pay a tax in return for the privilege of doing business and in return for the protection and services of the United States Government which they enjoy. Since these net margins are the measure of the income tax in the case of ordinary corporations and are not now subject to income tax in the case of the cooperatives because they are paid or allocated to patrons, it would be constitutional for Congress to require from the cooperatives a tax, in the form of an excise tax, which would be equivalent to the income tax paid by ordinary corporations. Certainly a tax based on this reasoning would not be so palpably arbitrary and unreasonable as to violate the due process clause of the fifth amendment.

Senator RIBICOFF. Now, you mention in your testimony that under my bill, S. 2646, there would be produced an additional revenue of $200 million to the Federal Treasury. What would be the reaction of the individual patrons of cooperatives to my bill, in your opinion?

Mr. CAPLIN. I used that figure in my written statement and would like to confirm orally that your bill, as contrasted to the House proposal, actually would raise significant revenue. The best estimates that we can make based on early Treasury studies indicates that your proposal for taxing cooperatives would produce approximately $200 million a year.

Now, so far as the patrons are concerned, if they understood what would be involved I think they would applaud your bill. You would shift most of the tax from the patron to the co-op. The patron-shareholders under your bill are given an exclusion of $300 for an individual, and if they were married with a joint return, $600, which is much better than the normal corporation shareholder result.

Senator RIBICOFF. So if you had a legitimate farm co-op and a farmer and his wife were part of that co-op, dividends that they would receive up to $600 would be tax free, as contrasted with the situation today where they are fully taxable on the share attributable to their account even though they get only 20 percent cash; 80 percent is sitting in the co-op management hands.

Mr. CAPLIN. The co-op managements, of course, are going to be in opposition as contrasted to the patron on the street, so to speak. The co-op management won't have the flexibility of having that extra cash which the business community doesn't have—that $200 million which would now be paid in taxes—to sharpen its competitive position.

So I think that you would have a duality of position here, and the big issue would be communicating properly to the patrons-shareholders. If the patrons understood your bill I think that they would favor it.

Senator RIBICOFF. You were giving examples during your testimony of different co-ops and different foundations that operated businesses. I think it would be much more helpful if you would be specific and name them. I think we ought to be able to get a perspective of what we are talking about.

Mr. CAPLIN. I would be very happy to submit for the record the identification as best we can. Some of the items come from Treasury materials already published without names, and where we rely on that we may not be able to give the names. But I will communicate with you in a letter, Senator, and let you use your discretion about making it part of the record.

Senator RIBICOFF. Mr. Chairman, I think the problem here is generalities. The public and ourselves just don't get the picture of what we are dealing with. There is a lack of awareness of some of the big operations, both foundations and cooperatives, that are receiving tax-exempt status and competing with other businesses in the same field.

I think it would make our task more meaningful if we knew what these companies were. I don't think it is a violation of any trust, if the staff of the committee will try to the fullest extent to give us some specific examples of these large operations that are competitive with other operations in this Nation.

Senator ANDERSON. Without objection, we will ask the witness to do that.

Mr. CAPLIN. Senator, I might add that the staff of the joint committee and the Senate Finance Committee would have easier access to Treasury material than I now have.

Senator RIBICOFF. That is why I asked the staff to procure it instead of you. I think it is a function of the staff to do it.

Mr. CAPLIN. But I will be glad to give you the letter to the extent we have the information.

I might mention that I did refer to one foundation which had 24 separate businesses, and whose tax exemption was upheld, notwithstanding that no tax was paid on its earnings. That is a reported case, the University Hills Foundation and it is reported in 51 Tax Court No. 54. So its full story is a matter of public record.

Senator RIBICOFF. Thank you very much.

(The information requested of the staff by Senator Ribicoff and a submission of Mr. Caplin, follows:)

There follows a list prepared by the Farmer Cooperative Service of the Department of Agriculture of the thirty largest farmer cooperatives based on their fiscal year 1968 sales volume:

Rank	Cooperative	Type	Fiscal year 1968 sales volume
1	Agway, Box 1333, Syracuse, N.Y.	Farm supply	$464,520,938
2	Land O' Lakes Creameries, 2215 Kennedy St. NE., Minneapolis, Minn.	Marketing	370,068,554
3	Farmland Industries, 3315 North Oak Traffic Way, Box 7305, Kansas City, Mo.	Farm supply	367,425,252
4	Farmers Union Grain Terminal Association, 1667 North Snelling Ave., St. Paul, Minn.	Marketing	301,574,974
5	Dairymen's League Co-op Association, 100 Park Ave., New York, N.Y.	do	290,227,723
6	Cotton Producers Association, Box 2210, 3348 Peachtree Rd., NE., Atlanta, Ga.	do	261,683,551
7	Sunkist Growers, Box 2706, Terminal Annex, 707 West 5th St., Los Angeles, Calif.	do	252,000,000
8	California & Hawaiian Sugar Refining Corp., 215 Market St., San Franciso, Calif.	do	245,828,000
9	Producers Livestock Association, 1561 Leonard Ave., Columbus, Ohio	do	232,746,140
10	Far-Mar-Co., 715 Wiley Bldg., Hutchinson, Kans.	do	212,002,061
11	Indiana Farm Bureau Co-op Association, 47 South Pennsylvania St., Indianapolis, Ind.	do	196,062,767
12	Central Livestock Association, 520 Exchange Bldg., South St. Paul, Minn.	do	187,402,233
13	Interstate Producers Livestock Association, 606 Exchange Bldg., Union Stock Yards, Chicago, Ill.	do	183,662,812
14	Producers Livestock Marketing Association, Union Stock Yards, North Salt Lake, Utah.	do	176,786,584
15	Illinois Grain Corp., 141 West Jackson Blvd., Chicago, Ill.	do	170,421,948
16	FS Services, 1701 Towanda Ave., Bloomington, Ill.	Farm supply	165,869,100
17	Pure Milk Association, 343 South Dearborn St., Chicago, Ill.	Marketing	153,664,515
18	Farmers Union Central Exchange, Box G-1185, North Concord St., St. Paul, Minn.	Farm supply	153,180,622
19	Michigan Milk Producers Association, 24270 West Seven Mile Rd., Detroit, Mich.	Marketing	140,273,760
20	Northeast Dairy Co-op Federation, Hedderman Bldg., 428 South Warren St., Syracuse, N.Y.	do	140,000,000
21	Southern States Co-op, Southern States Bldg., 7th and Main Sts., Richmond, Va.	Farm supply	123,980,001
22	Producers Livestock Marketing Association, 509 Livestock Exchange Bldg., Omaha, Nebr.	Marketing	123,950,686
23	Missouri Farmers Association, 201 South 7th St., Columbia, Mo.	Farm supply	119,000,000
24	Central Farmers Fertilizer Co., 100 South Wacker Drive, Chicago, Ill.	do	112,548,000
25	Arkansas Grain Corp., Box 661, Stuttgart, Ark.	Marketing	111,230,635
26	Producers Grain Corp., Box 111, Amarillo, Tex.	do	109,885,087
27	California Canners & Growers, 3100 Ferry Bldg., San Francisco, Calif.	do	107,295,457
28	Farm Bureau Co-op Association, 245 North High St., Columbus, Ohio	Farm supply	106,632,191
29	Midland Co-ops, 739 Johnson St. NE., Minneapolis, Minn.	do	104,864,835
30	Eastern Milk Producers Co-op Association, Kinne Rd., Syracuse, N.Y.	Marketing	104,520,000

CAPLIN & DRYSDALE,
Washington, D.C., September 30, 1969.

Hon. ABRAHAM A. RIBICOFF,
U.S. Senate,
Washington, D.C.

DEAR SENATOR RIBICOFF: When I testified before the Finance Committee on September 12 about the extensive involvement of tax-exempt and tax-free organizations in competitive business activities, you asked me to furnish illustrative material in addition to that contained in my prepared statement. You asked, specifically, for the names of organizations involved in such activities.

The following paragraphs provide a number of specific examples of 1) the business activities of cooperatives, 2) the advertising businesses of a variety of classes of exempt organizations, 3) the business involvement of private foundations, and 4) the business activities of churches.

COOPERATIVE BUSINESSES

Agway, Inc., was formed by the merger of the Cooperative Grange League Federation Exchange, Inc., and the Eastern States Farmer's Exchange, Inc., in mid-1964. Its businesses include manufacturing, processing, wholesaling, transportation, insurance, and retailing. Its sales volume for its 1968 fiscal year was $519,000,000. The farm products marketed by Agway include eggs, poultry, fruits, vegetables, grain, and beans. The commodities wholesaled by Agway include feed, fertilizer, petroleum products, auto supplies, seed, farm equipment, building material, farm chemicals, and lawn and garden equipment. In addition, wholly-owned subsidiaries of Agway include a real estate holding company, a petroleum corporation which operates gas stations on a non-cooperative basis, fruit and vegetable processors, and an insurance business.

Farmland Industries, Inc., had a fiscal 1968 sales volume of $375,000,000. It engages in mixing fertilizer, manufacturing feed, grease, and paint, fabricating steel products, and large scale wholesaling of petroleum products, fertilizer, feed, auto accessories, agricultural chemicals, building supplies, farm and plant equipment, and housewares. The cooperative also provides a hog marketing service and operates an egg cartoning plant. Subsidiaries produce refined fuels, lubricating oils, fertilizer, and soybean meal and provide finance and insurance facilities for members.

Farmers Union Central Exchange, Inc., wholesales most of the same supplies handled by Agway and Farmland. Its sales volume for fiscal 1968 was $153,000,000. It owns a refinery, a pipe line, a pipe line terminal, and oil blending plant, and various crude oil properties.

The Cotton Producers Association markets cotton and wholesales fertilizer, seed, general farm supplies, pesticides, chicks, and feed. It operates plants and mills for the production of all the items it supplies to its members. Its sales volume for fiscal 1968 was $272,000,000.

Land O'Lakes Creameries, Inc., markets a variety of products. Included is "Land O'Lakes" butter, which is distributed throughout the United States. The cooperative also wholesales products like those distributed by the Cotton Producers Association. Its fiscal 1968 sales volume was $370,000,000.

F. S. Services, Inc., Southern States Cooperative, Inc., and Indiana Farm Cooperative Association, Inc., each had gross sales volume for fiscal 1968 of considerably in excess of $100,000,000. These three cooperatives maket and distribute many of the same commodities handled by the cooperatives described above. Among their diversified business operations are a chemical manufacturing plant, a research laboratory, a pipe line operation, a petroleum refinery, and a lumber center.

Sunkist Grocers, Inc., a cooperative with principal offices in Los Angeles, markets the nationally known "Sunkist" commodities. The National Grape Cooperative Association, Inc., of Westfield, New York, operates the Welch Grape Juice Company. Sun-Maid Raisin Growers, a cooperative with home offices in Fresno, California, markets raisins under the nationally known "Sun-Maid" label. The California and Hawaiian Sugar Company, of San Francisco, markets "C & H Sugar." All of these businesses are large, national operations; but their sales volume and income figures are not made public.

EXEMPT ORGANIZATION ADVERTISING BUSINESSES

Representatives of the American Business Press reported in 1967 that over 700 exempt organizations conduct active advertising businesses in association with periodicals which they publish. The report estimated that these organizations realize annual gross revenues of considerably more than $100,000,000 from their advertising businesses. Because these figures are several years old, it seems likely that they are quite conservative estimates at the present time.

The American Medical Association (exempt from federal income tax under section 501(c)(6) of the Internal Revenue Code as a "trade association") publishes a number of magazines which contain commercial advertising. In 1967, for example, the organization realized gross income of $13,565,106 from its advertising business alone.

The Journal of the American Medical Association has the largest gross advertising income of any business publication in the United States. In 1967 its gross advertising income was $11,883,000. In 1968 its gross advertising income was $10,585,160.

The National Geographic (exempt from tax under section 501(c)(3) of the Code) also carries on a highly lucrative advertising business. In 1967 the gross income from advertising published in the *Geographic* was $8,635,619. In 1968 the *Geographic's* gross advertising income was $9,539,135.

The U.S. Chamber of Commerce (exempt under section 501(c)(6) of the Code) publishes *Nation's Business*, which includes a wide variety of general consumer advertising, covering products from cigarettes and automobiles to yachts. In 1967 the gross advertising income of *Nation's Business* was about $4,100,000. In 1968 it was about $3,500,000.

The Amercan Chemical Society is an example of the considerable number of specialized trade associations which conduct advertising businesses n conjunction with publications directed to their members and other participants in the industry which they represent. One of the Society's publications, *Chemical and Engineering News*, grossed $4,469,000 from advertising in 1968.

PRIVATE FOUNDATION INVOLVEMENT IN BUSINESS

You will recall that, in my testimony to the Finance Committee, I mentioned a foundation which at the time of the Treasury Department Report to the Finance Committee in 1965, held controlling interests in 26 corporations, including a large metropolitan newspaper, the largest radio broadcasting station in the state, a lumber company, several banks, three hotels, a garage, and a variety of office buildings. That foundation was identified in the New York Times shortly after the publication of the Treasury Report as the Houston Endowment. The newspaper which it owns is the *Houston Chronicle*.

I also mentioned a foundation involved in a recent Tax Court proceeding which, in the nine-year period covered by the Tax Court decision, acquired 24 different businesses, ranging from an oil burner manufacturing company, a foundry, and a window manufacturing establishment to a lumber company and sand, gravel, and concrete businesses. The foundation in question was University Hill Foundation, which was set up for the benefit of Loyola University of Los Angeles.

The James Irvine Foundation, located in California, is, by value of assets, one of the four or five largest foundations in the country. However, for many years it has maintained as its principal asset a controlling interest in a corporation holding very large areas of undeveloped and unproductive real estate. It has been reported that, as a result, over a 17-year period concluding at the time of the Treasury study of foundations, the Irvine Foundation had made annual charitable distributions which averaged less than one-tenth of one percent of its asset value.

I might also point out that the Treasury Department Report on Private Foundations, published by the Finance Committee on February 2, 1965, contains 19 specific examples of foundation involvement in business. Those examples are in addition to the Report's overall statistics on the incidence of foundation business ownership. Among the cases reported by the Treasury Department is one of a foundation which controls 45 business corporations, including 15 clothing manufacturing companies, 7 real estate businesses, 6 retail stores, one hotel, and paint, hardware, and jewelry businesses. I am sure that the Treasury Department would furnish you a list of the names of the foundations which provide the basis for the Report's examples.

BUSINESSES OWNED BY CHURCHES

A protestant church, known as the Cathedral of Tomorrow, in Cleveland, Ohio, owns the Real Form Girdle Company. At the time of my latest information, the same church also owned and operated a shopping center, the Unity Electronics Company, the Nassau Tire and Plastics Company, and an apartment house.

The Temple Beth El, another church, in Fall River, Massachusetts, owns and operates the United States Record Corporation. The business is a distributor of popular phonograph records.

In June of 1968, CBS did a television program entitled, "The Business of Religion," produced by Palmer Williams. Information developed by Mr. Williams and his staff for that program provided the basis for the following additional examples of church businesses.

Church	*Business*
St. Andrews Catholic Church, Chicago, Illinois	Hollywood Roosevelt Hotel, Hollywood, California El Rancho Motel, Sacramento, California
Presbytery of Muskiongum of the United Presbyterian Church	Cement block factory located in Arizona
Southern Baptist Seminary	Greyhound Bus Terminal, Louisville, Kentucky
Roman Catholic Society of Mary, Dayton, Ohio	Electronic subcontracting business
Stratford Retreat House	JFD Electronics, Brooklyn, New York
Calvary Baptist Church, New York City, New York	Hotel Salisbury, New York, New York
Bishop of Catholic Church, Austin, Texas (holding property on behalf of church)	Newton Asphalt Company, Alexandria, Virginia R. S. McClintock Diamond Drilling Company
Self Realization Fellowship	"Mushroom Burger" restaurant chain, California
Benedictine Order, St. Leo, Florida	St. Leo Fruit Company
St. Cornelius Chapel of Valley Forge	Cosmetic manufacturing company
Christ the King Roman Catholic Church of the Dallas Diocese, Dallas, Texas	Slacks, Inc. Wellington Manufacturing Co. Boy Slacks, Inc. Delmeade Slacks, Inc. Meadow Sportswear West Coast Slacks Delta Trouser Corp.

This list, of course, is far from exhaustive; but it is difficult even for the Treasury Department to obtain accurate and complete information upon the commercial holdings of churches because, unlike most other classes of tax-exempt organizations, churches are not required to file information returns with the Internal Revenue Service. I might mention that a recent book by a Mr. Balk, published by the Russell Sage Foundation and entitled *The Religion Business*, cites a number of other examples of church-owned businesses.

I should add that in some of the instances listed the church involved may operate the business through a separate, non-exempt corporation. It would be usual in such cases for the church to lease the business assets to the operating corporation and receive most or all of the profits in the form of rent—which is deductible by the operating company—so that tax is avoided altogether, or in any event minimized. The information which I have does not indicate the extent to which arrangements of this kind are being used in the listed cases. Of course, where the businesses are held directly by the churches, the business income is entirely tax free.

Many thanks for your interest in this subject. If I can be of any further assistance to you, please let me know.

Sincerely,

MORTIMER M. CAPLIN.

Senator ANDERSON. Senator Curtis.

Senator CURTIS. No questions.

Senator ANDERSON. Senator Byrd.

Senator BYRD of Virginia. No questions at this time, Mr. Chairman.

Senator ANDERSON. Senator Miller.

Senator MILLER. Thank you, Mr. Chairman.

It is good to see you again, Mr. Caplin.

Mr. CAPLIN. Senator, it is good to see you.

Senator MILLER. In your comments on foundations you did not refer to the other provision in the House bill which requires a 5 percent pay-out. Are you in favor of that provision?

Mr. CAPLIN. I would say preliminarily that was not within the ambit of the subject matter before me. But so far as the payout is concerned, I have a combined view: I think there should be a payout but I don't think there should be a 7½ percent tax as long as we see that the charity, the educational institution and the others in this category, are devoting their resources to their tax-exempt functions. Eliminate self-dealing, eliminate their business activities, but do not impose the 7½ percent tax on them.

Senator MILLER. Well, the Treasury's position is to have divestiture, knock out the 7½ and use the 2 percent fee and have the 5 percent payout.

Mr. CAPLIN. Yes; I understand that.

Senator MILLER. And I am still wondering what your position is on that particular part of the package.

Mr. CAPLIN. I feel that there should be a payout rule. A large number would have no difficulty with the 5 percent rule. Others would. There are some who have heavily invested in nonincome-producing assets or in stocks which produce very little in dividends. I know of one case where the stock is being held primarily to maintain control of the company, with no dividends being paid out.

Now, it seems to me that those situations should be corrected, and I think a payout rule, without trying to come up with the precise percentage, is sound.

Senator MILLER. Well, suppose instead of an arbitrary 5 percent, you used the Dow Jones stock average dividend payouts for the year?

Mr. CAPLIN. I would have to see just what this formula produced. It seems to me that the fiduciaries of a foundation have an obligation to generate income, and I wonder how they discharge their fiduciary obligations when they sit for years and years in a nondiversified position with large holdings of particular blocks of assets.

I would favor a more significant requirement than the Dow Jones average so far as foundations are concerned.

Senator MILLER. You see the problem?

Mr. CAPLIN. Yes.

Senator MILLER. Nobody knows it better than you, it is one of administration. Are you going to put the problem of determining whether there has been prudent investment to realize prudent returns to charity in the hands of the revenue agent, or in the hands of 5,000 revenue agents, or are we going to have some administratively feasible standard? Now, the House took 5 percent.

Mr. CAPLIN. Yes.

Senator MILLER. Well, administratively that is quite feasible. From the standpoint of equity I am not at all sure about it, and the reason for throwing out the Dow Jones average is that gives at least an administratively feasible standard and it might represent a fair cross section of returns on it, on dividends.

Mr. CAPLIN. Certainly to the extent that this committee would move in favor of eliminating the 7½ percent tax, and I hope it will, I think there is room to have a stronger payout rule. By that I mean supporting the House position which might be higher, let us say, than the Dow Jones average but it is an absolute figure. It would represent a fair distribution to charity of the assets owned by the foundation.

There are many charities that are prepared to go beyond that, who feel that they ought to be using all of their resources and perhaps shouldn't exist more than 20 years. I have seen some communications sent to the Ways and Means Committee, probably now a part of its record, on requiring a full use of the assets over a limited period of time—not to have the charities go on in perpetuity. I am not urging that but I merely cite that as another viewpoint.

There are many differing viewpoints and, on balance, I would favor a rule close to that 5 percent rule.

Senator MILLER. Well, the reason for my probing is that I think there is a relationship between this divestiture and the payout, and one possible solution would be to say that "If you wish to maintain control of a corporation then you are going to have to live with the 5-percent payout. On the other hand, if you are willing to divest yourself so that you are no longer in control of a corporation, well, then, some other standard, such as the Dow Jones standard would be acceptable."

This will give us some flexibility and, I think, more equity than this arbitrary 5 percent rule.

I was wondering if you had any comment on that.

Mr. CAPLIN. I certainly respect your thought. It is rather ingenious and it certainly suggests a middle ground between the position of some of the foundations and the House bill.

Senator MILLER. It is a trade-off.

Mr. CAPLIN. That is right. Yet, if I had to vote I would vote with the House bill but I respect very much the approach you suggest.

Senator MILLER. Thank you very much.

No further questions.

Senator ANDERSON. Senator Byrd.

Senator BYRD of Virginia. No questions.

Senator ANDERSON. Senator Jordan.

Senator JORDAN. No questions.

Senator ANDERSON. Senator Fannin.

Senator FANNIN. Has your association made any study of the special tax privileges enjoyed by giant union organizations? I understand hundreds of millions of dollars are involved in tax immunity of unrelated business income.

Mr. CAPLIN. We have come out in favor of subjecting all exempt organizations to the unrelated business income tax, without exception.

Senator FANNIN. Well, this is of such great magnitude, I was wondering if your association has made a study of what is involved?

Mr. CAPLIN. No, not particularly. Over the years, I have made a continuing study of unrelated business income both during my years in Government and in private life. But I do not have any specific figures on unions.

Again, this is something the staff, which I respect very much on financial projections, could procure from the Treasury. They have the statistics of income and a lot of information not available to the public.

Senator FANNIN. Well, thank you.

Senator ANDERSON. He is an important witness. Do we need to have any more questions?

If not, thank you very much, Mr. Caplin. We appreciate your appearance.

Mr. CAPLIN. Thank you very much, Senator. It is a pleasure to be here.

(Mr. Caplin's prepared statement follows:)

STATEMENT OF MORTIMER M. CAPLIN ON BEHALF OF THE NATIONAL TAX EQUALITY ASSOCIATION

UNFAIR BUSINESS COMPETITION BY TAX-FREE ORGANIZATIONS

Mr. Chairman and Members of the Committee:

My name is Mortimer M. Caplin. I am a member of the Washington law firm of Caplin & Drysdale. I am appearing today on behalf of the National Tax Equality Association.

The problem

The National Tax Equality Association represents approximately 6,000 taxpaying businesses and businessmen. The problem which concerns those businessmen—and the problem on which I would like to focus the Committee's attention today—is that of unfair business competition by tax-free organizations. With marked frequency and plain inequity, (1) the tax-exempt are entering the market-place; (2) the tax exemption is being stretched to shelter the earnings of ordinary commercial enterprises, operated in straightforward competition with taxable businesses; and (3) the general taxpayer is being asked to subsidize the commercial encroachments of those to whom Congress has granted the unique privilege of tax exemption.

Though the problem of business involvement exists among private foundations, it is not, I am sorry to say, confined to that class of tax-exempt organizations. A broad range of tax-exempt and tax-favored organizations has undertaken vigorous, large-scale business activities. The multi-million dollar industrial enterprise operating tax-free as a "cooperative," the university-owned department store (euphemistically labeled a "bookstore"), the church-owned girdle factory, and the trade association advertising business are not flights of fancy. They are facts. And, for the taxpaying businessmen of our country who must compete with them, they are very unpleasant facts.

Illustrations of tax-exempt businesses

Let us take a moment to survey some of these facts.

A private foundation whose tax exemption was upheld by the Tax Court this year had acquired twenty-four separate businesses during the nine-year period covered by the Tax Court decision.[1] Included were a plastics manufacturing business, three sand, gravel, and concrete businesses, a foundry, three dairies, a hotel, a printing establishment, and businesses manufacturing windows, oil burners, rubber treads, and locks. All were operated under arrangements designed to provide a complete tax shelter for the profits produced by the businesses.

At the time of the 1965 Treasury Department Report on Private Foundations, one foundation described in the Report held controlling interests in 26 separate corporations, 18 of which operated going businesses. One of the businesses is a large and highly competitive metropolitan newspaper, with assets valued most recently at $35,000,000 and gross receipts of more than $17,000,000 for 1962. Another of the corporations operates the largest radio broadcasting station in the

[1] *University Hills Foundation* v. *Commissioner*, 51 T.C. No. 54 (1969).

state. A third, sold to a national concern at the beginning of 1965, carried on a life insurance business whose total assets had a reported book value of more than $20,000,000 at the end of 1962. Among the other businesses controlled by the foundation are a lumber company, several banks, three large hotels, a garage, and a variety of office buildings. Concentrated largely in a single city, these properties present an economic empire of substantial power and influence.

A number of churches have entered into active and aggressive commercial endeavors. One, for example, has become a wholesale distributor of popular phonograph records. Another has acquired at least seven sportswear and clothing manufacturing businesses. A third manufactures mobile homes and operates a drilling business. Others conduct real estate development businesses, provide petroleum storage facilities, and carry on a broad variety of manufacturing enterprises.

Over 700 trade associations and other exempt organizations operate active and successful commercial advertising businesses in conjunction with periodicals which they publish. One trade association, for example, earns more than $10 million each year from its advertising businesses. Another has annual, advertising income of more than $6 million. Reports published in the press in recent years have estimated the advertising revenues of tax-exempt organizations to be considerably in excess of $100 million a year.

Fraternal beneficiary societies, exempt under section 501(c) (8) of the Internal Revenue Code, carry on a very large volume of insurance business. On January 1, 1964, they had approximately $13.8 billion of insurance in force. Beyond their insurance operations, they conduct a number of other businesses—including bowling alleys, driving ranges, restaurants, and hotels.

Cooperatives afford another—and extreme—illustration of the intrusion of tax-free organizations into the market-place. Though only a limited class of cooperatives is technically classified as "tax-exempt," the present tax rules available to other cooperatives accord them the practical effect of exemption. Where a cooperative makes paper allocations of its earnings to its patrons, and meets certain other requirements, the cooperative corporation—unlike other business corporations—need pay no federal income tax whatever. It can achieve that result despite the fact that it has earnings of several million dollars and retains up to 80 percent of those earnings for expansion and other business purposes.

The tax advantage of cooperatives evolved at an early stage in the development of our federal income tax laws, during a period when cooperatives consisted of small groups of farmers, forming simple associations for marketing farm produce or purchasing farm supplies. The cooperatives of today bear little resemblance to their predecessors of 50 years ago. No longer are they limited to group marketing of farm produce and group purchasing of farm supplies. No longer do they consist primarily of small groups of farmers operating at the local level. Consumers have organized cooperatives, and so have strictly business organizations. With accelerating rapidity, cooperatives have moved into the fields of processing, manufacturing, and wholesale and retail distribution of non-agricultural commodities. Upon a major scale, they produce fertilizer; refine oil; manufacture paint and agricultural chemicals; process citrus fruits; produce dairy goods; sell at wholesale such products as hardware, lumber, drugs, and groceries; and operate consumer retail stores.

One cooperative reported assets valued at $246,599,000 in 1967 and had sales totaling over $500,000,000 for that year. Another had 1967 sales of more than $350,000,000. A third reported sales of $246,508,000. Five cooperatives appear in *Fortune*'s latest lift of the 500 largest business operations in the United States.

Capitalizing upon their ability to generate tax-free earnings, cooperatives have become permanent, large-scale institutions, separate from, and in large measure independent of, their patron-owners. Many have developed complex corporate structures, closely resembling the parent-subsidiary organizational pattern of large corporations in the private business field. They have even joined the acquisition trend which has become so evident in the private business sector in recent years, taking over a considerable number of non-cooperative corporations in tax-free exchanges. The competition which they are capable of generating is aggressive and formidable.

Recent impetus for exempt organization involvement in business

Though exempt organizations have been involved in competitive business activities for many years, their acquisition of businesses received strong impetus from a 1965 Supreme Court decision. In the case of *Commissioner* v. *Clay B. Brown*, 380 U.S. 563 (1965), the Supreme Court accorded capital gains treatment to persons who transferred a lumber and sawmill business to an exempt organiza-

tion under an arrangement meticulously designed both to avoid tax on the business profits and to permit the organization to acquire the business entirely without investment of its own funds. Because of the tax immunity of the business profits, arrangements of this sort enable exempt organizations to pay higher prices for businesses than taxable purchasers can afford. An exempt organization can, in effect, pay to the seller the portion of the business profits which a taxpaying purchaser would have to pay to the government in taxes. The result is a clear and substantial incentive to sell businesses to exempt organizations.

The advantages of such sales have been thoroughly advertised by exempt organizations. A solicitation letter circulated on behalf of a church quite frankly explains that "the church has made and will continue to make acquisitions of companies by paying to the sellers *a more attractive selling price than a commercial buyer will pay* . . ." (The emphasis is that of the original.) An advertisement appearing in the Wall Street Journal states that a "TAX EXEMPT INSTITUTION SEEKS CLOSELY HELD COMPANIES," explaining "Negotiations conducted on generous pretax earnings basis." Another Wall Street Journal advertisement specifies that a "Highly respected charitable fund . . . will purchase private or closely held companies with minimum pretax profit of $250,000," taking care to point out that the "financial and other benefits [are] very rewarding."

With the incentive provided by the Supreme Court approval of capital gains treatment for sellers in such situations, and the compelling stimulant added by advertising of this kind, it is scarcely surprising to find that the acquisition of commercial businesses by tax exempt organizations is proceeding apace.

The nature of the problem

The tax immunity of exempt organization businesses produces substantial losses of federal revenues. Even more serious, however, is the fundamental problem of unfair competition. The businesses with which the exempt organization competes must pay taxes on their earnings. The exempt organization, on the other hand, can make a variety of effective uses of the additional funds which it derives from its exemption. It may cut its prices below those which are economically feasible for its competitors. It may reinvest its tax savings in capital improvement and expansion programs. It may utilize its tax subsidies—which, of course, are underwritten by other taxpayers, including precisely those businesses with which the exempt organization competes—to provide higher salaries and other benefits to attract capable personnel away from its competitors. It is, in sum, permitted to wage business competition with a major and often decisive advantage over other businesses.

Previous congressional action

The problem is hardly a new one to this Committee or the Congress. Over 25 years ago, the Ways and Means Committee stated straightforwardly that the problem should be analyzed "with a view to closing existing loopholes and requiring the payment of tax and the protection of legitimate companies against this unfair competitive situation." Again, in 1950, in applying the unrelated business income tax to certain exempt organizations, both the Finance Committee and the Ways and Means Committee stated that the problem at which the new tax was aimed was "primarily that of unfair competition." Again and again the legislative history of the 1950 statute demonstrates deep Congressional concern about unfair competition by tax-free organizations and clear Congressional consciousness of the seriousness of exempt organization expansion through commercial acquisitions.

Nothing makes the fundamental intent of the 1950 unrelated business income tax clearer than the minor and carefully limited character of the activities which Congress specifically meant to exclude. The Committee Reports provide the following examples of businesses which were not made subject to the new tax: sales of donated second-hand clothing by a shop operated by an orphanage; sales of articles manufactured by handicapped persons as a part of their rehabilitation; a laundry operated by a college primarily for the convenience of its students; the operation of a sandwich stand at an annual country fair; and occasional fund-raising dances.

The major, multi-million dollar, aggressively conducted business enterprises which tax-free organizations have today managed to bring under the shelter of their tax immunity afford a startling contrast to the minor business activities which Congress specifically intended to remain untaxed. The difference, indeed, could hardly be more extreme. What are the causes of that difference? And what can be done about them?

THE SOURCES OF THE DIFFICULTY; THE HOUSE SOLUTIONS; AND MY RECOMMENDATIONS

The sources of today's broadscale tax-exempt commercialism are of several different classes. The House tax reform bill contains provisions designed to deal with most of them. In some cases the House solutions are excellent; in others, analysis discloses them to be insufficient. Last week, the Treasury Department witnesses made their own recommendations to you.

To sort out the separate problems and to explain what I think should be done about them, I would like briefly to describe the source of each, analyze the relevant House provision and Treasury recommendation, and outline my own proposal.

1. Extension of unrelated business income tax

In its present form, the unrelated business income tax applies only to certain classes of exempt organizations. Designed to place the businesses of exempt organizations upon the same tax basis as their taxable competitors, the unrelated business income tax was made applicable only to those categories of exempt organizations which the Congress in 1950 found to be significantly involved in business. As a consequence, the tax does not apply at all to many types of organizations, including churches, so-called "social welfare" organizations, fraternal beneficiary societies, and others; and a considerable number of these organizations have taken advantage of their immunity to embark upon major commercial acquisitions.

The House approach to this problem is both simple and sufficient. With a single, limited exception, section 121 of the bill would extend the unrelated business income tax to all classes of organizations which are exempt under the general exemption provision.[1] The National Council of Churches, the United States Catholic Conference, and similar organizations have endorsed this approach, and the Treasury witnesses last week concurred. On this point, I think that the House and the Treasury Department are quite right; and I recommend that you adopt the House solution without qualification.

2. Debt-financed acquisitions

The incentive which present law establishes for the transfer of businesses to exempt organizations in debt-financed transactions of the kind involved in the *Clay Brown* case is both compelling and unjustifiable. It is, in the main, traceable to the tax immunity of earnings used to discharge indebtedness assumed by the exempt organization in acquiring the business.

Section 121 of the House bill strikes directly at the source of the problem: it imposes tax on the earnings of the acquired property to the extent of the indebtedness incurred in acquiring it. Since 1966, when the Ways and Means Committee originally held hearings on the *Clay Brown* problem, the Treasury Department has strongly supported the solution now incorporated in the House bill. Here again, it is my view that the House and the Treasury Department are entirely correct; and I urge you to approve this part of the House bill.

3. Taxation of cooperatives.

Present law contains no satisfactory provision for the taxation of profits earned by cooperative corporations. For many years cooperatives and their owner-patrons were able to deal with each other and with the general public without, in many circumstances, the inconvenience of paying tax at all—either at the cooperative level or at the owner-patron level. In 1962 Congress acted to curtail this extreme abuse. The measure which was adopted, however, aimed only at securing a single tax from the cooperative and its owner-patrons. Where a cooperative makes paper allocations of its earnings to owner-patrons, and pays them 20% of the earnings in cash, the responsibility for tax shifts entirely to the owner-patrons; and the cooperative remains able to engage in broad-scale business competition, earn large sums of income, and retain the major part of those earnings without paying tax.

The proper solution is to extend, to cooperative corporations and their owner-patrons, the fundamental two-tier system of taxation now applicable to other corporations and their shareholders. An extensive legal study which my firm completed this spring, and which has subsequently been published, demonstrates that cooperatives are corporations; that their owner-patrons are share-

[1] Only certain governmental instrumentalities would remain excluded from the tax.

holders; that cooperatives' activities are properly viewed as earning income for purposes of basic income tax principles; and that the cooperative-patron relationship has no special legal features which justify failure to tax that income to the cooperative. Cooperatives should be made fully taxable on the income which they earn, and where those earnings are subsequently distributed to owner-patrons, they should be taxed to the owners—just as other corporate dividends are now. Senator Ribicoff has recently introduced a bill (S. 2646) which incorporates precisely that approach. In my view, the Ribicoff bill should form the basis for this Committee's resolution of the cooperative problem.

Placing cooperatives on the same footing as other corporate business enterprises, Senator Ribicoff's bill allows cooperatives all of the tax advantages available to other corporations. Thus, for example, where cooperatives are able to qualify for the special treatment provided by Subchapter S for small business corporations, they would receive that treatment. Indeed, in an important particular, the Senator's bill allows the cooperative/patron relationship more liberal treatment than that now accorded other corporation/shareholder relationships: it grants patrons a $300 dividend exclusion, rather than the $100 exclusion which existing law provides for other shareholders.

Unfortunately, the House did not deal with the problem as effectively as Senator Ribicoff has. Though it began with important strides in the right direction, the House ended with a quite inadequate solution. The Ways and Means Committee Tentative Decisions of July 25 would have required cooperatives to distribute 50% of their earnings in cash—rather than the presently required 20%—to shift tax to their owner-patrons, and would have required the remaining 50% to be paid to owner-patrons within five years. Although these rules would not produce additional tax at the cooperative level, they would establish important limitations on the competitive advantages of cooperatives: for they would restrict the ability of cooperatives to retain up to 80% of their untaxed earnings for expansion, capital improvements, and similar competitive uses.

The final House action, however, substantially loosens the 50% requirement, and extends the five-year rule to 15 years. Awed by "administrative problems," the Treasury Department last week recommended that this Committee make the inadequate House solution even more inadequate. Treasury proposed that the 50% rule be scrapped altogether and the 20% rule of existing law be substituted. The Treasury approach would leave cooperatives with the same formidable advantages they now have over their taxpaying competitors—and would thereby leave a major and entirely unjustifiable gap in the considerable progress being made by other portions of the tax reform bill on the problem of competitive equality for businesses.

The Ribicoff bill has important advantages over both the House and the Treasury approaches. The relationship of cooperatives to their owner-patrons is, in all fundamental respects, identical to that of corporations and shareholders; and the Ribicoff bill reflects that identity by according essentially the same tax treatment to both situations. In doing so, it prescribes a fair and effective solution to the severe competitive abuses which have arisen in this field. Furthermore, while the House and Treasury proposals would have no revenue effect at all, the Ribicoff bill would produce an estimated annual revenue yield of $200,000,000. Consequently, I strongly recommend that you adopt the approach of the Ribicoff bill. If, however, you decide against that approach, I recommend that you adopt the original decision of the Ways and Means Committee on this matter. Anything short of that simply will not relieve the severe competitive inequities which now exist in this area.

4. Divestiture of foundation business holdings

The involvement of private foundations in business gives rise to a number of special and serious problems even where the business income is subject to tax. The Report on Private Foundations which the Treasury Department made to this Committee in 1965 provides an accurate catalog of those problems. Upon the grounds elaborated in that Report, the Treasury Department recommended that private foundations be required, over a reasonable period of time, to reduce their holdings in any unrelated business to below 20%. With relatively minor modifications, the House bill adopts that requirement.[1] I recommend that you approve it.

[1] The bill would accomplish this result by adding a new section 4943 to the Internal Revenue Code. Its fundamental divestiture rule is an important improvement upon the existing rules under which foundations operate, and should be enacted; but the Committee will have to give careful attention to transition problems arising under it. The Committee may, for example, wish to consider an exception to the general disposition requirement for foundations whose governing instruments provided for retention of specified business interests as of the time the Treasury proposal originally became public.

In passing, I would like to point out that, once the business and other specific foundation abuses at which the House bill aims are dealt with directly, it makes very little sense to impose a general tax upon the investment income of private foundations. The Congress should do everything within its power to make certain that foundation income and assets are applied to the educational, charitable, and other purposes for which exemption has been granted foundations, but once having done that, it seems to me an error of serious magnitude to divert foundation resources from exempt purposes by means of a tax on investment income. On the other hand, having spent several years attempting to cope with the administrative problems which some private foundations produce for the Internal Revenue Service, I would agree with last week's recommendation by the Treasury Department that a supervisory fee be imposed upon foundations and devoted to Service administrative operations in the foundation field.

5. Advertising income

In 1967 the Treasury Department adopted regulations under the unrelated business income tax which, among other thing, specified that that tax applies to the profits which exempt organizations earn from commercial advertising published in their periodicals. This position of the regulations has, of course, been strongly opposed by those exempt organizations which have advertising income. After careful study of the regulations, however, I am convinced that the taxation of advertising income represents an entirely valid interpretation of existing law; and last year the Senate overwhelmingly rejected an amendment which would have reversed the regulations on this point.

The Ways and Means Committee reviewed the problem this year and concluded that the judgment of the Senate and the Treasury Department was sound. To bring the controversy to an end, the House bill (in section 121(c)) specifically incorporates the position taken by the regulations. Because the taxation of advertising income is in direct accord with the fundamental policy of the unrelated business income tax—placing a highly competitive set of exempt organization business activities upon the same tax footing as their taxpaying competitors—I urge you to approve the action of the House.

In one respect, however, additional legislation is desirable. In recent articles, tax advisors of exempt organizations have indicated that they will attempt to defeat the effect of the tax on advertising income by accounting adjustments, special reporting techniques, and other devices. The problems here are intricate, and the scope for maneuvering uncertain. To insure that the fundamental policy decision to tax advertising income is not defeated by such maneuvering, I recommend that you grant the Treasury Department authority to prescribe legislative regulations (like those governing corporations which report their income on consolidated returns) for the determination of allowable deductions under the unrelated business income tax.

6. Technical correction of unrelated business income tax

A peripheral exception embodied in the original unrelated business income tax has proved to be a loophole of major dimensions. In its desire to permit exempt organizations to receive "passive" income free of tax, Congress incorporated exemptions for rent, royalties, and certain other forms of income in the 1950 statute. Tax planners have made full and repeated use of these exceptions to avoid the impact of the unrelated business income tax altogether.

A common method of achieving that result has been for an exempt organization which owns business assets to transfer an operating interest in the assets to a subsidiary in exchange for a payment—generally rent or royalty—which is deductible by the operating entity but qualified for one of the exemptions from the unrelated business income tax in the hands of the exempt organization. In that way, tax is avoided both at the operating company level and at the exempt organization level. The courts have repeatedly approved arrangements of this kind.[1]

The House bill (section 121(b)) attempts to deal with this problem, but its solution is limited to situations in which the exempt organization owns 80% or more the stock of the operating entity. So restricted, the House measure would fail to apply to a number of variations of this basic avoidance device—including those involved in several litigated cases.

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[1] See, for example, U.S. v. Robert A. Welch Foundation, 334 F. 2d 774 (5th Cir. 1964); University Hills Foundation v. Commissioner, 51 T.C. No. 54 (1969).

I recommend that:

The unrelated business income tax exclusions for rent, royalties, and interest be made unavailable for any class of income which is deductible by the payor and which is paid to the exempt organization by an entity in which the exempt organization, its creditors, or related persons have a significant interest;

These exclusions also be made unavailable for any rent, royalty, or interest whose amount is determined by the amount of income—gross or net—realized by the payor; and

Because experience demonstrates that the exclusion for real property rent creates a substantial competitive disadvantage for the taxable owners of real property, careful consideration be given to eliminating the rental exclusion from the statute altogether.

7. Taxation of related businesses

The 1950 unrelated business income statute does not tax profits of businesses which are "substantially related" to the exempt functions of the organization conducting them. Some highly competitive business activities can meet this test, and are therefore not taxed. For example, a large book or map publishing business might well be considered to have substantial relationship to the exempt purposes of certain kinds of educational organizations. The business would, therefore, escape taxation even though it constitutes a severe and direct competitive treatment to commercial publishing enterprises. Similarly, it seems clear that, if the present form of the unrelated business income tax were extended to fraternal beneficiary societies, the insurance businesses conducted by such societies would be considered related to their exempt purposes and therefore nontaxable. A number of other large and competitive—but "related"—businesses exist. The House bill does not address this problem.

No systematic study of the nature and dimensions of the problem has been conducted for many years. To develop the necessary background for measures bringing competitive equality to those fields in which taxpaying businessmen compete with exempt businesses "related" to exempt purposes, I recommend that this Committee and the Congress direct the Treasury Department to conduct a detailed review of such businesses and submit legislative proposals for the correction of any competitive inequalities which are found to exist.

8. Clarification of deduction rules

Some courts have adopted a rule for the allowance of deductions to non-exempt, non-profit organizations which accords such organizations the full practical effect of tax exemption. These courts have permitted such organizations to deduct the expenses of their non-profit activities—generally, the furnishing of services to their membership—from the net income which the organizations realize from unrelated sources.[1] Under this rule, for example, a non-profit water company would be permitted to offset the full cost of providing water services to its members against the income produced by its investment properties. It could, therefore, avoid tax upon the investment income entirely. Though other courts have rejected this rule, the law on the point is far from settled at the present time; and, where the more liberal rule obtains, a non-profit organization which, for one reason or another, fails to satisfy the technical requirements of tax exemption may nonetheless secure the real advantages of exemption for its business operations.

Adding a new section 278 to the Internal Revenue Code, the House bill deals directly and effectively with this problem. The Treasury Department has approved the House solution. I recommend that the Finance Committee incorporate such a provision in its final legislation here.

CONCLUSION

The problems presented by the business involvement of tax-free organizations are severe—and rapidly growing more severe. They constitute a major source of inequity in our present tax system. Congress has recognized the seriousness of the issue before, but the steps which have been taken to deal with it have proved insufficient to cope with the ingenuity of tax planners and the increasing willingness of tax-free organizations to enter the market-place.

[1] *Anaheim Union Water Co.* v. *Commissioner*, 321 F. 2d 253 (9th Cir. 1963); *Bear Valley Mutual Water Co.* v. *Riddell*, 283 F. Supp. 949 (D.C. Calif. 1968, appeal to 9th Cir. pending).

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I strongly recommend that this Committee take prompt and effective action to resolve these problems.

Senator ANDERSON. Father Jolley?

STATEMENT OF REV. HOMER R. JOLLEY, PRESIDENT, LOYOLA UNIVERSITY

Reverend JOLLEY. Good morning, Mr. Chairman. Thank you very much.

Mr. Chairman and members of the committee, my name is Father Homer Jolley. I am here as president of Loyola University of New Orleans, and I intend to keep within the request, the time request, that the committee asked, but I would like our full statement to be put into the record, if you don't mind.

Senator ANDERSON. It will be placed in the record.

Reverend JOLLEY. The House bill, 13270, which is the tax reform bill, contains many provisions that we feel will affect very seriously the charitable giving to educational and religious institutions.

However, my purpose here today is to point out the reasons for objecting to one particular provision, section 121, which extends the unrelated business income tax to churches.

I would like to make it very clear, first, that we hold no brief for keeping the possible abuses that are in the current law. For instance, we hold no brief for the Clay Brown type of transaction.

We do, however, object to extending the unrelated business income tax to churches, and I think that there are ways to prevent these abuses without removing the tax exemption.

I would just very briefly like to say something about Loyola. It was founded in 1849. It has a student body of about 5,000 students, and its commitment to broadcasting dates back to 1909, when that broadcasting was part of the university's physics department.

In 1922 our station WWL was the first station to broadcast in the New Orleans area, and in 1957 we began television operations.

Loyola is a private university. Its revenues are realized from tuition fees, gifts, small securities endowment and from the operation of these broadcasting facilities.

Even with these sources of financial assistance Loyola's 5-year financial projection indicates that even with the revenue of this unrelated business, we will have a deficit in all of the next 5 years, whereas without this tax exemption on this unrelated business we will have a very substantial deficit.

Prior to 1950, the Revenue Act of 1950, religious, charitable, and educational institutions were exempt from Federal tax.

In 1950 the tax on unrelated business activities was extended but it specifically exempted chuches.

Again this year Congress is concerned with what many people consider to be abuses in the unrelated activities of churches.

The House dealt with the abuses in two ways: That is, it enacted specific provisions to halt the Clay Brown-type or bootstrap-type transactions, and it also extended the unrelated business income tax to churches.

Recognizing the economic hardship of immediate extension of this tax to churches, the House allowed a 6-year period to restructure the

activities. However, we believe that Congress can both eliminate the abuses and also keep, retain, the exempt status of churches of unrelated business income under certain conditions.

Now, the principal reasons for extending this unrelated business income tax to churches are that, vis-a-vis the taxpaying competitors, churches, because of the tax exemption "charge lower prices and expand their business operations out of earnings undiminished by taxation."

WWL has always operated on a strictly competitive basis. Its employees belong to the same unions as employees of other stations. The advertising rates that we charge are comparable to the other stations in the New Orleans area. We feel that we have never engaged in any unfair business practices, and we support all efforts to prevent unfair business practices.

The other reason for extending the tax is that churches could expand their businesses out of the earnings undiminished by taxation.

The enactment of the Clay Brown provisions removed the possibility of doing that by debt financing. While others may have expanded their unrelated activities through the use of non-tax-retained earnings, WWL has expended more, not less, of its earnings than corporations in general.

For the last 5 years or any previous period selected, WWL has expended more than 82 percent and in some years even 90 percent of its earnings for the benefit of its religious and educational purposes.

In this connection, the recent Treasury Department studies revealed that in 1965 the effective tax rate upon most manufacturing companies was 44.4 percent. Another Treasury publication indicated that all manufacturing companies distributed to stockholders approximately 46 percent of after-tax income, which is equivalent to 30 percent of pretax income.

In other words, the average corporation accounts for about 74 percent of its taxable income, and the rest it has to plow back into its business. So, in other words, the average corporation retains about 25 percent of its pretax profits.

Now, this figure should be compared with approximately one-sixth that WWL, for example, retains.

Loyola recognizes that the potential for unfair competition does exist if churches neither pay taxes nor expend their earnings for the benefit of the public, the purpose for which they were founded, and we support all efforts to establish equality of operation, and to secure this result we recommend, as an alternative to an across-the-board extension of the unrelated business income tax to churches, that churches be required to expend a minimum of their earnings on an annual basis, say, 80 percent, for instance, of the pretaxed earnings.

Briefly, Loyola supports legislative efforts which would, (1) remove all nontax advantages enjoyed by the churches in the conduct of unrelated activities and, (2) require churches to expend at least 80 percent of the sum of (a) their unrelated business taxable income for the taxable year and (b) their gross revenue for the taxable year derived from any source, exclusive of gifts and grants, bequests and extraordinary items, other than any other unrelated trade or business income.

It is Loyola's position that a church should be required to expend such amounts in the exercise or performance of its religious, charitable, or educational purposes. We believe this minimum expenditure approach, combined with the inability to borrow imposed by the Clay Brown provisions, will remove any competitive edge which churches may enjoy and, at the same time, it permits churches to continue their positive contribution to the communities they serve, contributions which in our view are more significant than the potential revenue impact of extending across the board the section 511 tax to churches.

Churches, which do not expend at least 80 percent of total revenues should be taxed as a commercial entity on their unrelated trade or business income.

If this approach is not deemed desirable by the committee, we would hope that methods other than the provisions of the House bill, other than total removal of the exemption, might be explored. For example, churches could be allowed an unlimited deduction for earnings distributed to or permanently set aside for the benefit of certain qualified operations or organizations; namely, schools, hospitals, charities which derive their support from the general public.

The benefit of this approach is that the church would be required annually to distribute or permanently set aside a portion of its earnings or pay income taxes on its failure to do so.

This approach would also prevent churches which conduct business activities from expanding such businesses through retained earnings undiminished by income taxes.

Second, another alternative would be a phase-in period of 10 years could be provided. Churches which have relied on prior congressional action for nearly 50 years should not now be prejudiced by the far-reaching changes contained in the House bill.

Many churches, including Loyola, have expanded their church facilities and their other charitable activities by incurring substantial long-term indebtedness which, in major part, are financed by revenues from their unrelated activities.

In the event that it is deemed necessary to extend the unrelated-business income tax to these activities, we would hope that Congress would allow churches with existing business activities a 10-year, 10-percent-per-year, phase-in period following the effective date of the provision in the House bill.

Such a phase-in would provide churches with existing business activities a reasonable time within which to retire shorter-term obligations and make adequate provisions for previously incurred long-term indebtedness, which is secured in part by the expected revenues from these unrelated-business activities.

We would like to reiterate our belief that income earned by competitively conducted church businesses should continue to be tax exempt if the earnings are annually used for publicly supported religious, educational, or charitable activities.

I thank the committee members for their time, and I will be happy to try to answer any questions you have.

Senator WILLIAMS. No questions.

Senator TALMADGE. No questions.

Senator BENNETT. No questions.

Senator CURTIS. Thank you, Mr. Chairman.

Do you know how much money this is supposed to raise if we would enact the House bill as to churches?

Reverend JOLLEY. How much more revenue?

Senator CURTIS. Yes.

Reverend JOLLEY. No, I do not.

Senator CURTIS. Very small, isn't it?

Reverend JOLLEY. I am under the impression that it is relatively small.

Senator CURTIS. Can the staff provide that?

Reverend JOLLEY. I think the staff has that figure.

Senator CURTIS. How much revenue by extending the unrelated-business revenue to churches.

Mr. WOODWORTH. We do not have a breakdown on it, just churches. It is $20 million for churches and the other organizations. We will try to get a breakdown.

Senator CURTIS. That is a great many other organizations?

Mr. WOODWORTH. That is a number of others; yes, sir.

Senator CURTIS. Would you think the churches might account for 10 percent of it?

Mr. WOODWORTH. They may account for at least that much, yes. Based upon—there are a number of examples of where they do have—I would say they account for quite a bit of it.

Senator CURTIS. Just one more question: Has any broadcasting company, to your knowledge, asked that this tax be imposed?

Reverend JOLLEY. I just don't know. I have heard, there has been articles written about this, including say, our broadcasting company along with other unrelated-business activities that have been using the Clay Brown provision. We have never used the Clay Brown.

Senator CURTIS. That is all.

Senator ANDERSON. Senator Byrd.

Senator BYRD. Thank you, Mr. Chairman. I do not have a question but I would like to take just a moment to make a statement for the record and to the witnesses who will testify later today and next week.

I feel these are vitally important hearings and I would like to be present the full time and to hear all of the witnesses. However, the military authorization bill is being debated on the floor of the Senate now, and I am a member of the Committee on Armed Services, and I want to do what I can to help cut the fat from the military budget and simultaneously do what I can to see that the muscle is not cut from the military organization.

A vitally important amendment is being debated on the floor of the Senate now which would cut the muscle, so today, Mr. Chairman, I will be going back and forth from the committee to the Senate floor, and I just wanted the record to show the reason.

Thank you, Mr. Chairman.

Senator ANDERSON. Senator Miller.

Senator MILLER. Thank you, Mr. Chairman.

Father Jolley, there is a lot of merit in your testimony and I am deeply sympathetic with the problems you face. But there is one thing that still bothers me and that is that while you may testify that you operate your station on a competitive basis and are not undercutting competition, in your suggestion there is nothing that I can see that would prevent this from happening on the part of some other univer-

sity and, as I understand it, one of the concerns is that competing businesses fear undercutting competition.

Granted that 80 percent of the profits from the operation may accrue to charity or education, still there is the undercutting of competition which I understand has occurred in some cases.

What can we do to insure that that will not take place if we followed your 80-percent recommendation?

Reverend JOLLEY. We feel that that restriction is pretty tight to keep them from using their tax-exempt status to unfair advantage or some—now, the broadcast industry is so closely regulated by the FCC that it is very hard to engage in practices like that.

Senator MILLER. Then, let us get into some other type of activity.

Reverend JOLLEY. Fine.

Senator MILLER. Some business activity that is not a regulated business activity. I can understand how a tax adviser to a university might say, "Cut your prices 20 percent below the regular market. You will get a lot more volume of business that will just accrue to the benefit of the university, and that is what we are in business for anyhow," and then the competing businesses are very unhappy about it because they find more people buying from the university, with the 20 percent discount, and this is a loophole that I understand exists, and I don't see how that would be filled by just simply requiring an 80 percent payout.

I can see, some universities may say, pay out the entire 100 percent profits to the university. But that doesn't prevent the 20 percent discount designed to obtain more business, and then the ensuing hardship on competing taxpaying businesses.

Reverend JOLLEY. I imagine any kind of administrative regulations to control that would be very complex, but I think perhaps some, say, standards that the trade association to which this business belongs or something like that could set standards where the company was engaged in unfair price wars or something like that. It would be a complicated administrative thing to carry out, but I think something could be worked out, and we certainly would not be against that. Our rates are by no means lower, in many respects they are the highest.

Senator MILLER. I can see where as a regulated business you wouldn't have the problem, but in unregulated businesses like a spaghetti factory it would be. I grant that it could be an administrative difficulty.

Reverend JOLLEY. It might be complicated administratively. Perhaps some standards of the trade association could be set up.

Senator MILLER. Thank you.

Senator JORDAN. Father Jolley, just one question. Do you believe unrelated activities of churches should pay State and local taxes?

Reverend JOLLEY. Yes, yes. For instance, we do, Loyola does pay real estate taxes and ad valorem taxes and State taxes.

Senator JORDAN. Thank you.

Senator FANNIN. No questions.

Senator ANDERSON. Thank you very much. We appreciate your testimony and your complete statement will be placed in the record.

(The prepared statement with attachment follows:)

STATEMENT OF THE VERY REV. HOMER R. JOLLEY, S.J., LOYOLA UNIVERSITY, NEW ORLEANS, LA.

Re: Extension of the Unrelated Business Income Tax to Churches.

INTRODUCTION

This statement is made on behalf of Loyola University of New Orleans for the purpose of presenting its views on the extension of the unrealted business income tax to churches. Loyola wants to make its position perfectly clear at the outset: We do not oppose legislative efforts to stop the *Clay-Brown* type transactions. We do, however, have serious reservations concerning the extension of the unrelated business income tax to churches. In this connection, we feel there are ways of curing the abuses to which extension of the Section 511 taxes is aimed which permit churches to continue their traditional religious, educational and charitable activities.

BRIEF HISTORY OF LOYOLA UNIVERSITY OF NEW ORLEANS

In 1849, members of the Society of Jesus founded Immaculate Conception College in downtown New Orleans. Thereafter, in 1904, Loyola College and Academy moved to its present site in uptown New Orleans. In 1912, the State of Louisiana granted Loyola a University charter. Subsequent colleges established were Pharmacy in 1913; Law and Dentistry in 1914; Music in 1932; and Business Administration in 1947.

Presently, Loyola's student body, representing 43 states and 27 countries, consists of nearly 5,000 students, of which slightly more than 20 percent are not members of the Catholic faith. From its earliest days, Loyola has been active in the New Orleans community and committed to providing educational opportunity for all citizens in the South. Loyola has, since 1924, conducted an evening division for students employed during the day and present enrollment now exceeds 2,000 students. The Institute of Human Relations of Loyola University was founded in 1947 and evidences a long-standing commitment to the promotion of human and civil rights and to the education of the underemployed and the unemployed. The Institute has conducted four federally funded manpower training programs for the disadvantaged. Since 1965, the Inter-American Center, a division of the Institute, has directed 28 leadership training seminars, supported by the Agency for International Development. These six-week sessions have provided training for over 800 nationals from Central and Latin American countries. During the past three years, more than 150 students have participated in the University's Upward Bound Program. A college program for police officers and cadets was inaugurated in 1964 and more than 300 are now enrolled studying for degrees in Police Science. Projects ranging from studies in the Strontium-90 content in teeth to the desalinization of water are under way at the Loyola Health Research Center.

Loyola's commitment to broadcasting began in 1909 with a spark-gap transmitter as part of the Physics Department. At that time, radio licenses were granted to most of the higher educational institutions in Louisiana as well as other civic groups. The only requirement for preserving the license was that it be renewed every 90 days. Most of these licensees grew disenchanted with early radio and allowed their licenses to lapse. Loyola, recognizing the use to which radio could be put as an educational tool, renewed its license on a regular basis. Although much of its equipment was rudimentary by present standards, Loyola immediately placed its radio facilities, teaching aids and equipment at the service of the Government during World War I.

On March 31, 1922, radio station WWL beamed the first radio program ever broadcast in the City of New Orleans, and probably the entire Gulf Coast. Today, it is one of the few 50,000-watt clear-channel stations in the nation and is heard throughout the Mississippi Valley as well as other parts of the country. It was not, however, until December, 1929, that WWL broadcast its first commercial program. In 1957, Loyola branched into television, with WWL/TV. Both WWL and WWL/TV are still part of Loyola University and, aside from providing much needed financial assistance to Loyola, these facilities provide valuable technical assistance to the Department of Communications and furnish a media by which Loyola can better serve the New Orleans community.

Loyola was a pioneer in the use of television to offer education courses for credit. A typical lecture series might dwell on "Science of Optics" (Physics)

or "Marketing Techniques" (Business Administration) or "The Philosophy of Existentialism" (Philosophy). In 1966, Loyola instituted a full-time Department of Communications offering degrees in several fields of broadcasting. For some years prior to this, Loyola students were able to receive credits in a variety of broadcast courses using its broadcasting facilities as the primary classroom. Presently, courses are offered in all phases of broadcasting, including production, writing, announcing and even marketing. Beginning in 1962, Loyola through its broadcasting facilities presented a series of programs designed to teach functional illiterates how to read and write. Presented in cooperation with the Greater New Orleans Council of Jewish Women, the program "Project Learn" was aimed at the area's Negro minority. Public affairs programming is varied and reaches a majority of homes in the broad WWL broadcast range. Community service has become a hallmark of WWL broadcasting, as is evidenced by the fact that WWL has, within the last five years, received more national awards for programs and services than all other stations in New Orleans combined.

INCREASED DEMAND FOR EDUCATIONAL FACILITIES

In the past 10 years, Loyola's enrollment has increased more than 50 percent. In order to meet this increase, Loyola—like all other educational institutions—has substantially increased the size of its faculty, faculty salaries, and physical plant. Increased enrollment over the next five years is projected at nearly 20 percent. In the last five years, close to $14 million in capital improvements have been made. Indeed, within the last few months, Loyola dedicated a $6.7 million science complex in order to keep abreast of the widening vistas of science. With ever-increasing operating costs, the tuition fees continue to rise and the University is required to appropriate more scholarship aid to assist more deserving students. None of Loyola's past accomplishments or future goals could have been—or will be—possible without the direct financial assistance Loyola receives from WWL.

Loyola is a private university engaged in public service. University revenues are realized from tuition fees, alumni gifts, matching gifts of corporations, friends, and foundations, a small security endowment, and the revenues derived from the operation of its broadcasting facilities. Even with these sources of financial assistance, Loyola, like most private universities, must operate on a marginal budget. Our five-year projections indicate that without additional sources of revenue, the University will operate at a deficit for all five years. This deficit will be increased substantially without the anticipated revenue that would be derived from WWL.

While others may have expanded their unrelated businesses through the use of competitive practices gained as a result of tax exemption, WWL has always operated on a strictly competitive basis—on a par with other broadcast operations in its market. Its employees, both engineering and talent, belong to the same unions as the employees of other stations. Accordingly, the same union contracts are generally involved. While some business operations perhaps lend themselves more easily to utilizing a competitive edge, the broadcasting industry is strictly regulated by the Federal Communications Commission. New Orleans is a highly competitive local and national television market, with each of the network-affiliate stations and the independents competing for the same advertising dollars. Since television rates are primarily based on audience ratings compiled by the American Research Bureau and the A. C. Neilson Co., individual stations formulate rate cards to reflect audience flow during the broadcast day. WWL, with its CBS affiliation, maintains advertising rates comparable to the other stations in the area. For example, minute announcements during the 12 noon to 4:30 p.m. period for each of the stations are:

Station	*Cost per minute*
WDSU/TV	$120–$170
WWL/TV	110– 200
WVUE/TV	40– 65
WWOM/TV	15– 32

The advertising costs during the so-called prime time hours (7 to 10 p.m.) for each of the various stations are as follows:

Station	Cost per hour
WDSU/TV	$1,550
WWL/TV	1,550
WVUE/TV	1,100
WWOM/TV	300

HOW WWL EARNINGS ARE USED

Since WWL began commercial operations in 1929, Loyola's educational facilities have been the sole beneficiary of these earnings. For example, in the past five years, WWL has expended 82 percent of its earnings for the benefit of Loyola's educational facilities. Without this source of income, Loyola could neither afford to meet the ever increasing demand for higher education programs in the South nor continue to maintain our present level of competence in academic quality. Even with WWL, Loyola has and will continue to have difficulty competing with the public universities and colleges that receive State aid.

The Tax Reform Studies and Proposals of the United States Treasury Department, published on February 5, 1969, state that in 1965 the effective tax rate[1] was 29.6 percent for the lumber industry; 39.0 percent for the paper industry; and 44.4 percent for all manufacturing enterprises, except the petroleum and lumber industries. Another U.S. Treasury publication (Publication No. 159 (9-68)) entitled Preliminary Report, Statistics of Income—1966, Corporation Income Tax Returns, indicates that this effective tax rate for the various industries has not changed significantly. Moreover, this same publication indicates that all manufacturing companies distributed to stockholders approximately 46 percent of after-tax income (30 percent of pretax income), or, approximately 74 percent of taxable income was accounted for either in federal taxes or in distributions to shareholders. These figures show that, on the average, manufacturing corporations retained slightly more than 25 percent of pretax profits. This figure should be compared with the 18 percent retained by WWL. The Treasury Department does not break down radio and TV stations as a separate industry and, accordingly, no comparison on this particular industry can be made.

WAYS TO CURE ABUSES AND PERMIT CHURCH ACTIVITIES TO CONTINUE

Prior to the Revenue Act of 1950, religious, charitable and educational organizations were exempt from Federal income taxation. In the Revenue Act of 1950, Congress, concerned with certain business activities of exempt organizations, enacted the unrelated business income tax. In taking this step, Congress specifically exempted churches or a convention or association of churches. The primary basis for this exemption was the recognition of the vital role churches play in this nation and the feeling was that churches should continue to provide religious, charitable and educational services free from the burden of Federal income taxation. Earlier this year, the House of Representatives, concerned with what it considered to be abuses in the unrelated activities for certain organizations, including churches, chose to attack these abuses in two ways. The first was to enact certain provisions designed to halt the *Clay-Brown* type transactions. We agree that the *Clay-Brown* situations constituted a clear abuse; indeed, such transactions exploited the tax-exempt status conferred on non-profit organizations under existing law, and we applaud the House action in this regard. The second action taken by the House (Section 121 of H.R. 13270) was to extend the unrelated business income tax to certain tax-exempt organizations, including churches. Recognizing the economic hardship that such extension would cause, the House Bill provides churches with a six-year period within which to re-structure their activities. We believe that there is a middle ground available to Congress which will both curb the abuses to which the House Bill is aimed and, at the same time, retain the traditional tax-exempt status of churches.

The principal reasons advanced by the Treasury Department for extension of the unrelated business income tax to churches are that vis-a-vis their taxpaying competitors, churches (because of tax exemption) can "charge lower prices and . . . expand their business operations out of earnings undiminished by taxation."

[1] The effective tax rate is the actual tax, both domestic and foreign, as a percent of taxable income.

As evidenced by the advertising rates charged by WWL, it is apparent that WWL does not "charge lower prices" for its broadcasting services. WWL recognizes that tax exemption creates that potential advantage, but we can say unequivocally that WWL has not been guilty of any unfair competitive practices, and that we support all efforts to stop such activity. If, indeed, a church did use this potential advantage and did charge lower prices, it is difficult for us to understand how the imposition of the unrelated business income tax would materially change this situation. Rather, unfair competitive practives should be met head-on and not through the taxing statute.

The other reason advanced by the Treasury Department is that churches can expand their business operations out of earnings undiminished by taxation. The enactment of the *Clay-Brown* provisions will curb debt financed business expansions. Moreover, as the above figures indicate, WWL has expended *more, not less*, of its earnings than corporations in general. For the last five years, or any previous period selected, WWL has expended more than 80% (often more than 90%) of its earnings for the benefit of its religious and educational purposes. As a consequence, WWL has *less* funds available for expansion than do taxpaying corporations.

Loyola recognizes that the potential for unfair competition does exist if churches neither pay taxes nor expend their earnings for the benefit of the public. We support all efforts to establish equality of operation, and to secure this result we recommend, as an alternative to across the board extension of the unrelated business income tax to churches, that churches be *required* to expend a minimum of their earnings on an annual basis.

Loyola supports legislative efforts which would (i) remove all non-tax advantages enjoyed by churches in the conduct of unrelated activities, and (ii) require churches to expend at least 80% of the sum of (a) their unrelated business taxable income for the taxable year *and* (b) their gross revenues for the taxable year derived from any source (exclusive of gifts, grants, bequests, and extraordinary items) other than any unrelated trade or business income. It is Loyola's position that a church should be required to expend such amounts in the exercise or performance of its religious, charitable or educational purposes. We believe that this minimum expenditure approach combined with the inability to borrow imposed by the *Clay-Brown* provisions will remove any competitive edge which churches may enjoy, and, at the same time, permit churches to continue making positive contributions to the communities they serve—contributions which, in our view, are far more significant than the potential revenue impact of extending across the board the Section 511 tax to churches. Churches which do not expend at least 80% of their total revenues should be taxed as commercial entities on their unrelated trade or business income. We have attached a draft bill which embodies these proposals and would hope that the Committee will give it serious consideration.

If this approach is not deemed desirable by the Committee, we would hope that methods other than the provisions of the House bill which would eliminate abuses will be explored. Examples of these methods include:

(1) Churches could be allowed an unlimited deduction for earnings distributed to or permanently set aside for the benefit of certain qualified operations or organizations such as schools, hospitals, and charities which derive their support from the general public.

The benefit of this approach is that the church would be required annually to distribute or permanently set aside a porion of its earnings or pay income taxes on its failure to do so. This approach would also prevent churches which conduct business activities from expanding such businesses through retained earnings undiminished by income taxes.

(2) A phase-in period of 10 years could be provided. Churches which have relied on prior Congressional action for nearly 50 years should not now be prejudiced by the far reaching changes contained in the House Bill. Many churches, including Loyola, have expanded their church facilities by incurring substantial long term indebtedness which in major part is financed by revenues from their unrelated activities. In the event that it is deemed necessary to extend the unrelated business income tax to these activties, we hope that Congress would allow churches with existing business activities a 10 year—10% per year—phase-in period following the effective date of this provision in the House Bill. Such a phase-in would provide churches with existing business activities a reasonable time within which to retire shorter term obligations and make adequate provisions for previously incurred long term indebtedness secured in part by the expected revenues from their business activities.

SUMMARY

In summary, Loyola believes strongly that churches have an obligation to the community they serve, as well as to the nation, to benefit the general public. While the primary obligation runs from the church to its members, its obligation to serve the community extends to the public. Among the ways the public benefits from church activities are the operation of schools, hospitals, day-care centers, etc. To continue such activities, large amounts of money are necessary. Because of its deep commitment to higher education and its need to secure funds to operate a university, Loyola operates WWL. As was noted above, Loyola's entry into the broadcasting field was not inspired by economics, but rather, as an educational tool to serve the New Orleans area. As New Orleans grew, so did Loyola and WWL; and, while not originally conceived as a revenue producer, WWL—there is little doubt on this point—has in large measure made possible Loyola's recent expansion of its university facilities, through the funds which it provides. Moreover, Loyola's ability to expand and improve its existing educational facilities is heavily dependent on the revenue produced by WWL.

In recognition of the obligation which churches owe to the communities they serve, we have suggested two alternatives to outright extension of the unrelated business income tax to churches. Loyola supports legislative efforts which would (i) remove all non-tax advantages enjoyed by churches in the conduct of unrelated business, and (ii) require churches to expend on an annual basis a minimum amount of both unrelated business income and other gross revenue for the benefit of educational facilities, religious and other charitable purposes for which they were formed. We believe that such an approach would remove any competitive edge which churches may enjoy and, at the same time, make a positive contribution to the local communities they serve. In our view, such a contribution is far more significant than the potential revenue impact of extending the Section 511 tax across the board to churches. Churches which do not meet this minimum expenditure requirement should be taxed on their commercial activities.

Loyola and all its representatives stand ready to assist the Committee in attempts to reach a satisfactory conclusion in this area. We feel that the minimum expenditure requirement discussed above is equitable under the circumstances and should be adopted.

[Attachment]

A BILL To amend H.R. 13270 to provide that after 1975 a church shall be subject to the unrelated business income tax unless it expends or distributes currently more than 80 percent of its unrelated business income

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That, effective with respect to taxable years beginning after December 31, 1975, Section 121 of H.R. 13270 (relating to the imposition of tax on unrelated business income of charitable, etc., organizations) is amended by inserting after subsection (b) the following new subsection:

"(c) SPECIAL RULE FOR CHURCHES WHICH EXPEND INCOME CURRENTLY FOR QUALIFIED PURPOSES.—

"(1) GENERAL RULE.—The tax imposed by subsection (a)(1)(A) shall not apply to a church or to a convention or association of churches if, during the taxable year and the succeeding one-year period, its qualified expenditures exceed 80 per cent of the sum of (A) its unrelated business taxable income for the taxable, and (B) its gross revenues for the taxable year derived from any source (exclusive of gifts, grants, bequests and extraordinary items), other than any unrelated trade or business regularly carried on by it.

"(2) QUALIFIED EXPENDITURES.—For purposes of paragraph (1)—

"(A) The qualified expenditures of a church, a convention or association of churches are (i) amounts expended by it in the exercise or performance of its religious, charitable, or educational purposes, and (ii) amounts distributed by it to qualified organizations.

"(B) Any qualified expenditure during a taxable year may, at the election of the organization, be taken into account for the taxable year or for any preceding taxable year which ended not more than one year before the date of the expenditure.

"(3) QUALIFIED ORGANIZATION.—For purposes of clause (ii) of paragraph (2)(A), an organization is a qualified organization if it is—

"(A) an educational organization which normally maintains a regular faculty and curriculum and normally has a regularly enrolled body of pupils or students in attendance at the place where its educational activities are regularly carried on; or

"(B) an organization which normally receives a substantial part of its support (exclusive of income received in the exercise or performance by such organization or its charitable, educational or other purpose or function constituting the basis for its exemption under section 501(a) from the United States or any State or political subdivision thereof or from direct or indirect contributions from the general public."

Senator ANDERSON. Mr. McKenna? Will you announce who your associates are?

STATEMENT OF ROBERT E. McKENNA, PRESIDENT, CHILTON CO., CHAIRMAN, WASHINGTON LEGAL COMMITTEE OF THE AMERICAN BUSINESS PRESS; ACCOMPANIED BY PAUL CONRAD, GENERAL COUNSEL, NATIONAL NEWSPAPER ASSOCIATION; AND ROBERT SALTZSTEIN, GENERAL COUNSEL, AMERICAN BUSINESS PRESS

Mr. McKENNA. Yes, I will.

Mr. SALTZSTEIN. Mr. Chairman, before we proceed we have a statement that will take about 15 minutes to read. We think we can develop our case better if we read it. If the Chair prefers we can go over this summary of principal points.

Senator ANDERSON. Go ahead.

Mr. McKENNA. Mr. Chairman and members of the committee, my name is Robert McKenna, I am president of Chilton Co. in Philadelphia and chairman of the Washington Legal Committee of the American Business Press, which numbers among its membership over 400 specialized business publications published coast to coast.

On my right is Mr. Paul Conrad, general counsel of the National Newspaper Association which includes in its membership 7,000 newspapers in all 50 States. Known from 1885 until 1966 as the National Editorial Association, the organization is generally thought of as representing the Nation's community press, although some of the Nation's largest metropolitan daily newspapers are members also.

On my left is Robert Saltzstein, Wyatt & Saltzstein, general counsel of the American Business Press, and Mr. Resh from Mr. Saltzstein's office.

I am authorized to say that Fairchild Publications, New York; C. V. Mosby Medical Publications, St. Louis; Holiday magazine, New York; the Atlantic, Boston; Investment Dealers Digest, New York; Safety Journal, Anderson, S.C.; Second Class Mail Publications, an association of publications mailed at second class rates including such publications as Public Utilities Fortnightly, and Yachting, and Associated Construction Publications, published in 14 different States, have associated themselves with the testimony of the National Newspaper Association and the American Business Press in order to conserve the time of this committee. They all support the principles we are privileged to put before you today.

The National Newspaper Association, the American Business Press and the other associations and publications I have just mentioned, have consolidated their testimony because they see eye to eye on the

principle that advertising is a business, that profits earned on advertising should not take the place of professional society or trade association dues or membership charges, and that where advertising makes a profit, it should pay an income tax on that profit.

The Ways and Means Committee, by including section 278(d) beginning at line 22 on page 93 of the bill before you and headed "advertising, etc. activities" legislatively supported the loophole-closing IRS had achieved when the service issued its regulation applying the unrelated-business tax to advertising profits of tax-exempt publications. It is our hope that this committee will make certain that section 278(c) is administered so as to prevent tax avoidance through the use of accounting devices which could dissipate possibly $25 million in tax collections.

In July 1967, before issuing its regulation and after much public discussion about its intention to do so, IRS held an extensive hearing at which it heard those who oppose the tax, and those who favor the tax. On February 24 and 25 of this year, the Ways and Means Committee included advertising profits of tax-exempt organizations as part of its tax reform hearings.

At the IRS hearing and at the Ways and Means Committee hearings, the following arguments were made against the tax:

1. IRS had no authority to issue the regulation and this constituted "administrative regulation" and "usurpation of the powers of Congress."

2. The profits earned on advertising in tax-exempt publications are devoted to good works, so they should be untaxed, even though the same advertisement which runs in a tax-exempt publication may also run in a tax-paying publication.

3. Since the editorial portion of an association publication is for the appropriate purpose of communicating with members, advertising cannot be separated out for tax purposes even though the exempt communication function is exploited by the running of advertising.

4. Advertising is somehow related to a tax-exempt purpose.

Prior to issuance of the regulation, all of these arguments had been repeatedly made for several years at tax symposiums and in tax literature, but none of these hypotheses or written comments took into account the very critical statement appearing in both the House and Senate committee reports at the time the unrelated business tax was passed in 1950.

That statement follows:

> The problem at which the tax on unrelated business income is directed is primarily that of unfair competition.

After hearing all these arguments, IRS went ahead and issued its regulation. Then the opponents of the regulation, again led by the American Medical Association, the U.S. Chamber of Commerce, the American Society of Association Executives, the Society of National Association Publications, the American Chemical Society—and based on a statement filed in the House committee report by the National Geographic Society as well—appeared or filed statements before the Ways and Means Committee and, in general, repeated the same arguments they had made to IRS, and before that to the Treasury, to slow down issuance of the regulation.

Once again, the argument was made that IRS did not have the authority to issue the regulation.

To the statement that IRS had no authority to issue the regulation, the taxpaying press illustrated both before the IRS hearing and the ways and means hearing that IRS did have such authority.

There is ample evidence in the legislative history of 1950 when the unrelated business tax was passed, that IRS was granted discretion to apply the tax to situations which would come up in the future. For example, in the 1950 hearings, Chairman Knutson read a list of business activities carried on by tax-exempt organizations, and publishing is mentioned five times.

Moreover, in the floor debate in the House, Congressman Lynch was asked where the tax would apply and where it would not, and he replied:

> It is not possible to define in the bill exactly every case that is going to be covered. We have drawn it so that there is a certain amount of discretion for the determination of questions of fact as to whether or not a certain matter comes within the purview of the bill.

Thus, in applying the tax, IRS was properly exercising the discretion Congress had delegated to it.

Page 1179, in volume 3 of the House Ways and Means Committee hearings this year, contains a brief setting forth the legislative history behind the unrelated business tax.

The arguments in support of the IRS regulation and its codification in the bill before you, are that when an advertisement appears in two publications, one of which pays a tax and the other does not, this is unfair competition.

Secondly, unless this loophole remains plugged, some 700 trade associations and professional societies will continue to take a tax-free handout from the Government, which is preoisely what tax-exempt profits really are. A little later Mr. Conrad will show you some examples of this in the newspaper field.

I would like to show an illustration which was presented earlier to the IRS hearing. Mr. Resh and his assistant will take care of that. This was also presented to the Ways and Means Committee.

In this display are all the identical advertisements which appeared in Chemical and Engineering News, published by the American Chemical Society during the first 6 months of 1967, and the same advertisements which appeared in Chemical Week, published by taxpaying McGraw-Hill during the same time. The situation is no different today. Why should one pay a tax and the other be tax free?

Now the reason why an advertisement appears in the tax-exempt chemical publication is to sell chemicals, which certainly is not a tax-exempt purpose. If the profit earned on that advertisement is tax exempt, then the profits of the taxpaying publisher should be tax exempt and taxpaying publishers, of course, do not ask for tax exemption.

Here is a copy of Hardware Retailer, published by the National Retail Hardware Association, and here is a copy of Hardware Age, published by my company, Chilton. No one needs a crying towel for the Hardware Association which has agreed to pay a tax on its profits, and the last thing they need is a tax sanctuary, but it is not hard to imagine

that if this committee does not back up IRS and the House codification, the hardware dealers aren't going to pay a tax either.

The National Geographic Society competes directly with Holiday Magazine, the Atlantic Monthly, and others. Here are some advertisements run recently by the National Geographic in Advertising Age for the purpose of selling advertising to advertisers.

Note the headlines on these advertisements:

> The Bridge to 6,000,000 high income households.
> National Geographic—the Bridge to 6,360,000 upscaled households.

"Upscaled" is a Madison Avenue term.

Why should the National Geographic be tax exempt when from a publishing standpoint it operates in exactly the same manner as Holiday, except that the 6,360,000 recipients who read the National Geographic are called "members" rather than "subscribers."

The taxpaying publishers for whom we speak share what we believe to be the viewpoint of the taxpaying public in general. We don't object to paying taxes as long as everybody pays theirs, and this is equally true in the publishing business.

The American Medical Association is also a large publishing house. In 1967, it had a gross income from all sources of $31,677,215 against expenses of $28,346,984. Of that, $31,677,215 gross income, 42.8 percent was from advertising whereas dues represented only 36.5 percent. The AMA also received in 1967 $1,538,139 for use of its mailing lists for other medical publications and for direct mail advertising to doctors. The following table, taken from figures published in the AMA News, show growth and net worth of the AMA as follows: 1965, $14,307, 334; 1966, $15,681,397; 1967, $19,011,610. And I understand it was over $20 million in 1968.

When the general counsel of the AMA appeared in February 1969, before the Ways and Means Committee, Congressman Burke asked the following question:

> Have you a financial statement ready to present to this Committee containing the operating expenses, the revenues, and how any excess revenues over operating expenses are expended?

To which Mr. Hirsh replied:

> No, I do not have any financial statements with me, Congressman. They are in the process of preparation. These regulations have made it necessary for the American Medical Association to review and revise its entire accounting procedures and this is now being done.

Mr. Hirsh also testified:

> Present indications are that after paying all of the costs of publication—editorial cost, paper cost, overhead, et cetera—that the profit, or so-called profit, if any, will be nominal. I do not have these figures now because they are in the process of being determined by our accountants. I will be glad to furnish them to the committee when they are available if the committee so desires.

The record then includes a letter dated April 15, 1969, from Dr. E. B. Howard, executive vice president of the AMA, which includes the following pertinent paragraph:

> With respect to a request for a financial statement indicating revenues from, and operating expenses of, the Association's publications and the use of any excess over operating expenses, we sincerely regret that this information is not available. As Mr. Hirsch indicated, the promulgation by the Internal Revenue Service of the expanded unrelated business tax regulations has required the

Association to completely review and revise its accounting procedures. This was and is being done. However, the problems of this revision are so complex that the Association has requested a 60-day extension for filing its return for 1968.

If, because of accounting revisions, nominal or no tax results for the AMA, this would be very much in line with a statement submitted at the IRS hearing in July 1967, by the attorney for the U.S. Chamber of Commerce.

Page 59 of that statement contains the following comment:

Normally, in the case of a proposed new tax measure, the effect of the tax on the revenues would be another important consideration. But even the proponents of the advertising tax concede that gross advertising receipts of all tax-exempt publications are only some $100,000,000 annually. It is probable that at least 50 percent of this would be offset by deductions under any realistic and fair tax statute. Thus, net receipts probably would be less than $25,000,000, a nominal figure in terms of overall revenues. As tax-exempt organizations stepped up their expenditures to improve their publications to make them more competitive, and realigned their publishing activities, perhaps by judicious combination of profitable and unprofitable activities in taxable subsidiary corporations, tax revenues might well dwindle to the vanishing point.

For the U.S. Chamber of Commerce to take this position is, to us, incredible. The business press and the newspapers of this country are no less advocates of free enterprise than the chamber. When the unrelated business tax was passed in 1950, the leading advocate in support of the tax was the chamber.

Its witness then told the Senate Finance Committee:

It is our policy that we are opposed to Government favoritism in any form, and we urge that no enterprise be favored over any other, and that each enterprise, whether it is cooperative, individual, or corporation, should stand on its own feet, with protection from unfair competition, and free from either tax exemption or other public subsidy.

The CHAIRMAN (presiding). We have a rule here that we don't want witnesses to read their statements. We want them just to summarize them and we will print the entire statement for you.

It is difficult for us because, as you know, Mr. McKenna, we have had requests from more than 700 witnesses who want to be heard, and you have got a pretty good attendance to hear your presentation today and we will certainly consider your problem but we do have to ask you to be brief and to summarize. We ask all witnesses.

Mr. McKENNA. We will finish, Mr. Chairman, this way, and I would like you to know that personally I am not an attorney.

The CHAIRMAN. Yes, sir.

Mr. McKENNA. But I am surrounded by them.

The CHAIRMAN. I am sure you are well advised, I have no doubt about that. Maybe you have too much advice.

Mr. McKENNA. I think I have covered enough that it would be of interest to the committee, I hope, and I would like to turn it over to Mr. Conrad.

Senator BENNETT. Are we going to have 10 minutes from each of these four witnesses. It is 10 minutes after 11 and we have 16 witnesses. We have been here an hour and a half and 13 yet to testify and I respectfully suggest that when the bell rings the witness is required to stop within 10 minutes.

The CHAIRMAN. I am afraid we will have to do that.

Mr. McKENNA. As long as you don't shoot us, Senator, it is OK.

The CHAIRMAN. I am afraid we will have to do that and after awhile

we will have to even start trying to gag Senators on the questions we ask to try to limit ourselves in order that this hearing can come to an end because we can't pass this bill if we can't finish the hearing.

Mr. SALTZSTEIN. We agree, Senator. No problem.

The CHAIRMAN. Senator Anderson, would you care to ask any questions of the witness?

Senator ANDERSON. How much money would you estimate the Government would lose in taxes from tax exempt organizations if we allowed them to escape tax on income derived from advertising in their publications?

Mr. SALTZSTEIN. A statement submitted for the U.S. Chamber of Commerce at the IRS hearing in July 1967, used the approximate figuse of $25,000,000, but said these tax revenues could dwindle to the vanishing point by the "judicious combination of profitable and unprofitable activities * * *." The full quotation, appearing on page 59 of U.S. Chamber statement follows:

"Uormally, in the case of a proposed new tax measure, the effect of the tax on the revenues would be another important consideration. But even the proponents of the advertising tax concede that gross advertising receipts of all tax exempt publications are only some $100,000,000 annually. It is probable that at least 50% of this would be offset by deductions under any realistic and fair tax statute. Thus, net receipts probably would be less than $25,000,000, a nominal figure in terms of overall revenues. As tax-exempt organizations stepped up their expenditures to improve their publications to make them more competitive, and realigned their publishing activities, perhaps by the judicious combination of profitable and unprofitable activities in taxable subsidiary corporations, tax revenues might well dwindle to the vanishing point."

Senator ANDERSON. Let's use the American Medical Association as an example. Approximately how many members do they have?

Mr. SALTZSTEIN. It is our understanding that the American Medical Association has in excess of 200,000 members.

Senator ANDERSON. What is the amount of their individual dues each year?

Mr. SALTZSTEIN. $70, per year per doctor.

Senator ANDERSON. 200,000 members of $70 per year would bring in $14 million a year. If they increased their dues only $5 per member that would raise an additional $1 a year, is that not right?

Mr. SALTZSTEIN. Yes. And if they raise their dues even $10 to $80 per annum, they would yield an additional $2,000,000.

In 1967 the AMA advertising sales exceeded its dues collections. They sold $13,565,106 of advertising, and had dues income of $11,547,120; so advertising exceeded dues about $2,000,000, or $10 more dues per doctor.

Senator ANDERSON. And after examining charges under medicare and medicaid, they could easily afford to pay that amount?

Mr. SALTZSTEIN. There does not seem to be any question about that.

Senator ANDERSON. What would happen if organizations that publish two magazines could average the two together and pay tax only on profits from the two together?

Mr. SALTZSTEIN. If one magazine makes a profit, and the other established a loss in excess of the profit the first magazine made, there would

be no tax to pay. If this kind of consolidation is permitted, it is probable that little or no tax will be collected.

A tax-exempt organization is very different from a tax paying organization. A tax paying organization will necessarily fold a losing publication.

A tax exempt organization can use profits from a money making publication to carry on losing publications, which would really be paid for by dues, into perpetuity. If this happens, the unrelated business tax will be meaningless; because tax exempt organizations will use accounting procedures which will, as the U.S. Chamber of Commerce statement says, "cause the tax to dwindle to the vanishing point."

Senator ANDERSON. I notice on page 50 of the House report, in the fourth paragraph, that this consolidation might be possible. Do you have information as to how that has been abused by "tricky" bookkeeping?

Mr. SALTZSTEIN. We understand that the American Medical Association has been circulating an amendment to the House provision, the amendment stating as follows:

> "Provided, that the activities carried on by an organization in the sale of publications, and advertising in any of such publications may, at its option, be treated as a single unrelated trade or business.

The import of that language is that the American Medical Association would be able to put all of its publications together, or all of its advertising together, to include for tax purposes what it wished to include, or exclude what it wished to exclude, and it could work out accounting procedures which would provide no tax, simply because tax exempt organizations are just not the same thing as tax paying organizations, which could not remain in business if they did not produce profits on which they pay taxes over the years.

We know of one example of an organization which previously reported a profit for its magazine, but the following year consolidated two or more publications and showed a loss for both years by this kind of combining.

The CHAIRMAN. I have no questions.

Senator ANDERSON. I wanted to have your testimony in because the National Geographic Magazine is involved—I am on the Board of Regents of the Smithsonian Institution so this is very important testimony to me.

Senator BENNETT. I just have one question. This is an interesting display on the floor. Is it your argument that if there were no National Geographic that there would be two advertisements, one of which would be in Holiday and one of which would be in another magazine. In other words, is the National Geographic actually in competition with Holiday? Has it reduced Holiday's income?

Mr. MCKENNA. I can't be too specific. I don't know the accounting of Holiday but I would say off the top of my head that it is certainly competitive.

Senator, when a company allocates money to, for advertising for a product, service, whatever it may be, equipment, they intend to spend so much money and they will use certain selected media. Within an area they will spend, let us say, a hundred thousand dollars. Now, it is a fight between the taxpaying publication and the nontaxpaying

publication to go out and fight for those dollars. Whoever has the best story and can fight well enough wins it.

On this display——

Senator BENNETT. Then it is your position that if there were no National Geographic advertising that same amount of money would be appropriated by the same company and it would be spent in other publications?

Mr. McKENNA. Correct.

Senator BENNETT. Therefore, why don't we just tell the National Geographic it can't advertise and it can't sell advertising under any circumstances and still be a tax-exempt organization.

Mr. SALTZSTEIN. Senator, we say it can carry the advertising. It just ought to pay a tax if it makes a profit on it.

Senator BENNETT. Is it your position, the same position that was taken by Mr. Caplin, that National Geographic should not be allowed to offset its losses against its income, but that every source of income should be treated separately and if they had income from advertising they should pay full tax on that income?

Mr. CONRAD. Yes, Senator, I think it is important to maintain this distinction between publishing publications and actually selling advertising, which is the unrelated business, and further, it is very important to maintain the distinction between a taxpaying organization which, of course, has to show a profit on whatever they produce, and a nonprofit tax-exempt organization, which is in the business of making "losses" as far as that is concerned. That is the whole idea of the organization, that it will collect dues and then expend that money for the purposes of the organization. Therefore, it is just loaded with "losses" and if you allow the organization then to mix its profits out of the unrelated business of selling advertising, against those losses of which it is so well supplied there will never be any tax.

Senator BENNETT. No further questions, Mr. Chairman.

Senator CURTIS. Mr. Chairman, Mr. McKenna, does your firm publish more than one magazine?

Mr. McKENNA. 23.

Senator CURTIS. 23.

Mr. McKENNA. Yes, sir.

Senator CURTIS. Are they 23 different corporations?

Mr. McKENNA. No, it is one company.

Senator CURTIS. One company?

Mr. McKENNA. Yes.

Senator CURTIS. Do they file consolidated, a tax return for the whole business?

Mr. McKENNA. That is right.

Senator CURTIS. So if one particular publication has a loss that loss is offset against one of the other publications or against the total?

Mr. McKENNA. Well, if you don't mind, I would have to qualify that. That is true, but it is also true if we went too many years like that, like a couple of years, we would say we fold a magazine or we would try to sell it to some unsuspecting person. [Laughter.]

Senator CURTIS. You might try the AMA. [Laughter.]

Mr. McKENNA. They can afford it.

Senator CURTIS. Do you recommend the same rule for nonprofit organizations as applied to your own publishing company, to-wit, that

all your publications, I didn't say all your activities, but all your publications, be combined in one tax return to show that you are operating at a profit or at a loss?

Mr. McKENNA. I have to answer no, Senator, because in one area, in the association activity, there is a membership thing which in our case we call a subscription, and on that subscription we would pay a tax. In their case they would obviously not pay a tax. So I would have to separate that.

In other words, we wouldn't have that kind of a subsidy to go along and support what we are trying to do in making a profit with publications.

Senator, I should have answered that we have 22 publications, not 23. I forgot that just last month we folded Butane-Propane News, which could not successfully compete with L-P Gas Times, published by the National L-P Gas Association. And that really answers your question. We pay taxes to begin with and have to show a profit, so we can't carry on losers. An association does not pay taxes to begin with, and shouldn't be allowed to use the taxes it would pay on the advertising profits of one journal to finance another journal instead of paying taxes on the first one. If the unrelated business tax is administered that way, a tax exempt organization could go on so using taxes forever. A taxpayer could not and would not.

Senator CURTIS. Then you do suggest a separate rule for a tax-exempt organization than you have for yourself?

Mr. SALTZSTEIN. Senator, tax-exempt organizations and taxpaying organizations are two different things.

Senator CURTIS. I know there has been a lot of loose talk around here. They would be paying dues if they didn't have any publications.

Mr. McKENNA. Right.

Senator CURTIS. It takes dues to run an organization, to send out notices, to hold meetings, to get speakers, to hold panels, and just to glibly say that dues are a subsidy to publications without any audits——

Mr. SALTZSTEIN. Senator, we don't say that, sir.

Senator CURTIS. I understood Mr. McKenna to say that.

Mr. SALTZSTEIN. People belong to an organization and receive certain membership services and for that they pay the dues.

Senator CURTIS. That was referred to by Mr. McKenna as a subsidy to advertising.

Mr. SALTZSTEIN. What he meant was that if the dues are kept low, if advertising profits are used to keep them low, there can be members of organizations who if the dues were higher perhaps wouldn't belong, and wouldn't think it had a great value; maybe they would, we don't know. The dues are deducted in the first place and advertising shouldn't pay for services to members, dues should.

Senator CURTIS. Yes. I don't want to prolong it, but I think the tax equality has got two sides to it. This has to be equal both ways, and a private publisher can combine his accounts for 23 publications in one tax return, and I don't know how we can deny that to another taxpayer.

Mr. SALTZSTEIN. Well, if the Chilton Co. didn't pay a tax it wouldn't be in business. It couldn't consistently do that. The difference between a tax-exempt organization and a taxpaying organization is so great, that if this were permitted in the case of a tax-exempt organization

there would be no tax collected, and the organization would go on without any difficulty, whereas the taxpaying organization would have to stop business ultimately. That would be the ultimate end of it. It goes to the nature of the two, sir.

Senator CURTIS. The differences do not end there, and I don't want to prolong this, a concern established for profit is owned by someone. They can sell it. It is hoped that they draw some dividends from it. Nobody could sell a professional association. They don't draw any dividends from it. There are just a lot of differences.

I won't take the committee's time any further. But I believe that the tax-exempt organization should be allowed to put their unrelated income all together. I think we start a very bad policy if we start saying to taxpayers, and they become taxpayers as soon as we tax them, if we start saying to taxpayers, "We are going to tax you on every activity on the profits you make regardless of what you may have lost in some other areas." We will get into a lot of trouble as a committee recommending taxes to Congress. That is all, Mr. Chairman.

Mr. CONRAD. Senator, the tax-exempt organization becomes a taxpayer only to the extent that it engages in an unrelated business. Therefore it is our position that its unrelated business should be kept wholly distinct from its other activities. And since advertising is the unrelated business—not the issuance of publications—we believe the sales of advertising in each separate publication should be treated apart from the expenses of publications not intended to make profits from advertising sales.

Senator MILLER. Mr. McKenna, would you draw a line between the kind of advertising that is run in professional publications? For example, suppose in the American Bar Association Journal there is an advertisement by West Publishing Co. for law books, which are intimately tied in with the profession. That could be one thing. Then on the next page suppose there is an advertisement for some kind of resort and combination air fare deal which would compete with Holiday Magazine. Wouldn't it be feasible to draw a line between types of advertising that are unrelated to the profession?

Mr. MCKENNA. I think, Senator, it would be a little difficult to do it. For example, in the area of the law books, in the law publication, possibly those law books could be sold through, to name a name, Business Week, not as, logically the audience wouldn't be that vertical but it would hit some lawyers who possibly would be interested in buying that.

I think it would be difficult, personally, I think it would be difficult to draw a line on the type of advertising.

Senator MILLER. Well, I could see where it might be difficult but that doesn't mean we shouldn't draw a line for the sake of equity and for the sake of a profession. I can certainly see a big difference between the American Bar Association Journal running advertisements relating to the law book publications and running a lot of advertising relating with holiday trips and things of that nature. Where it is related to the profession in some respects you could argue that it is related to the activity of the association. It is to the interest of the members to see certain professional advertising for their own professional uses as distinguished from something relating to vacations and things of that nature.

Mr. SALTZSTEIN. Senator, I think our point is that advertising itself is not related activity to any purpose of tax exemption, and if we take——

Senator MILLER. You say that is your position.

Mr. SALTZSTEIN. Our position is that advertising itself is not related. Now if, carrying it to its logical conclusion, if the advertising in the American Bar Association Journal, which you and I read, is essential, then it ought not to be paid for. Why doesn't the bar association donate that space?

Senator MILLER. Well, I must say that I think you have had a lot of points in your presentation but I can see a difference in the types of advertising I describe.

Mr. SALTZSTEIN. I would like to talk to you about it if I may Senator.

Senator MILLER. Thank you, Mr. Chairman.

The CHAIRMAN (presiding). Senator Jordan.

Senator JORDAN. No questions.

Senator FANNIN. No questions.

(The statements of the American Business Press and the National Newspaper Association follow:)

STATEMENT OF ROBERT E. MCKENNA, PRESIDENT, CHILTON CO., PHILADELPHIA, PA., ON BEHALF OF THE AMERICAN BUSINESS PRESS

Mr. Chairman and members of the committee, My name is Robert E. McKenna. I am President of the Chilton Company in Philadelphia and Chairman of the Washington Legal Committee of the American Business Press, which numbers among its membership over 400 specialized business publications published coast to coast.

On my right is Mr. Paul Conrad, General Counsel of the National Newspaper Association which includes in its membership 7,000 newspapers in all 50 states. Known from 1885 until 1966 as the National Editorial Association, the organization is generally thought of as representing the nation's community press, although some of the nation's largest metropolitan daily newspapers are members also.

On my left is Robert Saltzstein, Wyatt and Saltzstein, General Counsel of the American Business Press.

I am authorized to say that Fairchild Publications, New York; C. V. Mosby Medical Publications, St. Louis; Holiday Magazine, New York; the Atlantic, Boston; Investment Dealers Digest, New York; Safety Journal, Anderson, S.C., Second Class Mail Publications, an association of publications mailed at second class rates including such publications as Public Utilities Fortnightly, and Yachting, and Associated Construction Publications, published in 14 different states, have associated themselves with the testimony of the National Newspaper Association and the American Business Press in order to conserve the time of this Committee. They all support the principles we are privileged to put before you today.

The National Newspaper Association, the American Business Press and the other associations and publications I have just mentioned, have consolidated their testimony because they see eye to eye on the principle that advertising is a business, that profits earned on advertising should not take the place of professional society or trade association dues or membership charges, and that where advertising makes a profit, it should pay an income tax on that profit.

The Ways and Means Committee, by including Section 278(c) beginning at line 22 on page 93 of the bill before you and headed "advertising, etc., activities" legislatively supported the loophole closing IRS had achieved when the service issues its regulation applying the unrelated business tax to advertising profits of tax exempt publications. It is our hope that this Committee will make certain that Section 278(c) is administered so as to prevent tax avoidance through the use of accounting devices which could dissipate possibly $25,000,000 in tax collections.

In July, 1967, before issuing its regulation and after much public discussion about its intention to do so, IRS held an extensive hearing at which it heard

those who oppose the tax, and those who favor the tax. On February 24 and 25 of this year, the Ways and Means Committee included advertising profits of tax-exempt organizations as part of its tax reform hearings.

At the IRS hearing and at the Ways and Means Committee hearings, the following arguments were made against the tax:

(1) IRS had no authority to issue the regulation and this constituted "administrative regulation" and "usurpation of the powers of Congress".

(2) The profits earned on advertising in tax exempt publications are devoted to good works, so they should be untaxed, even though the same advertisement which runs in a tax exempt publication may also run in a tax paying publication.

(3) Since the editorial portion of an association publication is for the appropriate purpose of communicating with members, advertising cannot be separated out for tax purposes even though the exempt communication function is exploited by the running of advertising.

(4) Advertising is somehow related to a tax exempt purpose.

Prior to issuance of the regulation, all of these arguments had been repeatedly made for several years at tax symposiums and in tax literature, but none of these hypotheses or written comments took into account the very critical statement appearing in both the House and Senate Committee reports at the time the unrelated business tax was passed in 1950. That statement follows:

> "The problem at which the tax on unrelated business income is directed is primarily that of unfair competition."

After hearing all these arguments, IRS went ahead and issued its regulation. Then the opponents of the regulation, again lead by the American Medical Association, the United States Chamber of Commerce, the American Society of Association Executives, the Society of National Association Publications, the American Chemical Society (and based on a statement filed in the House Committee report by the National Geographic Society as well) or appeared or filed statements before the Ways and Means Committee and, in general, repeated the same arguments they had made to IRS, and before that to the Treasury, to slow down issuance of the regulation. Once again the argument was made that IRS did not have the authority to issue the regulation.

To the statement that IRS had no authority to issue the regulation, the tax paying press illustrated both before the IRS hearing and the Ways and Means hearing that IRS *did* have such authority. There is ample evidence in the legislative history of 1950 when the Unrelated Business Tax was passed, that IRS was granted *discretion* to apply the tax to situations which would come up in the future. For example, in the 1950 hearings, Chairman Knutson read a list of business activities carried on by tax exempt organizations, and *publishing is mentioned five times.* Moreover, in the floor debate in the House, Congressman Lynch was asked where the tax would apply and where it would not, and he replied:

"It is not possible to define in the bill exactly every case that is going to be covered. We have drawn it so that there is a certain amount of discretion of the determination of questions of fact as to whether or not a certain matter comes within the purview of the bill."

Thus, in applying the tax, IRS was properly exercising the discretion Congress had delegated to it.

Page 1179, in Volume 3 of the House Ways and Means Committee hearings this year, contains a brief prepared by Wyatt and Saltzstein setting forth the legislative history behind the unrelated business tax.

The arguments in support of the IRS regulation and its codification in the bill before you, are that when an advertisement appears in two publications, one of which pays a tax and the other does not, this is unfair competition. Secondly, unless this loophole remains plugged, some 700 trade associations and professional societies will continue to take a tax-free handout from the government, which is precisely what tax exempt profits really are. A little later Mr. Conrad will show you some examples of this in the newspaper field.

I would like to show an illustration which was presented earlier to the IRS hearing and also to the Ways and Means Committee. In this display are all the identical advertisements which appeared in Chemical and Engineering News, published by the American Chemical Society during the first six months of 1967, and the same advertisements which appeared in Chemical Week, published by taxpaying McGraw-Hill during the same time. The situation is no different today.

Now the reason why an advertisement appears in the tax exempt chemical publication is to sell chemicals, which certainly is not a tax exempt purpose. If the profit earned on that advertisement is tax exempt, then the profits of the

[illegible]

tax paying publisher should be tax exempt and tax paying publishers, of course, do not ask for tax exemption.

Here is a copy of Hardware Retailer, published by the National Retail Hardware Association, and here is a copy of Hardware Age, published by my company, Chilton. No one needs a crying towel for the Hardware Association which has agreed to pay a tax on its profits, and the last thing they need is a tax sanctuary, but it is not hard to imagine that if this Committee does not back up IRS and the House codification, the hardware dealers aren't going to pay a tax either.

The National Geographic Society competes directly with Holiday Magazine, the Atlantic Monthly, and others. Here are some advertisements run recently by the National Geographic in Advertising Age for the purpose of selling advertising to advertisers. Note the headlines on these advertisements:

"The Bridge to 6,000,000 high income households."

"National Geographic—the Bridge to 6,360,000 upscaled households."

Why should the National Geographic be tax exempt when from a publishing standpoint it operates in exactly the same manner as Holiday, except that the 6,360,000 recipients who read the National Geographic are called "members" rather than "subscribers".

The tax paying publishers for whom we speak share what we believe to be the viewpoint of the taxpaying public in general. We don't object to paying taxes as long as everybody pays theirs, and this is equally true in the publishing business.

The American Medical Association is also a large publishing house. In 1967, it had a gross income from all sources of $31,677,215 against expenses of $28,346,984. Of that $31,677,215 gross income, 42.8% was from advertising whereas dues represented only 36.5%. The AMA also received in 1967 $1,538,139 for use of its mailing lists for other medical publications and for direct mail advertising to doctors. The following table, taken from figures published in the AMA News, show growth and net worth of thet AMA as follows:

1965	$14,307,334
1966	15,681,397
1967	19,011,610

When the General Counsel of the AMA appeared before the Ways and Means Committee, Congressman Burke asked the following question:

"Have you a financial statement ready to present to this Committee containing the operating expenses, the revenues, and how any excess revenues over operating expenses are expended?"

To which Mr. Hirsh replied:

"No, I do not have any financial statements with me, Congressman. They are in the process of preparation. *These regulations have made it necessary for the American Medical Association to review and revise its entire accounting procedures* and this is now being done." (emphasis supplied)

Mr. Hirsh also testified:

"Present indications are that *after paying all of the costs of publication—editorial cost, paper cost, overhead, et cetera—that the profit, or so-called profit, if any will be nominal.* I do not have these figures now because they are in the process of being determined by our accountants. I will be glad to furnish them to the Committee when they are available if the Committee so desires." (emphasis supplied)

The record then includes a letter dated April 15, 1969, from Dr. E. B. Howard, Executive Vice President of the AMA, which includes the following pertinent paragraph:

"With respect to a request for a financial statement indicating revenues from, and operating expenses of, the Association's publications and the use of any excess over operating expenses, we sincerely regret that this information is not available. As Mr. Hirsch indicated, *the promulgation by the Internal Revenue Service of the expanded unrelated business tax regulations has required the Association to completely review and revise its accounting procedures.* This was and is being done. However, the problems of this revision are so complex that the Association has requested a 60-day extension for filing its return for 1968." (emphasis supplied)

If, because of accounting revisions, nominal or no tax results for the AMA, this would be very much in line with a statement submitted at the IRS hearing in July by the Attorney for the U.S. Chamber of Commerce. Page 59 of that statement contains the following comment:

"Normally, in the case of a proposed new tax measure, the effect of the tax on the revenues would be another important consideration. But even the proponents of the advertising tax concede that gross advertising receipts of all tax-exempt publications are only some $100,000,000 annually. It is probable that at least 50% of this would be offset by deductions under any realistic and fair tax statute. Thus, net receipts probably would be less than $25,000,000, a nominal figure in terms of overall revenues. As tax-exempt organizations stepped up their expenditures to improve their publications to make them more competitive, *and realigned their publishing activities, perhaps by the judicious combination of profitable and unprofitable activities in taxable subsidiary corporations, tax revenues might well dwindle to the vanishing point.*" (emphasis supplied)

For the United States Chamber of Commerce to take this position is, to us, incredible. The business press and the newspapers of this country are no less advocates of free enterprise than the Chamber. When the unrelated business tax was passed in 1950, the leading advocate in support of the tax was the Chamber. Its witness then told the Senate Finance Committee:

"It is our policy that we are opposed to Government favoritism in any form, and we urge that no enterprise be favored over any other, and that each enterprise, whether it is cooperative, individual, or corporation, should stand on its own feet, with protection from unfair competition, and free from either tax exemption or other public subsidy."

It is all the more astounding that even at this late date, the Chamber, in its Congressional Action Bulletin, dated August 19, 1969, in talking about the bill now before you, takes the following two opposite positions in urging its local members to write you or to visit with you. Among other things, the Chamber is asking its members to:

"Urge passage of the Clay-Brown provision and the extension of the unrelated business income to debt-financed income."

and

"Oppose the section which taxes advertising income as unrelated business income even though the publication is related to the exempt purpose of the organization."

How the Chamber can support the Unrelated Business Tax except when the Chamber itself has to pay a tax, is something we find disappointing to say the least.

An August 19 press release of the Chamber quotes its President as stating:

"We in Chambers of Commerce are going to have to exercise a little self-discipline ourselves. We are in a poor position to yawp about the destruction of the currency as long as we reward best those public servants who have been most willing to loot the Treasury.

"If we want to save the dollar we're going to have to stretch out our gimmies. We are going to have to be willing to wait another six months for the new bridge and maybe a year for the new hospital wing. And we're going to have to get the word to Washington . . . ."

Wouldn't one think that with this philosophy, the Chamber could well pay a tax to support the government when it makes a profit on Nation's Business, which it publishes?

In the Senate last year, two votes were taken on this issue:

The first, March 27, carried as a floor amendment to the Excise Tax extension bill, and had it not been deleted in conference, it would have nullified the IRS regulation in its entirety. The second vote came on September 20,[1] and in the floor debate at the time, Senator Anderson, who with Senators Fulbright, Metcalf and Morton had offered an amendment to a Committee proviso postponing the effective date of the provision, made the following exemplary statement which succinctly and clearly explains that situation:

"Mr. ANDERSON. Mr. President, when the excise tax bill was before the Senate on March 27, an amendment nullifying the IRS regulation which would apply the unrelated business tax to advertising profits of tax-exempt organizations was introduced. IRS issued its regulation after lengthy study and exhaustive hearings. Without any hearing before either the Ways and Means Committee or the Senate Finance Committee, and without complete information, after very brief debate, the Senate passed this amendment. In the conference on the excise tax bill this provision was deleted, and I think wisely.

"When the matter was before the Senate on March 27, I think we all must admit we knew very little about it. We did not know, for example, that we were

[1] In the September 20th Senate vote, the IRS position was sustained.

opening up a loophole that could cost the general taxpayers $25,000,000 a year, and this at a time when we are raising taxes for everyone else.

"Now the committee's amendment is another attempt to nullify the IRS regulation, albeit if only for a year.

"Mr. President, I hope that the Senate will agree to this action to strike out the committee's amendment. I limit myself to these remarks at this time. I believe my amendment to be a most important one which should be adopted by the Senate." (S-11184)

When the Conference Committee deleted the March 27 proviso, the Ways and Means Committee stated that it would hold hearings. It did so shortly after the new Congress convened and the result of that hearing is that the IRS regulation was codified by Section 278(c) of the bill before you.

The difficulty now is that unless the tax is so administered as to prevent the use of accounting devices to nullify it, unfair competition will continue and the tax revenue achievable will be frittered away. Mr. Conrad will discuss this. Mr. Conrad.

STATEMENT OF THE NATIONAL NEWSPAPER ASSOCIATION

The Unrelated Business Income tax imposed by Congress in 1950 was intended to end the unfair competitive advantage of businesses conducted by tax-exempt organizations. With the exception of the business of advertising, this has been accomplished. In 1967 the Internal Revenue Service adopted regulations which made it clear that the sale of advertising by a tax-exempt organization did give rise to constitute Unrelated Business Income which would hereafter be subjected to tax.

The National Newspaper Association submits the following information in support of the IRS regulation, to the specific point that non-profit, tax-exempt organizations are selling advertising in direct competition to the nation's newspapers. Since newspapers rely heavily on advertising for revenue, permitting tax-exempt competitors to profit from the sale of advertising without subjecting those profits to income tax would permit the unfair competition the UBI tax was adopted to end.

Advertising in the February, 1969, National Geographic included Ford Motor Company's Lincoln-Mercury and Ford Divisions; General Motors' Cadillac, Pontiac and Chevrolet Divisions; International Harvester; Quantas and BOAC; Johnson Outboard Motors; Aetna Insurance; and Kellogg's Cereals.

The Journal of the American Medical Association in recent issues has carried advertising of Bufferin; Bayer Aspirin; Haley's M.O.; Phillips Milk of Magnesia; Ivory Soap; and Zeiss Ikon Cameras.

Nation's Business of February, 1969, included advertisements of all Chrysler Corporation automobiles; Lark Cigarettes; Chevrolet; Cadillac; GMC Trucks; Evinrude; New York Life; and Aetna Life and Casualty.

All of these products and services would be appropriately advertised in a newspaper, or any other medium of consumer advertising.

A little noticed product of the past decade or two is the city chamber of commerce publication. These magazines, usually printed on fine paper and in full color, have become common across the U.S. They qualify at the city level as publications of tax-exempt business leagues, in the manner of *Nation's Business*, the publication of the U.S. Chamber of Commerce on the national scene. The following examples of consumer advertising have been gleaned from a review of recent city chamber of commerce magazine issues.

The Baltimore Chamber of Commerce publication, Baltimore Magazine, in its January issue carried advertising for three banks a number of restaurants; liquor distilleries; a Chevrolet agency; several realtors; a Ford dealer; a Volkswagen dealer; a dry cleaners; a deodorant; a jeweler; an exterminator; Esso; Baltimore Gas & Electric; Blue Cross-Blue Shield; the Chesapeake and Potomac Telephone Company; the C&O and B&O Railroads; and a nursing convalescent home.

A recent issue of the Birmingham (Alabama) Chamber's magazine carried advertising of life insurance companies; airlines; Pepsi-Cola; hotels; bars and night clubs; furniture; clothing; book stores; jewelry and watches; organ and piano sales.

The Louisville (Kentucky) Area Chamber of Commerce magazine includes many of these types of advertising plus Viceroy Cigarettes and Kentucky Fried Chicken.

The Chicagoland Voice of Business and Industry in its December issue, which came in two parts and totaled 146 pages, included many of these types of advertising plus Bell & Howell products; the Burlington Railroad; All-State Insurance; and Montgomery Ward.

The Duluthian, a publication of the Duluth Chamber of Commerce adds to the list beer; retail liquor store; and a Chinese restaurant.

Dayton, U.S.A., the Dayton Area Chamber's publication, contributes tire advertising; Omega watches; the Book of Knowledge; Trans World Airlines; an anti-perspirant; and a women's fashion shop.

Nor are all of these publications in metropolitan areas. The Fayetteville Chamber of Commerce magazine, while a modest four pages, carries more than half of its total space in advertising.

The Mid-Monmouth Panorama Magazine, published by the Mid-Monmouth-Greater Freehold Chamber of Commerce in central New Jersey, serves the communities of Freehold, Colt's Neck, Englishtown, Howell, Manalapan, Marlboro and Millstone. In addition to some of the advertising mentioned above add a lawn and garden shop; a sporting goods store; United Van Lines; a music and dance studio; a florist; a poultry farm; a beauty salon; a supermarket; and a painter and paperhanger.

In short, there exist today localized publications of tax-exempt organizations which are selling local advertising in direct competition with local media.

The potential is virtually unlimited, if advertising is laid open to tax-exempt usage by the non-profits. The advent of shopping centers has seen also the development of shopping center-oriented boards of trade. Some of them are already producing their own advertising publications. Surely they should not be allowed to escape taxation if these publications show a net profit, for they are in direct competition with taxpaying media.

Farm groups, civic associations, unions, lodges, fraternal groups—the list of potential exploiters of advertising is long. Many now publish periodicals of one type or another, and sell advertising. So long as their tax-exempt status does not preclude such activity, we have no quarrel. But surely no one could argue that, in addition to other inherent advantages these publications enjoy, their profits should escape ordinary federal tax.

In the course of studying the extent to which tax-exempt organizations compete with NNA member newspapers for advertising sales, this Association uncovered at least two publications which are community newspapers in the full sense, yet avoid federal income tax as non-profit organizations.

The first is the Dover (Massachusetts) Reporter, registered with the state as a non-profit bulletin "formed to promote the civic and social welfare of the Town of Dover." It has been declared tax-exempt as a 501(c)(3) organization. Started as a twice-a-month mimeographed bulletin, it is now published weekly as an offset tabloid and in every appearance is a weekly newspaper. It employs a manager and staff, pays salaries, and competes directly with the txpaying newspapers of that area.

At Greenbelt, Maryland, the Greenbelt News-Review is produced by the Greenbelt Cooperative Publishing Association, Inc., a non-profit organization. It too pays no federal income taxes.

The point is that non-profit newspapers can and do exist; can and do compete against taxpaying newspaper publishers. If Congress were to reverse the Internal Revenue Service in its application of the Unrelated Business Income tax to these organizations, it is quite conceivable that local boards of trade, shopping center merchant groups, or even the local Kiwanis or Lions club could launch a newspaper. The publisher would draw a salary appropriate for a publication that makes tax-free profits, and could pay liberal salaries to this staff. The profits remaining could be used to expand the publication. Token contributions could be turned over to the tax-exempt organization in payment for the tax umbrella. Everybody benefits except the government and competing, taxpaying media.

At a time when Congress is trying to close loopholes and insure that all are paying their fair share; at a time when individuals and corporations are being asked to pay a surtax on top of already substantial federal income taxes—we urge this Committee to ratify the action of the Treasury Department in applying the Unrelated Business Income tax to the sale of advertising. We know of no sound reason why our field—advertising—should be singled out as the one exception to the 1950 rule that tax-exempt organizations, when they elect to go into business for profit, must compete on an equal footing with taxpaying business competitors.

The CHAIRMAN. William J. Lehrfeld of the National Fraternal Congress of America.

STATEMENT OF WILLIAM J. LEHRFELD, THE NATIONAL FRATERNAL CONGRESS OF AMERICA

Mr. LEHRFELD. Mr. Chairman and members of the committee, my name is William Lehrfeld. I am tax counsel for the National Fraternal Congress of America, an association of 101 fraternal beneficiary societies.

On my left is Mr. Cyrus Rachie, chairman of the Law Committee of the National Fraternal Congress and vice president and general counsel of the Aid Association for Lutherans, the largest fraternal beneficiary society in the United States.

We have inserted in the record a statement on behalf of the National Farternal Congress dealing with the taxation of unrelated-business income as applied to fraternal beneficiary societies.

Initially I would like to make one point. In Mr. Caplin's testimony on page 4 he notes that fraternal beneficiary societies had in force $13.8 billion of insurance and they also carried on bowling alleys, driving ranges, restaurants and hotels.

Let me say that the National Fraternal Congress endorses the extension of the unrelated-business income tax to fraternal beneficiary societies. It endorses the extension of the unrelated debt financed tax to fraternal beneficiary societies; it endorses the application of the extension of the requirement for filing information returns and making these information returns public. If a fraternal beneficiary society is carrying on a driving range, a bowling alley, a restaurant or hotel it should pay tax on it. However when we get into the problem of proposed section 512(a) (3), you have a special and discriminatory treatment to fraternal beneficiary societies in particular and section 501(c) (7), (8), (9) and (10) organizations in general.

The unrelated-business income tax is a progeny of an attempt in 1942 by Congress to extend the tax to charitable organizations. It was finally enacted in 1950 and now it looks like it will be completely extended.

When the tax was originally proposed in 1942 and when enacted in 1950, the Congress recognized that passive investment income, interest, rent, dividends and royalties, should be excluded from the tax, and it has done so for those organizations presently subject to the tax.

Our position is that this passive investment exclusion should not be struck when applied to fraternal beneficiary societies. We see no reason why fraternal beneficiary societies should be singled out from all other membership and mutual organizations to have a potential tax applied to their passive investment income.

As the Finance Committee is aware, there are membership organizations now subject to the tax. You have professional societies in 501 (c)(3) that are tax-exempt and pay no tax on their interest and dividends regardless of the membership use. You have labor unions exempt under 501(c)(5) which pay no tax on their investment income. You have trade associations exempt under 501(c) (6) which pay no tax on their investment income. If the tax is extended to all exempt organizations, you will have membership organizations in 501(c) (4)

paying no tax on their investment income. You will have membership organizations in 501(c) (12), (13) and (16) paying no tax on their investment income. However, you have a special class of subject organizations created under the House bill of certain mutual or membership organizations described in 501(c)(7) which are social clubs, (c)(8), which are fraternal societies, (c)(9) and (c)(10) which are employee beneficiary associations. Section 512(a)(3) will have a potential tax applied to their investment income.

We take objection also to the fact, apart from the discrimination simply on a membership basis, that there are many tax-exempt insurance organizations that will not be subjected to tax on their investment income. TIAA, for example, the largest insurance organization for college professors, is a section 501(c)(3) organization and it has no tax on investment income. Blue Cross, Blue Shield, the largest health insurance organization in the United States, exempt under section 501(c)(4) will pay no tax on its investment income. You have labor union health plans, exempt under section 501(c)(5) which will pay no tax on investment income. You have teacher death benefit and retirement funds described in section 501(c)(11) which will pay no tax on investment income. You have local life insurance organizations exempt under section 501(c)(12), which will pay no tax on investment income.

I believe there is no justification for this discriminatory treatment. It is unfair to apply a potential tax on passive investment income of fraternal beneficiary societies where large numbers of other membership organizations, and other insurance organizations are not similarly treated.

We have, as I indicated, no objection to paying tax on any unrelated business income nor do we have any objection with respect to the unrelated debt-financed income tax.

It is when you get into this passive investment income which Congress has long recognized and excluded from the unrelated tax, where fraternals are now being subjected to this discriminatory treatment that we must strongly object. We urge the Finance Committee to strike section 512(a)(3) from this bill and give tax equality to fraternal beneficiary societies.

Thank you very much.

Senator CURTIS. Is there a list of societies that you speak for in your statement?

Mr. LEHRFELD. No, Senator Curtis, but I have a list with me which I will give you.

The CHAIRMAN. Thank you so much, sir.

(The membership list of the National Fraternal Congress was made a part of the official files of the committee.)

(Mr. Lehrfeld's prepared statement and a subsequent letter received by the committee from Mr. Lehrfeld follow:)

STATEMENT OF NATIONAL FRATERNAL CONGRESS OF AMERICA PRESENTED BY WILLIAM J. LEHRFELD, TAX CONSULTANT

The National Fraternal Congress has no substantial objection to the extension of the unrelated business income tax in its present form across the board even though there is no apparent justification for applying it to fraternal beneficiary societies. Likewise, in the case of the taxation of unrelated debt financed income, we have no substantial objection to this provision since all exempt organizations

are being treated in equal fashion. Where we do object is not in extension of the unrelated business income tax in its present form, but to the extension of the tax in discriminatory fashion where applied to fraternal beneficiary societies.

Under § 121 of the House bill, four classes of exempt organizations are grouped together and all their income, except exempt function income, is treated as unrelated business income; income is treated as exempt if derived directly from members in the insurance function (e.g., premiums) or if derived from investments and permanently committed to charitable purposes or for providing benefits. Unrelated income, debt financed income, income from controlled corporation etc. regardless of its commitment would be taxable to a fraternal beneficiary society. Discrimination arises in the following contexts:

1. *Membership Organizations Now Subject to Unrelated Tax Are Exempt On Their Investment Income.* Under present law (§§ 512(b)(1)–(5)), technical or professional societies, labor organizations (including unions), business leagues, though taxed on their unrelated income, are not taxed on any investment income such as dividends, interest, royalties, annuities, or other passive income which they receive (except the taxable proportion of business lease income, §514(a)). They may use this investment income to provide "purely personal facilities" for their members without any adverse tax implications.

2. *Membership Organizations Proposed For Coverage Would Be Exempt On Their Investment Income.* If the provisions of the unrelated business tax are extended to all mutual or membership organizations, regardless of classification, e.g., to social welfare organizations, civic leagues, farmers cooperatives, cemeteries, credit unions, employee beneficiary societies, only two classes of mutual organizations, other than fraternals, *viz.*, social clubs and employee beneficiary societies would be subject to tax on their investment income. All other classes of membership organizations would enjoy the use of their investment income free from any tax whatsoever, regardless of member services provided by such income.

3. *Substantially All Other Tax Exempt Self-Insurance Organizations Under the Proposal, Except Fraternal Beneficiary Societies, Will Be Exempt From Tax On Their Investment Income.* Under present law, there are a variety of exempt organizations which provide benefits or perform insurance functions respecting the payment of life, sick, accident, or other benefits, similar to that performed by fraternal organizations operating under the lodge system. In large measure, regardless of the exemption classification, the investment income of these other exempt insurers, as described below, will not have their investment income disturbed if the unrelated business tax is extended to them.

A. § *501(c)(3) Organizations.* The largest plan for life insurance and retirement benefits for college professors and related employees, the Teachers Insurance and Annuity Association, is exempt as a charitable organization. A.R.R. 218, Cum. Bull. No. 3, 238 (1920). No part of its investment income is taxable (see §§512(b)(1)–(5)), although the organization is now subject to the unrelated tax. Its investment income can be used for any membership purpose, consistent with its charter and exemption classification, without any limitation under the proposed bill.

B. § *501(c)(4) Organizations.* The largest health insurance system in the United States, Blue Cross-Blue Shield, is exempt from tax (private ruling to Group Hospitalization Association of America dated November, 1947). Even if the unrelated tax is extended to §501(c)(4) social welfare organizations, the entire investment income of this entity, and all similar entities providing insurance benefits (*Cf.* Rev. Rul. 55-495, Cum. Bull. 1955-2, 259) will be free from tax without regard to any other membership use.

C. § *501(c)(5) Organizations.* Labor organizations exempt under this section are permitted to provide their members with death, sick and accident benefits (Rev. Rul. 62-17, Cum. Bull. 1962-1, 87), and no part of the investment income of these organizations would be reached.

D. § *501(c)(11) Organizations.* Teachers retirement fund associations which pay retirement and death benefits and whose earnings must include investment income, will not have any part of such investment income taxed.

E. § *501(c)(12) Organizations.* Local benevolent life insurance associations will not have any part of their investment income taxed. To maintain exempt status, this class of exempt insurer must have less than 15% of its income from sources other than members.

F. § *501(c)(15) Organizations.* Mutual insurance associations (providing other than life and marine insurance) exempt under this section will not have any part of their investment income taxed. To maintain exempt status, the total in-

come (excluding capital gain) of such associations must not exceed $150,000 per year.

4. *Voluntary Employee Beneficiary Associations Do Not Rely On Investment Income, Are Not Self-Insurers, and Members Don't Pay For Their Own Benefits.* In the case of the 4830 voluntary employee beneficiary associations exempt under § 501(c)(9) and the 467 voluntary government employee beneficiary associations exempt under § 501(c)(10), there is some parallel to the insurance functions of a fraternal beneficiary society. Even though classed with fraternals, the potential affect upon them is likely to be minimal as compared to the treatment of fraternals. These membership organizations provide benefits including life, accident and sick benefits but primarily through the use of a commercial insurance company rather than being self-insurers.

The great body of these organizations are supported not by employee-members themselves (which is the case with fraternal insurance), but through the contributions by the employers of such employees in union negotiated plans as part of overall wage and fringe benefit packages provided employees. Since a major portion of § 501(c)(9) and (10) organizations are not self-insurers, investment income arises only from investments of excess contributions from employers and is of significantly less consequence to them than to an organization which must invest premiums to assure payments of the contracted benefits. Because a substantial portion of these organizations are funded either completely or primarily by nonmembers (employers) the cost of maintaining the benefit schedule if any tax is applied to investment income would not be borne by the members. On the other hand, since members of fraternals pay for their own insurance, any reduction in benefits or services because of the application of tax would be borne entirely by fraternal members. Only fraternal organizations (among the § 512(a)(3) grouping) must *rely* on investment income for providing and maintaining the purposes and functions constituting the basis of its exemption.

5. *Social Clubs Will Be Able To Avoid Investment Tax On All But 15% Of Their Investment Income.* Social clubs and fraternals are supposedly on a par with respect to the taxation of their investment income. However, social clubs need only shift their portfolio, if any, into dividend producing properties to enjoy an 85% exclusion of such income pursuant to § 243. Because of reserve and solvency regulations imposed by the states, no more than 5% to 10% of the investments of fraternal beneficiary societies may be invested in dividend producing securities but rather must be in fixed income, interest bearing obligations.

Secondly, the aspect of taxation of social club investment income is almost illusory since such organizations generally do not have such income. In testimony before the Ways and Means Committee, representatives of social clubs indicated that investment income is "minor" and of very little consequence in the overall scheme of application of the unrelated business tax to such clubs. This is obviously not the case for fraternal beneficiary societies.

To summarize and conclude: Of the hundreds of thousands of tax exempt mutual or membership organizations providing service or facilities to members (whether insurance, economic, social or the like) no class of exempt organization is more likely to be adversely affected by the enactment of § 512(a)(3) than fraternal beneficiary societies.

We cannot understand why the unsupported allegation of social services to members represents the principal basis for the change in tax status of investment income when many other services rendered by membership organizations (like labor unions) may be of far more direct importance to the participating member. Furthermore, we fail to see the distinction which permits the largest (indeed larger than any commercial insurer) health insurance plan to be tax exempt on it investment income along with a great variety of member-centered insurance organizations exempt under classifications other than §§ 501(c) (8), (9), and (10). Today, insurance issued by fraternal benefit societies represents only 1.8% of the insurance in force in the United States, and this percentage has been in steady decline since 1900. Because of limitations on the types of insurance which can be issued, and the limitations as to the fact that purchasers (local lodge members) must meet membership tests and participate in local lodge functions to be eligible to purchase a benefit contract, fraternal beneficiary societies are not an anti-competitive force in the insurance industry today. We do not believe that Congress really wants legislation of this type which is so unjustified and discriminatory.

IV. SUGGESTED TECHNICAL (NONSUBSTANTIVE) CHANGES

If it is the will of the Senate to make special provisions with respect to fraternal beneficiary societies in the manner proposed by the House, we suggest certain technical changes which would be helpful when and as problems of interpretation arise.

The National Fraternal Congress understands that the rationale of the proposal seeks to eliminate the exemption for investment earnings used to defray the costs of providing "social recreations." On the other hand, there is no intention to tax "investment income associated with fraternal insurance." The language used by the draftsmen, while generally consistent with this purpose, is not sufficiently precise to provide definitive answers to several questions posed by normal fraternal operations. In discussions with representatives of the executive and legislative staffs, the points covered below were raised and the reply was that the present language is broad enough to provide answers satisfactory to fraternals. While we believe that favorable interpretations may be made under the provision as now written, we would prefer to rely on a more precise statute.

The National Fraternal Congress forsees difficulties with the Internal Revenue Service on the interpretation of the present language of the H.R. 13270 (§ 121(b)) on matters relating to (1) premium income and benefit payments, (2) treatment of surplus, and (3) use of term "permanently" in the statute.

1. *Premium Income and Benefits.* Initially, there is the ambiguity in scope of proposed § 512(a)(3)(B), first sentence, lines 9–17, p. 88 of the bill. As we read the first sentence, this seems to include, as "exempt function income" within the phrase "charge or similar account" all premiums paid by an insurance member with respect to his benefit certificate. We believe that the term "services" used is that first sentence includes the insurance or benefit function. Neither the bill nor the general or supplemental reports explicitly makes this point. The sentence seems to cover, in addition to social clubs dues, etc., dues or charges paid to the local lodge of the fraternal by a member for the goods or facilities which are offered in connection with any recreational, fraternal, or benevolent function of the lodge. We believe it would clarify the status of premium income under the first sentence of proposed § 512(a)(3)(B) to insert the terms "premiums" and "benefits" therein. The first sentence then, as clarified, would also cover an assessment which might have to be made upon all insurance members of a society where the legal or related insurance reserves and surplus were not adequate to cover outstanding or new contracts for insurance and an assessment was required to bring reserves or surplus up to a specified amount.

2. *Treatment of Surplus.* Next, there are several ambiguities in the scope of proposed § 512(a)(3)(B) second sentence, lines 17–24, p. 88 and lines 1–11, p. 89 of the bill.

As for the second sentence of § 512(a)(3)(B), it includes all other related income not from a member source, earned by either the parent organization or the local lodge, such as investment income. We do not include, of course, any income earned from an unrelated business (such as advertising, debt financed income, or income from controlled corporations) in this classification of exempt function income. Thus, for the national organization holding the benefit contracts, it includes the traditional passive income generally excluded from tax under present law.

Where such investment income is expended or set aside ["permanently committed"] for either (i) charitable purposes ["§ 170(c)(4) purposes"] or (ii) for providing for benefits (or policy dividends) then such investment income is not taxed. However, there is concern over investment earned by the fraternal which, after provision for reserves and policy dividends, is accumulated at the close of the year in a surplus account called, "Unassigned Funds." The term "Unassigned Funds" is the name prescribed by the National Association of Insurance Commissioners in their uniform accounting form required of fraternals when submitting annual statements of financial condition to the state insurance departments.

As you know, regulation of fraternal benefit societies by insurance departments differs from state to state. The degree of control or supervision varies and some states are more strict than others in prescribing limitations on operations. A number of jurisdictions prescribe with great detail the reserve factors, fraternal fund and surplus requirements. Since many of our member societies do business in the jurisdictions with strict regulations, such jurisdictions' regulations have the effect of protecting the policyholders of other states whose laws are less strict.

Some states require a separation of insurance funds and fraternal funds. They prescribe the limits allowed for fraternal disbursements. Some states provide that a fraternal beneficiary society must have "Unassigned Funds" representing the excess of 105% of liabilities (legal life and related reserves) over the amount of such reserves before insurance funds may be used for charitable, educational or fraternal purposes. Thus, the "Unassigned Funds" must be more than five percent of liabilities before disbursements may be made from this surplus for other than insurance purposes.

The "Unassigned Funds" account of fraternals represents a solvency account which is available in the event of extraordinary losses (claims) or severe market depressions. It may be used in the event of an extraordinary claim for cash surrender values, may hold dividends or benefits retained by the society, and may be used for charitable purposes. It provides a cushion in excess of the legal life and other reserves held for benefit purposes. If "Unassigned Funds" become too large, some states may require a fraternal to return to the policyholders a portion of the excess so that this cushion is not too inflated. On the other hand, if there is no surplus, the state regulatory agency can order the provisions of such surplus (through assessments), bar new contracts and/or revoke a license to do business. By addition of the term "or securing" to § 512(a)(3)(B)(ii), it would indicate that surplus, i.e., "Unassigned Funds," which secures the payment of benefits is proper and appropriate and investment earnings so committed are not taxable unless diverted.

3. *Use of Term Permanently.* In the context of my discussion on "Unassigned Funds", the term "permanently" added to the term "committed" could cause administrators at a later date to differ with the scope of the term intended by the Committee on Ways and Means.

According to the dictionary, the term "permanently" means "continuing or enduring without fundamental or marked change." This definition is contradicted by the last sentence in § 512(a)(3)(B) (p. 89, lines 6–11) when it provides:

> If during the taxable year, an amount which is attributable to income so permanently committed is used for a purpose other than that described in clause (i) or (ii), such amount shall be included under subparagraph (A), in related business taxable income for the taxable year.

It doesn't make sense how amounts *permanently* committed can be diverted. The purpose of the last sentence is to tax investment income which was not set aside for benefits (or policy dividends) or charity but expended for "social recreations" or like "purely personal facilities for the membership" of fraternal societies. Since that language will tax any untoward diversion, the term "permanently" is superfluous and rather confusing. The fact that "permanently" didn't mean "permanently" was pointed out in the debates on the Tax Reform Act prior to passage by the House.

As Congressman Byrnes pointed out during the House debates on the Tax Reform Act the term "permanently committed" in § 512(a)(3)(B) does not require a commitment pursuant to state law or benefit contract. What is required is that the governing board of the fraternal beneficiary society takes steps to assure that accumulated earnings in the "unassigned Funds" surplus account be used exclusively for charitable or insurance purposes. This would be done by a corporate resolution to effect such commitment.

As Chairman Mills pointed out, the "permanently committed" test does not turn on some legally binding contract which absolutely requires such but rather on the commitment made by the organization as to the proper (charitable or insurance) disposition intended for such funds. If this is the case, the use of the term "permanently" is almost contradictory and implies an unintended obligation which needed clarification during the floor debates.

We believe that deletion of the term "permanently" would clarify the fact that investment earnings added to such "Unassigned Funds" need not be committed by state law or contract to the insurance or charitable functions to qualify as "exempt function income." Thus, § 512(a)(3)(B) as altered by our changes would more clearly reflect the intention of Congress. Our version as altered appears as an appendix to this statement.

V. COMMENTS UPON REQUIREMENT THAT FRATERNAL BENEFICIARY SOCIETIES FILE PUBLIC INFORMATION RETURNS

Under § 101(d) of the House bill, all exempt organizations shall be required to file annual information returns with the Internal Revenue Service. By amend

ment to § 6104 such returns will be made available for public inspection. This provision presents no substantial problems for fraternals because under state law, fraternals are required to file extremely detailed statements of financial condition. In addition, these statements in some states are made public.

When the insurance departments of the various statutes conduct their triennial examination of the books and records of fraternal beneficiary societies, the operations, investments and related activities of the national organization are scrutinized in great detail. We could not foresee any examination by the Internal Revenue Service which would approximate the examinations of the state insurance departments. While we do not believe it is necessary for fraternals to file information returns because of the detailed returns filed with the states which regulate their insurance activities (which are available to any Internal Revenue agent at any time) the nondiscriminatory aspect of this provision deserves our support. Fraternal organizations are being treated like all other exempt organizations. No particular class of exempt organizations are particularly favored over any other class. All classes of organizations will file information returns and all such returns will be made public.

We are concerned, however, that an undue burden would be placed on very small organizations (regardless of class) which maintain themselves through the services of volunteers.

If these volunteers would be required to analyze and prepare the complicated information returns of nonprofit organizations, few people would be willing to offer their services. In addition, if the volunteer overlooks the filing, he may under certain circumstances, be liable for a personal penalty for his failure to file a return. While this personal penalty may be appropriate for larger organizations, it could be very mischievous as to smaller ones operating with volunteer assistance. We suggest, therefore, that the proposed § 6033 be amended to exclude from the annual filing requirement organizations which have less than $5,000 gross income and $5,000 in assets in any year. Such a provision would not be administratively harmful since the potential abuse of exempt status in such small organizations is almost nil. Also, the Revenue Service would not be deluged with hundreds of thousands of meaningless returns serving no audit or revenue function.

Finally, it would not place an undue burden on small organizations operating with volunteer help and would not discourage individuals from associating themselves in the administration of these small organizations. It makes a great deal of sense for the Internal Revenue Service to obtain returns which enables them to carry on their audit and enforcement procedures more ably and efficiently; we do not believe a statutory exclusion for very small organizations would in any way adversely affect these functions and indeed could well save the taxpayers thousands of dollars which would have to be spent to process, colate and perfect such returns. We believe our proposition is a salutory one and urge its adoption.

VI. CONCLUSION

The National Fraternal Congress of America wishes to emphasize that it has no substantial objection to the extension of the unrelated business income tax in its present form to fraternal beneficiary societies since all other exempt organizations will be subject to this tax. The equivalent treatment of all other exempt organizations as to the taxation of unrelated debt financed income is supportable for the same reason. However, we strongly object to the discrimination inherent in proposed IRC § 512(a)(3) of the House bill. There is no justification for singling out fraternal beneficiary societies (and § 501(c)(7), (9) and (10) groups) for special treatment of "diverted" passive income where all other tax exempt membership organizations can do as they please with such income under the exclusions granted by §§ 512(b) (1), (2), (3) and (5). Proposed § 512(a)(3) does not treat equivalent organizations on an equal basis; it does not treat equivalent income on an equal basis. We urge the Senate to reject this provision.

ARENT, FOX, KINTNER, PLOTKIN & KAHN,
Washington, D.C., September 24, 1969.

HON. RUSSELL B. LONG,
Chairman, Committee on Finance,
U.S. Senate, Washington, D.C.

DEAR SENATOR LONG: This letter is written on behalf of the National Fraternal Congress of America, an association of 101 fraternal beneficiary societies exempt from federal income tax under section 501(c)(8) of the Internal Revenue Code.

The National Fraternal Congress submitted a statement to the Committee on Finance concerning proposed § 512(a)(3) (extension of the unrelated business income tax to fraternal societies) and was granted the opportunity to testify before your Committee on September 12.

The National Fraternal Congress is not opposed to the across the board extension of the unrelated business income tax with the present exclusions for passive investment income. We are opposed, however, to the limitations imposed on the expenditure of such investment income since (i) other tax exempt membership organizations have no such limitations imposed and (ii) other tax exempt insurance organizations have no such limitations imposed. In our estimation, there is no substantial justification for such discrimination.

If the provisions governing the taxation of unrelated business income are enacted in the present format, there are a number of questions posed in its application to the normal operations of fraternal societies. While it is believed that literal interpretations of the proposed unrelated tax provisions would provide answers favorable to fraternals, we would appreciate any technical comments you may have with respect to our observations.

1. Fraternal A offers members of its local lodges the opportunity to purchase life insurance on the lives of their children or other dependents (including wives) subject to the restrictions on amounts and age imposed by the state in which the members reside. The member pays the premiums on the benefit certificates and is the beneficiary under these dependency contracts. Under prop. IRC § 512(a)(3)(B) (definition of "exempt function income", line 9, page 88 of the bill) amounts paid by members in connection with such dependency insurance may be considered as services rendered for the member. However, if the insured (the juvenile or wife) is considered the person to whom the service is rendered, then the first sentence may not exclude this premium income. It does appear that the second sentence (p. 88, lines 17-24, p. 89, lines 1-5) would exempt such premium income where the premium is committed for a purpose specified in § 170(c)(4), or for providing for the normal § 501(c)(8)(B) benefits. Since it is our understanding that the first sentence was drafted to cover (and exempt) a fraternal society's entire premium income, there seems to be some disparity in requiring a fraternal to separate accounts and trace dependent's insurance premiums as is required under the second sentence. We believe an appropriate reference in the Senate Finance Committee report could attribute dependent's insurance to the member under the first sentence and thereby treat all premium income the same.

2. Fraternal B publishes a monthly journal which contains commercial advertising as well as advertising by religious orders seeking young men to join the orders, enroll in seminaries, etc. The magazine is distributed to all members of the fraternal directly from its national headquarters and members pay a subscription fee of $1 per year as part of their joint national-local dues. The magazine as a whole produces a loss in excess of $100,000 per year although there is net advertising profit based upon direct advertising income and direct advertising expenses.

Under prop. § 512(a)(3)(A), the entire gross income of a fraternal is treated as unrelated business income except for exempt function income. Deductions are allowed (p. 88, lines 3-8) for those expenses directly connected with the production of gross income. Proposed § 512(a)(3)(A) may be interpreted to disallow certain expenses of a fraternal related to the production of exempt function income in the context of publishing a journal. For example, if the editorial expenses incurred in connection with a journal by a fraternal society are classed as attributable to "exempt function income" (income from member subscriptions) then these expenses are not allowed to offset net advertising profits as is the case for trade associations and others under Regulations 1.512(a)-1(d)(3) and Regulations 1.512(a)-1(e), Example 2. If that were the case, the fraternal periodicals carrying commercial advertising are treated far more harshly than (i) a commercial counterpart and (ii) a counterpart periodical published by a trade association.

On the other hand, parenthetical exclusion contained in the second sentence of proposed § 512(a)(3)(B) (p. 88, lines 20-24) could be interpreted to require the "netting" of exempt function journal losses against advertising profits with an overall journal profits being thrown back to § 512(a)(3)(A) and be taxable under that provision. We believe that there is no reason for distinguishing between journals of various exempt organizations and that the appropriate provisions would permit a fraternal journal to benefit from regulations 1.512(a)-1(d)(2) and 1.512(a)-1(e), Example 2.

3. Fraternal C invests retained insurance dividends, unclaimed or deferred benefits and the like in order to make such assets productive. These items are an indebtedness of the fraternal (owed to certificate holders or beneficiaries) and are shown as liabilities on the balance sheet of the society. In the case of these items, the society is committed to pay a certain stipulated return to the beneficiary and should the rate of return exceed the contracted amount, such excess is added to the general funds of the society.

Under § 514 as amended, income attributable to acquisition indebtedness may be taxable depending upon, *inter alia*, whether the property or indebtedness is related to any exempt function.

Under proposed IRC §514(c)(4) (indebtedness incurred in performing exempt purpose) the term "acquisition indebtedness" does not apply to indebtedness where the incurrence of it is inherent in the performance or exercise of the organizations exempt function. We believe that deferred or unclaimed benefits, and re-invested dividends constitute indebtedness inherent in the fraternal society's exempt function, and are very much like deposits made by members of credit unions (an example cited in the statute). Thus, the statute seems to exclude from taxation earnings attributable to such indebtedness. Since such amounts are sometimes very substantial, a reference to such "related" indebtedness would be appropriate to clarify and affirm the status of such indebtedness.

Your assistance on these questions would be greatly appreciated.

Very truly yours,

WILLIAM J. LEHRFELD.

The CHAIRMAN. Mr. Edwin Steers, counsel for the Imperial Council of the Ancient Arabic Order of the Nobles of the Mystic Shrine for North America.

It is a fine organization, sir, but it is a real mouthfilling phrase.

STATEMENT OF EDWIN STEERS, GENERAL COUNSEL, THE IMPERIAL COUNCIL OF THE ANCIENT ARABIC ORDER OF THE NOBLES OF THE MYSTIC SHRINE FOR NORTH AMERICA; ACCOMPANIED BY J. WORTH BAKER, IMPERIAL POTENTATE; GEORGE SAUNDERS, IMPERIAL RECORDER; PAUL E. IBACH, ASSISTANT GENERAL COUNSEL; AND ROBERT MOUNTAIN, CPA

Mr. STEERS. Mr. Chairman and members of the committee, I am Edwin Steers, attorney, from Indianapolis, Ind., and recently appointed as general counsel for the Shrine, succeeding Stanley Gerrity, an eminent lawyer from Wichita, Kans., who had held that position for some years. He died just several weeks ago after a trip here on this bill.

On my right is the imperial potentate of Shrine, J. Worth Baker.

On my immediate right is George Saunders, the imperial recorder, who has held that position for some 20 years.

On my left is assistant general counsel of the Shrine who will make the oral presentation and remarks and Bob Mountain from Billings, Mont., a CPA.

I will present Paul E. Ibach, the assistant general counsel.

Mr. IBACH. I appreciate very much this opportunity to appear before this committee in person today as a representative of more than 863,000 Shriners of which there are 4 million Masons, and to express the general views of our fraternal organization on certain aspects of the House Tax Reform Act of 1969.

The objects and purposes of the Shrine reflect such attitudes as faith in God, man's relationship with his brother and philanthropy.

The Shrine has long been characterized for the color and pageantry

of its parades, its marching uniform units, its bands and its fund-raising activities, which have helped raise many millions for our philanthropy, Shriners hospitals for crippled children.

As many of you are probably aware, our fraternity supports and maintains currently 19 orthopedic Shriners hospitals and three Burns Institutes. From the time our first hospital was constructed in 1922, we have cured or materially helped more than 140,000 children. The treatment which has been provided at Shriners hospitals for crippled children has always been wholly without any charge to the parents. We estimate that the operating expenses for our charity for the calendar year 1969 will amount to in excess of $22 million.

It is the Shrine fraternal organization which has made all of this possible. While most drives for charitable funds by various charities require a certain amount of selling and expenses incident thereto, we of the Shrine have always prided ourselves on never attempting to make any form of direct solicitation upon the general public. Rather, we have attempted to attract charitable gifts and bequests for our philanthropy from the pagentry and color displayed at our sporting events, and through our fraternalism and assistance of local, worthwhile community projects.

Having given you this rather brief background concerning the Shrine fraternal organization, I should like to address my remarks today to section 121(b)(1) of the Tax Reform Act which creates special taxable rules as to fraternal beneficiary societies and places them in the same taxable category as social clubs with few exceptions. This we feel to be a fundamental error, whereby a fraternal organization's passive investment income, together with its income generated from intermittent or annual fundraising activities would be taxed at corporation rates when it is not directly committed for charitable purposes. It is important to observe that these special taxable rules are not made applicable to other exempt organizations, such as labor unions, social welfare organizations and business leagues to merely name a few. In our estimation, it should be more the intent of Congress to actually eliminate the inequities in our present tax system than create a greater hodgepodge and further disparity among exempt organizations.

There is no question but that a tax placed on income from investments and fundraising activities such as circuses and sporting events would result in a drastic reduction in available support which the Shrine Fraternal Order could give its philanthropy. All such income which right now is not being directed for our charity is either being set aside for capital improvements, equipment and traveling expenses for our Shrine units when they participate at various sporting events and community parades which have always done so much to call attention to our philanthropy, Shriners Hospitals for Crippled Children. It is this way that we have been able to get charitable gifts and bequests from the general public.

Certainly the revenue advantages from the Treasury's standpoint of this form of taxation of fraternal organizations must be considered nominal, but the amounts from the standpoint of the Shrine would be prodigious. At the same time, such a tax at corporation rates would be doing nothing toward correcting any inequities or abuses in our current tax system. The primary impetus and purpose for the unre-

lated-business income tax was to eliminate a source of unfair competition with private taxpaying businesses and the taxation of a fraternal organization's passive investment income and income from fundraising activities would have no bearing whatsoever on this primary purpose.

Actually, the public welfare would be far better sustained if the Shrine were permitted to continue conducting its fundraising events unhampered which both by direct and indirect means aids charitable and philanthropic purposes.

Even as late as July 7, 1969, when this tax bill was in its latter stages of being considered by the Committee on Ways and Means, it is quite apparent from a letter written by Chairman Mills of the committee in responding to a letter received by a fellow Congressman from one of our Shrine temples, that the chairman firmly believed that Shrine football games and circuses would be subject to the same applicable tax-exempt provisions under the unrelated-business income regulations (Regulations sec. 1.513–1(c)(iii)) as other exempt organizations having annual or intermittent fund raising activities. However, this would not be so under section 121(b)(1), and it would make no difference that an annual Shrine football game or circus was not considered a business "regularly carried on."

Does it seem equitable by this House tax bill that all income generated by such exempt organizations as a business league, real estate board, or labor union from an annual fundraising dance, would continue to remain tax exempt while the income generated from our annual Shrine dance or circus would be taxed at corporation rates on any income not directly committed for charitable purposes? Why is such a distinction proposed between these exempt organizations?

As I have heretofore indicated, a fundamental error did occur when the Treasury Department made its initial proposal to Congress to treat fraternal organizations in the "same boat" as social clubs. Actually, the organizational structure and purposes of these two exempt organizations are quite dissimilar from each other, with the exception that both are a "membership" form of organization. For that matter, churches, too, are a membership organization.

An exempt social club must be organized and operated exclusively for the pleasure and recreation of its members and be supported "solely" by membership fees, dues, and assessments.

Contrast this wording in the Internal Revenue Code as to social clubs with that pertaining to fraternal beneficiary societies which are far different than mere social and recreational clubs.

The regulations as to fraternal organizations, unlike social clubs, specifically allow the "carrying on of activities which raise revenue from members and their guests. Congress clearly then has always manifested a willingness to recognize fundraising activities of fraternal organizations as long as these organizations according to regulations do "not engage in business activities of a kind carried on for profit."

It can also be observed that numerous revenue rulings have been promulgated in the past few years by the Treasury Department dealing with exempt social clubs and under what conditions and to what extent a social club may make its social and recreational facilities available to the general public. In none of these revenue rulings has there ever

been the slightest indication by the Treasury Department that these rulings were to be also made applicable to fraternal beneficiary societies. Merely because social clubs and fraternal organizations are both membership organizations, does not mean their purposes, their activities and their operations are at all similar. If that were true, there would be no need for two separate tax exemption categories under section 501(c) of the code.

We can appreciate the reasons for the Treasury Department's recommendation to the House Committee on Ways and Means to tax the income of a social club should it permit its bar, restaurant, social, or other recreational facilities to be utilized in any substantial degree by nonmembers; this very likely could result in an unfair competitive advantage to the exempt social club over private taxpaying businesses within the community offering similar services to the general public. However, there is no competitive advantage to be concerned with in taxing the investment income of fraternal organizations or the income they receive from nonmember admissions to annual fundraising events. We have never heard of any complaint ever being lodged by a taxpaying business objecting to any fundraising activity of the Shrine.

In summary, let me make clear that the Shrine supports extending organizations including fraternal beneficiary societies. However, it is the position of the Shrine that it should be treated with the same degree of farness and with the same present exemptions, additions, and limitations referred to under section 512(b) of the Internal Revenue Code that are now accorded other exempt organizations under the unrelated-business income tax sections of the code.

We therefore strongly take exception to fraternal beneficiary societies being summarily categorized in a manner similar to social clubs without any justifiable basis and have all their investment income and all their income from annual or intermittent fundraising activities, henceforth taxable at corporation rates if not permanently committed strictly for charitable purposes or for insurance benefits for members.

We respectfully request that the Committee on Finance give earnest consideration toward amending the Tax Reform Act of 1969 by removing any and all references to section 501(c)(8) organizations from the discriminatory provisions of section 121(b)(1) of the Tax Reform Act. It is this section of the House bill which adds section 512(a)(3) to the Internal Revenue Code and creates special taxable rules applicable to fraternal organizations.

Thank you.

Mr. STEERS. We will be happy to answer any questions if we could.

Senator ANDERSON. I am afraid I will be a prejudiced witness. I have been elected as the potentate of my Shrine organization in New Mexico, and I am a member of my divan of my own temple now.

Senator CURTIS. Is one of the points you make that the tax on passive investment income is not applied across the board to all tax-exempt organizations?

Mr. IBACH. Right. It only applies to social clubs, fraternal organizations, and voluntary beneficiary associations.

Senator CURTIS. Over the long period is the Shrine substantially protected from exemption of the tax of funds committed to charity?

Mr. IBACH. Until this House bill, Senator, we have never come

within the purview of the unrelated business income tax sections of the code.

Senator CURTIS. I understand.

Mr. IBACH. However, as I stated in our statement before the committee here, we are fully—we fully support being under the act as any other exempt organization should be, but we think that we should be treated with the same degree of fairness as the other exempt organizations and not specially categorized.

Senator CURTIS. My question was, to what extent are you saved from the tax by the provision that there is an exemption to the tax of funds committed to charity?

Mr. IBACH. That is right. Any funds that are directly committed for charitable purposes or for insurance purposes for the benefit of members and their dependents, we would be exempt from that.

Senator CURTIS. I understand that, but to what extent in your case does that grant you relief? Would you still have substantial income taxed?

Mr. IBACH. Yes. The reason being that it would hurt our temples, Shrine temples, in accumulating funds for capital improvements, for renovating needs.

It would hurt us in trying to have our temples secure funds to buy new uniforms, to buy equipment, and to go to these various parades and football games which we feel have done so much to call attention to our charity and to raise funds.

Just in 1968, we had 31 Shrine football games, and they had net receipts of our hospitals of $1,370,000, and this is done through calling attention to our charity.

We do not have, as I said, any form of direct solicitation to the general public.

Senator CURTIS. Nor any paid for solicitation.

Mr. IBACH. Right.

Senator CURTIS. That is all.

Senator MILLER. My question is somewhat related to Senator Curtis' questions, and that is, to what extent would you obtain relief from the effect of the House-passed bill if you were allowed to take a deduction against fundraising events income for funds set aside for charity or for funds set aside for operations of the Shrine or, for that matter, for any other fraternal organization, which are calculated to tie in with the fundraising activities, the public participation parades to which you refer?

Would that commitment of funds—wouldn't that pretty well use up this income from fundraising events?

Mr. IBACH. I am sorry I did not get the full import of your question.

Senator MILLER. Take, for example, the annual Shrine game in San Francisco. Aren't the funds from that pretty generally used entirely for charity?

Mr. IBACH. Right, sir.

Senator MILLER. Proceeds.

Mr. IBACH. Right, sir, all charity after the expenses.

Senator MILLER. And Shrine circuses, don't the proceeds from those pretty generally go to charity or possibly some of the public relations operations, participation in parades and activities of that type, like that?

Mr. IBACH. That is right.

Senator MILLER. Then I am wondering if it would help you if the House-passed bill was amended so that fraternal organizations would have an offsetting deduction for amounts committed to charity or for amounts committed to activities of the fraternal organization which are of a public-participation-type activity.

You mentioned Shrine temples. They would not be included in that. I was wondering if that was not included, but the other activities were, funds for other activities, that would pretty well kill off any income tax consequences.

Mr. IBACH. Yes, except for what we were trying to raise money for, a new temple or new temple building needs, would cover most of that other income, I would say.

Senator MILLER. So that if you had a fundraising event calculated to raise money for a temple that would be subject to tax——

Mr. IBACH. Yes.

Senator MILLER (continuing). Under my approach.

Mr. IBACH. Right.

Senator MILLER. Of course, that would be true for any fraternal organization. If the Elks Club had a fundraising event to construct a new Elks Club.

Mr. IBACH. You see, one of the problems, though, Senator, is that, if you take a Shrine temple, they may have a building in a community, and land values get so expensive, and real estate taxes, that they decide to move out to the outskirts of town, well, it would hurt us tremendously if we were to have to pay a captial-gains tax on what the basic cost of that building might have been 50 years ago, and what it is now, and when we decide to move out——

Senator MILLER. Yes.

Now, we are getting into this passive investment income. My questions are not related to that. Your testimony is substantially like Mr. Lehrfeld's before you on that.

Mr. IBACH. Right.

Senator MILLER. I think your points are very well taken. I am not talking about passive income. I am talking about these fundraising activities.

Mr. IBACH. Fundraising activities.

Senator MILLER. And we have a problem there. If every fraternal organization in the country wanted to have a fundraising event to get money to build a new building, well, that is one thing.

But, on the other hand, if the fraternal organizations are using the income from a fundraising event for charity or for their, let us say, public or community service-type activity, participation in parades and things of that nature, that might be a little different. I am just wondering where the line could be drawn, and, if it were drawn, how much of an impact it would have on you, because I do not think we—and I am sure you do not want us to single the Shrine out for any particularly special treatment. We are talking about fraternal organizations here.

Mr. IBACH. Right.

Senator MILLER. And I have no question but what the way you people operate is very much aboveboard, but there are some cases where, I think, all of us have experienced some criticism of some fraternal organizations for certain activities.

So the question is, Where do we draw the line? and I think that you make a strong point that you are quite different from social clubs.

I have no difficulty with that, but whether or not we should try to draw a line between fundraising income for the community service and charity activities, on the one hand, and the lodge's own buildings, on the other, is the question I am trying to ask here.

Do you have any experience from your activities as to how many activities of the Shrine are calculated to raise funds for service activities on things of that nature, as distinguished from other activities to build capital?

Mr. SAUNDERS. I would say that, with the present dues structure of the Shrine organization, they would need some supplemental income in order to be able to handle their fraternal activity, to cover the cost of their units in making the parades, and cover the cost of the uniforms and that sort of participation which, in itself, is helping the charitable project of the Shrine.

Senator MILLER. Yes. But I do not think maybe I got my point across to you.

Suppose you are allowed to take a deduction against the fundraising income for those very activities, and for charity, would that pretty well eliminate the problem of the income or is there very much activity calculated to raise money for capital-type spending such as a new temple?

I am just wondering how much it would impinge upon you if we drew the line at allowing deductions against fundraising event income, the proceeds to go to charity, and the proceeds that are used by fraternal organizations in carrying out service-type activities such as those you mentioned.

Mr. SAUNDERS. That is something that I could not—I get your thought, Senator, but I could not give you an answer.

Senator MILLER. Perhaps you could look at it and submit something for the record.

Mr. SAUNDERS. It would have to be studied, that is right.

Mr. STEERS. We have our accountants and auditors—we will have them make a study of it. We would have to have an overall profit with a net income for the overall proposition, but I do not think we have ever had to study it.

Senator MILLER. But give us something on it.

Mr. STEERS. Will do.

Senator MILLER. I do not want an intensive review, but you might take a few examples and see how you come out, which might be helpful in guiding us on it.

(Mr. Ibach's prepared statement follows:)

STATEMENT OF PAUL E. IBACH, ASSISTANT GENERAL COUNSEL, THE IMPERIAL COUNCIL OF THE ANCIENT ARABIC ORDER OF THE NOBLES OF THE MYSTIC SHRINE FOR NORTH AMERICA

Mr. Chairman, for the record my name is Paul E. Ibach and I am Assistant General Counsel for The Imperial Council of the Ancient Arabic Order of the Nobles of the Mystic Shrine for North America, which is more commonly known and referred to as the Shrine of North America. I appreciate very much this opportunity to appear in person before the Committee today as a representative of more than 863,000 Shriners and to express the general views of our fraternal organization on certain aspects of the House Tax Reform Act of 1969.

The objects and purposes of the Shrine, as set forth in its Articles of Incorporation, reflects such attitudes as Faith in God, man's relationship with his brother and philanthropy.

The Shrine has long been characterized for the color and pageantry of its parades, its marching uniform units, its bands and its fund-raising activities, which have helped raise many millions for what we believe to be the "World's Greatest Philanthropy", Shriners Hospitals for Crippled Children. As many of you are probably aware, our fraternity supports and maintains currently nineteen orthopedic Shriners Hospitals and three Burns Institutes. From the time our first hospital was constructed in 1922, we have cured or materially helped more than 140,000 children, and in doing so, we have currently trained approximately one-fourth of the certified orthopedists in this nation. The treatment which has been provided at Shriners Hospitals for Crippled Children has always been wholly without any charge to the parents. We estimate that the operating expenses for our charity for the calendar year 1969 will amount to in excess of $22,000,000.

It is the Shrine faternal organization which has made all of this possible in its humane endeavors to assist those less fortunate. While most drives for charitable funds by various charities require a certain amount of selling and expenses incident thereto, we of the Shrine have always prided ourselves on never attempting to make any form of direct solicitation upon the general public. Rather, we have attempted to attract charitable gifts and bequests for our philanthropy from the pageantry and color displayed at our sporting events, and through our fraternalism and assistance of local, worthwhile community projects. Last year, there were thirty-one Shrine charity football games alone sponsored by our Shrine Temples throughout the United States which helped raise approximately $1,370,000 in net receipts for our hospital program.

Having given you this rather brief background concerning the Shrine fraternal organization, I should like to address my remarks today to Section 121(b)(1) of the Tax Reform Act which creates special taxable rules as to fraternal beneficiary societies and places them in the same taxable category as social clubs with few exceptions. This we feel to be a fundamental error, whereby a fraternal organization's investment income, including rents, dividends, interest and gains from the sale of property, together with its income generated from intermittent or annual fund-raising activities would be taxed at corporation rates when it is not directly committed for charitable purposes. It is important to observe that these special taxable rules are not made applicable to other exempt organizations, such as labor unions, social welfare organizations and business leagues to merely name a few. In our estimation, it should be more the intent of Congress to actually eliminate the inequities in our present tax system than create a greater hodgepodge and further disparity among exempt organizations.

There is no question but that a tax placed on income from investments and fund-raising activities such as circuses and sporting events would result in a drastic reduction in available support which the Shrine Fraternal Order could give its philanthropy. All such income which right now is not being directed for our charity is either being set aside for capital improvements or renovating needs or such income is being used by Shrine Temples to provide parade vehicles, uniforms, equipment and traveling expenses for our Shrine Units when they participate at various sporting events and community parades which have always done so much to call attention to Shriners Hospitals and to assist us in obtaining gifts and bequests from the general public.

Certainly the revenue advantages from the Treasury's standpoint of this form of taxation of fraternal organizations must be considered nominal, but the amounts from the standpoint of the Shrine would be prodigious. At the same time, such a tax at corporation rates would be doing nothing toward correcting any inequities or abuses in our current tax system. The primary impetus and purpose for the Unrelated Business Income Tax was to eliminate a source of unfair competition with private taxpaying businesses and the taxation of a fraternal organization's investment income and income from fund-raising activities would have no bearing whatsoever on this primary purpose.

Actually, the public welfare would be far better sustained if the Shrine were permitted to continue conducting its fund-raising events unhampered which both by direct and indirect means aids charitable and philanthropic purposes which might otherwise of necessity become federally financed and controlled.

Even as late as July 7, 1969, when this tax bill was in its latter stages of being considered by the Committee on Ways and Means, it is quite apparent from a letter written by Chairman Mills of the Committee in responding to a letter

received by a fellow Congressman from one of our Shrine Temples, that the Chairman firmly believed that Shrine football games and circuses would be subject to the same applicable tax exempt provisions under the Unrelated Business Income Regulations (Regs. § 1.513–1(c)(2)(iii)) as other exempt organizations having annual or intermittent fund-raising activities. However, this would not be so under Section 121(b)(1), and it would make no difference that an annual Shrine football game or circus was not considered a business "regularly carried on."

Does it seem equitable by this House Tax Bill that all income generated by such exempt organizations as a business league, real estate board, or labor union from an annual fund-raising dance, would continue to remain tax exempt while the income generated from our annual Shrine dance or circus would be taxed at corporation rates on any income not directly committed for charitable purposes? Why is such a distinction proposed between these exempt organizations?

As I have heretofore indicated, a fundamental error did occur when the Treasury Department made its initial proposal to Congress to treat fraternal organizations in the "same boat" as social clubs. Actually, the organizational structure and purposes of these two exempt organizations are quite dissimilar from each other, with the exception that both are a "membership" form of organization. For that matter, churches, too, are a membership organization.

An exempt social club must be organized and operated exclusively for the pleasure and recreation of its members and be supported "solely" by membership fees, dues and assessments.

Contrast this wording in the Internal Revenue Code as to social clubs with that pertaining to fraternal beneficiary societies which are far different than mere social and recreational clubs. The Regulations governing fraternal organizations state they must be operated in furtherance of their fraternal purposes. In the case of the Shrine, we are operated in accordance with Masonic principles which, as I have stated, include Faith in God, philanthropy and brotherhood among our basic attitudes.

The Regulations as to fraternal organization, unlike social clubs, further specifically provide that the "carrying on of activities which raise revenue from members and their guests will not deprive the society of its exemption." Congress clearly then has always manifested a willingness to recognize fund-raising activities of fraternal organizations as long as these organizations according to the Regulations do "not engage in business activities of a kind carried on for profit."

It can also be observed that numerous Revenue Rulings have been promulgated in the past few years by the Treasury Department dealing with exempt social clubs and under what conditions and to what extent a social club may make its social and recreational facilities available to the general public. In none of these Revenue Rulings has there ever been the slightest indication by the Treasury Department that these rulings were to be also made applicable to fraternal beneficiary societies. Merely because social clubs and fraternal organizations are both membership organizations, does not mean their purposes, activities and operations are at all similar. If that were true, there would be no need for two separate tax exemption categories under Section 501(c) of the Code.

We can appreciate the reasons for the Treasury Department's recommendation to the House Committee on Ways and Means to tax the income of a social club should it permit its bar, restaurant, social, or other recreational facilities to be utilized in any substantial degree by non-members; this very likely could result in an unfair competitive advantage to the exempt social club over private taxpaying businesses within the community offering similar services to the general public. However, there is no competitive advantage to be concerned with in taxing the investment income of fraternal organizations or the income they receive from non-member admissions to annual fund-raising events, which actually go to support their fraternal activities and in many ways their charitable endeavors. We have never heard of any complaint ever being lodged by a tax-paying business objecting to any fund-raising activity of the Shrine.

While some social clubs have taken the position in statements previously filed with the House Committee on Ways and Means that a tax being placed on their investment income would represent to them only a minor problem since this has for a number of years been the subject of Revenue Rulings pertaining only to them, (see in particular Revenue Ruling 66–149), this is certainly not true as far as the Shrine or many other fraternal beneficiary societies where it could have a catastrophic effect.

In summary, let me make clear that the Shrine supports extending the Unrelated Business Income Tax as presently constituted to all exempt organizations including fraternal beneficiary societies. However, it is the position of the Shrine that it should be treated with the same degree of fairness and with the same present exemptions, additions, and limitations referred to under Section 512(b) of the Internal Revenue Code that are now accorded other exempt organizations under the Unrelated Business Income tax sections of the Code.

We therefore strongly take exception to fraternal beneficiary societies being summarily categorized in a manner similar to social clubs without any justifiable basis and have *all* their *investment income and all their income from annual or intermittent fund-raising activities*, henceforth taxable at corporation rates, if not permanently committed strictly for charitable purposes or for insurance benefits for members.

We respectfully request that the Committee on Finance give earnest consideration toward amending the Tax Reform Act of 1969 by removing any and all references to *Section 501(c)(8)* organizations from the discriminatory provisions of Section 121(b)(1) of the Tax Reform Act. It is this section of the House Bill which adds Section 512(a)(3) to the Internal Revenue Code and creates Special Taxable Rules Applicable to fraternal organizations.

Senator JORDAN. I have no questions.
Senator ANDERSON. Mr. Kachlein.

STATEMENT OF GEORGE F. KACHLEIN, JR., EXECUTIVE VICE PRESIDENT, AMERICAN AUTOMOBILE ASSOCIATION; ACCOMPANIED BY JOSEPH E. McANDREWS, TAX COUNSEL; AND ARTHUR I. COOPER, ASSISTANT TREASURER, AMERICAN AUTOMOBILE ASSOCIATION

Mr. KACHLEIN. Thank you, Mr. Chairman.

My name is George F. Kachlein, Jr., executive vice president of the American Automobile Association, and I am asking to sit with me, because of their technical qualifications to answer questions, Mr. Joseph E. McAndrews of Ivins, Phillips & Barker, who is our tax counsel, and Mr. Arthur I. Cooper, who is assistant treasurer of the American Automobile Association.

The American Automobile Association on behalf of its 227 affiliated clubs, and 12 million members, is appearing to voice its objection to section 121 of the House-passed H.R. 13270, the Tax Reform Act of 1969.

We specifically refer to that portion of section 121 which relates to limitations on deductions of certain nonexempt organizations, and would add a new section 278 to the Internal Revenue Code.

While the American Automobile Association and its 227 affiliated clubs are each a nonprofit corporation, each of them, however, are taxpayers like any other private corporation under our Federal income tax laws and under a majority of our State income tax laws.

When one looks at the title of the hearing today we find we are talking about tax-exempt corporations, I wish to clearly point out that we are a regular taxpayer. We are a taxpaying service organization, and though section 121 (now Sec. 278) appear to be directed to social clubs and other taxable organizations whose members have direct control over dues structures, as presently written it will apply to the American Automobile Association and its 227 affiliated clubs, and will have in each case a catastrophic effect on the finances of these clubs and the American Automobile Association.

I just returned late yesterday from our annual meeting in Chicago

where this matter was discussed with each of the club managers and the presidents of these 227 clubs and, therefore, I speak in their behalf as well as the American Automobile Association.

Organizations which compete with the AAA but have a nonmember stockholder's interest appear to be excluded from the application of section 278, while we are not. This would put us in a serious competitive disadvantage and subject us to severe tax discrimination.

The AAA and its affiliated clubs are unique organizations in the motoring and travel field whose activities benefit far more than just our members. For a few examples of AAA activities which benefit the general public and are in the public's interest, attention is called to pages 4 through 11 of the statement which we submitted.

If section 278 is enacted into law in its present form, the AAA and its affiliated clubs would be forced to curtail, if not eliminate, many public service-oriented activities such as outlined there.

Our other objections to section 278 are:

(1) Discriminatory

AAA competitors, insurance companies, oil companies, with subsidiary motor clubs, will apparently be permitted to deduct membership operation losses while the AAA will not, and again I refer to pages 11 and 12 of our statement.

(2) Membership service costs—Impossible to predict accurately

No deduction would be permitted for costs of servicing members in excess of income derived from the members. If a net operating loss results in any year the loss would be disallowed forever.

When winters, with heavy snows, with severe cold or other unusual weather conditions occur, like it occurred last year, the cost to the AAA in carrying out its services may substantially exceed dues income for that year.

It is impossible to predict membership costs accurately, primarily because of weather conditions.

If we guess incorrectly as to the severity of the weather or members demand for other services, we bear the entire loss.

If we guess correctly, income taxes will take away more than half of our net income.

(3) Investment income--Dues paid in advance

Membership dues, are paid annually in advance. These funds are invested at the best possible return.

Under section 278, income from these invested dues would be subject to tax without any offset even though this income results from the fact that dues are paid in advance of the receipt of services.

This is discriminatory since taxable newspapers and magazines receive subscription income in advance and may invest such funds. Yet these publications are not required to be taxed on their investment income separately from the remainder of their operations.

The AAA publishes and provides its members with tour books and other publications which describe and give ratings to hotels, motels, restaurants, and similar facilities which have met AAA standards.

Hotels, motels, restaurants, and so forth, advertise in our tour books, and through "Official Appointments," publicize the fact that they are AAA inspected and are approved.

(4) *Advertising and other income used to reduce publication costs*

Under section 278 AAA would be required to pay taxes on such advertising and related income without reduction for the cost of the publication, which contains the advertising, because it is nonmember income.

A newspaper can apply its advertising revenue to its production costs without a penalty so as to reduce the price of its magazine or newspaper to its subscribers. B , the AAA, because it is a member organization, even though it is subject to income taxes and the like, would be penalized in a similar transaction. Once again, a clear case of discrimination.

(5) *Cost allocation between members and nonmembers—Impractical*

The AAA and its clubs cannot provide certain services to its members unless it provides the same services to the general public.

For example, international driving permits are issued by the AAA under rules of the United Nations Convention on Road Traffic, which prohibits their issuance to members only.

Similar rules are enforced by the Air Traffic Conference, the International Air Transport Association, and various steamship companies covering the sale of airline and steamship tickets.

Under section 278, the AAA would be required to segregate dealings with members from nonmembers and to compute taxes separately from nonmember transactions. This would be difficult and most expensive, if not impossible, to develop a cost accounting system which would make a reasonable allocation of costs between members and nonmembers.

(6) *Section 278 scope too broad.*

The effort to close loopholes in unrelated business income of tax-exempt organizations while, at the same time, trying to prevent them from escaping by adopting a nonexempt status, is understandable.

However, the all-encompassing scope of section 278, we believe, is too broad for the apparent purposes for which it was designed. Only banking and insurance institutions are specifically excluded.

The AAA advertising and other income is clearly related to the stated purposes of our organization. Unlike social or other organizations in which the membership may have a direct control over the dues structure, our dues are not based upon the whims of the membership but are determined by competitive conditions and costs in the marketplace.

While section 278 strives to eliminate specific abuses, because of the scope of the language, it will also penalize organizations such as the AAA which are not guilty of these abuses.

Recommendation.

AAA strongly recommends that the committee carefully consider the full implications of this section, and if the committee still feels that section 278(a) is required as presently worded, then we would urge that 278(b) be amended so that section (a) would not apply to nonabusers such as the American Automobile Association.

Mr. Chairman and members of the committee, we appreciate the opportunity of presenting our views before you.

Senator ANDERSON. Any questions? Well, thank you very much for a very fine statement indeed.

Mr. KACHLEIN. Thank you.

(Mr. Kachlein's prepared statement follows:)

STATEMENT BY GEORGE F. KACHLEIN, JR., EXECUTIVE VICE PRESIDENT, AMERICAN AUTOMOBILE ASSOCIATION

The American Automobile Association and it 227 affiliated clubs representing 12,000,000 members, appreciate this opportunity to voice their objection to Section 121 of House passed H.R. 13270, the Tax Reform Act of 1969.

Section 121 which relates to limitations on deductions of certain non-exempt membership organizations would add a new Section 278 to the Internal Revenue Code as follows:

"SEC. 278. DEDUCTIONS INCURRED BY CERTAIN MEMBERSHIP ORGANIZATIONS IN TRANSACTIONS WITH MEMBERS.

"(a) GENERAL RULE.—In the case of a social club *or other membership organization* which is operated primarily to furnish services or goods to members and *which is not exempt from taxation*, deductions for the taxable year in furnishing services, insurance, goods, or other items of value to members shall be allowed only to the extent of income derived during such year from members or transactions with members. (Italic ours.)

"(b) EXCEPTIONS.—Subsection (a) shall not apply to any organization which for the taxable year is subject to taxation under subchapter H or L."

The above exceptions in paragraph (b) relate solely to band and insurance companies.

The House Ways and Means Committee Report #91-413 contains the following explanation of the above quoted portion of Section 121 of the bill:

"*Present law.*—Certain non-exempt corporations organized to provide services to members on a non-profit basis realize investment income, or income from providing services to non-members, which is used to defray all or part of the cost of providing services to members. The courts have upheld this treatment in certain cases, although the effect is to render the investment income nontaxable, and therefore to permit untaxed dollars to be used by the organization to provide services for its members.

* * *

"*Explanation of provisions.*—Your committee's bill adds a new provision (sec. 278) which provides that in the case of a social club or other membership organization operated primarily to furnish services or goods to members and which is not exempt from taxation, deductions in furnishing services, insurance, goods, and other items of value to members are allowable only to the extent of income from members or transactions with members. This provision does not apply to organizations that are taxable as banking institutions or insurance companies under the code.

". . . New section 278 applies in the case of a social club, cooperative, or other membership organization which is not exempt from taxation and which is operated primarily to furnish services or goods to members. New section 278 provides that the deductions for the taxable year in furnishing services, insurance, goods, or other items of value to members (or shareholders) of such organizations are to be allowed only to the extent of income derived during such year from members or transactions with members. Therefore, in such a case, income from sources other than members may not be reduced, in determining taxable income, by losses arising from dealings with members."

Our tax counsel which is the Washington law firm of Ivins, Phillips and Barker advises that the above quoted provision of the House passed bill would appear to be applicable to the AAA and its affiliated clubs as membership organizations operated primarily to furnish services to members. They further advise that deductions would be allowable only to the extent income was received from members or transactions with members. This would mean, they point out, that any excess of deductions over income would not be allowable for net operating loss purposes. Also, any excess of deductions over income with respect to members or transactions with members could not be offset against income generated from transactions with non-members.

This provision of the bill, if enacted into law in its present form, would have a devastating effect on the AAA and its affiliated clubs.

AAA Organization Structure

The AAA is a tax-paying service organization subject to both Federal and State taxation. It was organized in March 1902 and in 1910 was incorporated as a non-profit corporation under the laws of the State of Connecticut relating to corporations without capital stock.

The AAA consists of 227 tax-paying affiliated autonomous clubs and 11 divisions with 841 offices serving 12,000,000 members throughout the United States and Canada.

AAA Serves Public Interest—Benefits Non-members

Since its formation over 67 years ago, the AAA has devoted its energies and activities to serving its members with such services as emergency road service, towing service, maps, touring and travel services, etc. However, many of its other activities are of direct benefit to the motoring and general public.

The AAA By-Laws provide in part:

"ARTICLE II

"Objects and Purposes

"SECTION 3. (Objects and Purposes) The objects and purposes of this corporation are:

"(a) To aid in the establishment and maintenance of a uniform and stable system of laws relating to the regulation and use of automobiles and motor vehicles, and the rights and privileges of the owners and users thereof.

"(b) To promote the construction, maintenance, improvement and supervision of highways that are safe, convenient and accessible to motor vehicles.

"(c) To educate the users of motor vehicles and the public at large in the principles of traffic safety.

"(d) To collect and distribute information as to all matters or things of whatsoever character concerning motor vehicles, or of interest to the users thereof.

"(e) To conduct and participate in exhibitions, contests and safety activities and to offer and grant awards, in connection with the interests of the users of motor vehicles.

"(f) To organize, and grant affiliation to other corporations, associations and organizations with objects and purposes similar to those of this corporation.

"(g) To engage in any activity permitted by law intended to further and protect the interests of the users of motor vehicles.

"(h) To promote understanding among people in the United States and Canada and abroad and to that end to promote, arrange, and provide for travel of all kinds by land, sea and air; and to take all steps reasonable or necessary to carry out the foregoing.

"(i) To do any and all acts or things incidental, necessary or convenient to the accomplishment of these objects and purposes.

"SECTION 4. (Use of Funds) This corporation shall use its funds only to accomplish the objects and purposes specified in Section 3, and no part of said funds shall inure, or be distributed, to the Members of this corporation. On dissolution the funds of the corporation shall be distributed to one or more regularly organized charitable organizations to be selected by the Board of Directors."

Members of the AAA corporation referred to in Section 4 of the By-Laws quoted above consist of the 227 affiliated clubs and the 11 divisions. These affiliated clubs have similar provisions in their By-Laws.

AAA PUBLIC INTEREST ACTIVITIES—A FEW EXAMPLES

Highways.—Down through the years, AAA and its affiliated clubs throughout the country have supported and promoted improved highways. The organization was a leader in the campaign which resulted in the first Federal-aid highway program in 1916. It was one of the first to seek public support for the limited-access highway concept worked out by the U.S. Bureau of Public Roads prior to World War II. Jointly, AAA and its clubs staged an intensive educational campaign to build widespread enthusiasm for the expanded Federal highway program, with emphasis on the Interstate system, which was adopted in 1956. In the states, AAA

clubs have worked for better highways, supporting motorist tax increases when that seemed necessary.

In recent years, AAA has given increasing attention to urban transportation problems, producing a variety of materials on advantages of urban freeways, explaining the space-saving possibility of joint development of highways and other urban facilities. It has worked diligently for provision of adequate off-street parking spaces, both as a convenience to the motorist and as a measure necessary for downtown health.

AAA and its clubs were early advocates of roadside protection and gave hearty support to Federal legislation for roadside beautification. They approve of the expenditure of motorist tax money for roadside rest and information areas, scenic look-outs and similar amenities within the highway right-of-way.

Safety Programs for Drivers.—Over 25,000 high school driver education teachers have attended intensive short courses conducted by AAA Educational Consultants since our teacher preparation program began in 1936.

Since 1936, AAA clubs have assisted high schools in obtaining some 250,000 free-loan cars from dealers for high school driver education programs. AAA has pioneered in the production of driver education text materials with AAA's Sportsmanlike Driving textbook currently being the most widely used text in the field.

AAA Driver Education Television Series is being used in closed circuit TV school programs as well as on public service programs on regular TV channels for the general public.

AAA sponsors a nationwide holiday highway safety program "Bring 'Em Back Alive." This year, 5.5 million free pieces of promotional literature were distributed during Memorial, Fourth of July, and Labor Day Holidays. A network of public service radio and TV holiday news reports are also used in conjunction with the BEBA program.

Pedestrian Safety Programs.—Each year, AAA clubs distribute free to schools over 25 million pieces of safety education posters, lesson guides for teachers, and safety stories for children.

Each year, AAA clubs conduct a nationwide "School's Open—Drive Carefully" campaign to alert motorists to look out for children at school opening time.

Each year, AAA sponsors a National Pedestrian Safety Inventory Program with some 2,000 cities in U.S. and Canada submitting detailed reports on their pedestrian safety programs. Since AAA started this program in 1939, pedestrian *deaths* have been reduced by 45% while all other traffic deaths have increased nearly 75%—this is the most remarkable improvement made in highway safety to date.

AAA club furnish free literature and equipment to some 900,000 School Safety Patrol Boys and Girls serving in 40,000 schools across the nation who are helping to protect the lives of 20 million children as they walk to and from school.

Annually, an estimated 100,000 traffic safety posters are drawn by youngsters from grades 1–12 for AAA's National School Traffic Safety Poster Contest. Some $10,000 in U.S. Savings Bonds are distributed to student Poster Contest Winners.

Traffic Engineering.—In cooperation with the Institute of Traffic Engineers, AAA recently sponsored 13 regional Workshops on Urban Arterial Traffic Improvements which were attended by city officials and lay persons working for traffic improvement. ($35,000 was contributed by AAA to help underwrite this project.)

AAA clubs conduct local traffic surveys and traffic forums to help officials develop effective traffic improvement programs.

AAA in the interest of uniformity of Traffic Control Devices, signs, signals, markings, actively participates in keeping current the National Manual on "Uniform Traffic Control Devices" which serves as a guide to states and localities.

Federal Safety Standards—AAA Support.—AAA actively promotes the National Highway Safety Program Standards developed as a result of the 1966 Highway Safety Act. AAA is a financial contributor and active participant in the "STATES" program—a Public Support program designed to get states to implement the National Highway Safety Standards.

AAA worked with the National Highway Safety Bureau in the development of the National Standards and Manuals on pedestrian safety, driver education, codes and laws, etc.

National Parks—Recreation Areas.—In recent years AAA has appeared before Congressional committees and enthusiastically supported the creation of several new national parks and seashore recreational areas.

The AAA was the first non-government issuer of the Golden Eagle Passport. AAA affiliated clubs during 1968 sold for the U.S. Government more than 30,000 passports, at no handling cost, thus facilitating use of national parks and recreational areas by the general public.

International Driving Permits.—The AAA has been authorized by the U.S. State Department to issue International Driving Permits as provided for in the United Nations Convention on Road Traffic (Geneva, 1949). Among the criteria established for such authorization is that the licenser has to be a non-profit organization and must be officially affiliated with automobile clubs in all foreign countries.

In 1968 AAA issued 238,766 International Driver's Licenses. Such licenses entitle U.S. motorists to drive in foreign countries and also permit foreigners to drive in the U.S.

International Motoring—Uniform Laws.—For many years, AAA has promoted uniformity in national laws and regulations applicable to international traffic. AAA representatives participated with U.S. Government officials when the United Nations promulgated the "1949 Convention on Road Traffic" at a conference in Geneva, Switzerland. This United Nations Convention (treaty) has greatly facilitated international motoring. The 1949 convention was ratified by 80 nations in all parts of the world including the United States, which ratified it in 1950. AAA was a member of the official U.S. delegation to the United Nations Conference held in Vienna, Austria in November 1968, which revised the Convention on Road Traffic. This revised and expanded "Convention on Road Traffic" is currently before the United Nations and will soon be distributed to the member nations including the United States for ratification.

Uniform Traffic Laws.—AAA and its affiliated clubs have since their inception promoted uniform traffic laws throughout the United States. Representatives of the AAA and its affiliated clubs actively participate in the activities of the National Committee on Uniform Traffic Laws and Ordinances. The National Committee published in 1926 the "Uniform Vehicle Code" which has been used, and the 1968 amended version is currently being used, by the 50 states as a guide in achieving uniform traffic laws. The draftsman for the Uniform Vehicle Code in the mid 1920's was then the General Counsel of the Automobile Club of Southern California. The General Counsel of the Chicago Motor Club played a prominent role in drafting the chapter of the Code dealing with Financial Responsibility. Currently, the Director of the Legal Department of AAA is chairman of the Rules of the Road Subcommittee of the National Committee.

AAA contributes annually $4,000 to the National Committee on Uniform Traffic Laws and Ordinances.

Digest of Motor Laws.—AAA publishes annually a "Digest of Motor Laws" of the 50 states and Canadian Provinces. The 36th edition was published in January 1969. Affiliated clubs distribute the Digest as a public service to municipal traffic court judges, state highway patrol and local traffic enforcement officials as an aid in their enforcement activities.

Auto Thefts.—In 1968 AAA representatives testified before Congressional committees in support of legislation subsequently enacted into law which prohibits the mailing of motor vehicle master keys. The AAA and its affiliated clubs actively participate in a public information campaign by the distribution of considerable pamphlets and material aimed at alerting motorists to the importance of removing keys from unattended vehicles and locking their cars. In 1968, 776,000 cars were stolen. Auto thefts are one of the country's most serious crime problems.

Speed Traps.—AAA with the full cooperation of its affiliated clubs investigates traffic arrest complaints and speed trap areas (traffic enforcement for monetary rather than for safety purposes). Where traffic arrest complaints involve highway design problems, such matters are brought to the attention of appropriate state and local Highway Departments as are complaints involving confusing signing, traffic signs, signals and markings. From time to time, AAA publishes a list of speed trap areas and "strict enforcement" areas where frequent traffic arrests are made. These lists are given wide public distribution, thus alerting the motoring public of such situations. Affiliated clubs throughout the years have promoted state laws to eliminate the "fee system"—arresting officer and traffic judge or justice of the peace is compensated on the basis of the number of traffic arrests and convictions rather than on a salary. (About 25 states still have the "fee system.")

Gambling Traps.—AAA and its affiliated clubs process and investigate complaints from out-of-state motorists who have been victimized by gyp artists when

they stop for food, pecans or just to rest. What happens is, the proprietor entices the traveler into rolling dice for a free meal, free alligator bag or some other item. Individual victims are normally taken for several hundred dollars before they depart—all in a matter of minutes. AAA with the cooperation of its affiliated clubs have been successful in having appropriate police authority eliminate several such gambling traps.

Traffic Court Reform.—For many years AAA and its affiliated clubs have worked to improve traffic courts throughout the country. Just recently, the Automobile Club of New York was successful in their support of a new approach. With the assistance of the five Borough District Attorneys of New York City, Mayor Lindsay, Governor Rockefeller, New York City Bar Association and the New York State Legislature, a law was enacted which will remove minor traffic law violation cases from the criminal courts of New York City to Administrative Hearing Officers of the State Motor Vehicle Department.

In addition to relieving the crushing backlog of criminal cases of the criminal courts of New York City, this new traffic court procedure should be most beneficial to the motoring public. If it proves successful, no doubt other AAA clubs throughout the country will follow the New York lead.

Protection of the Motorist as Consumer.—Through materials supplied to freelance writers and magazine editors, and through annually-distributed pamphlets, the AAA and its affiliated clubs help motorists to operate their cars with a maximum of economy and a minimum of difficulty. They are given figures on how much it costs to operate a car, how to figure vacation costs, state laws affecting car operation, special winter car-care, and so on.

Special recent efforts in this direction include a special report to the Federal Trade Commission on purchasers' complaints about new car warranties and a warning about gyp practices of some filling stations in selling unneeded car parts.

In light of the foregoing comments, we believe that the AAA and its affiliated clubs, is a unique organization in the motoring and travel field whose activities benefit far more than just its members. Thus, one may well wonder why this provision is a problem to the AAA as it appears to be directed at social clubs and other taxable organizations whose members have direct control over the dues structure.

As presently written, however, this section will apply to the AAA and, if passed, it will have catastrophic effects on our finances and will place us at a severe competitive disadvantage.

Our additional objections to this proposed Section 278 are as follows:

Section 278 is discriminatroy

The AAA and its affiliates are not exempt from income tax. We have no objection to paying our fair share of corporate income taxes and make no claim for special treatment. We do, however, object to tax discrimination and we believe that Section 278 of this Bill is unfair to our organization.

Members of the AAA are, in reality, persons who pay an annual fee, called dues, for the right to certain services such as emergency road service, personal accident insurance coverage, bail bond service, etc., as they may be needed. In this light, we see no essential difference between the AAA and mutual insurance companies. Yet insurance companies are specifically exempted from Section 278.

Furthermore, although the statutory language of Section 278 appears to make no distinction between corporations with stockholders and those without stockholders, page 49 of part I of the Ways and Means Committee report refers to corporations organized to provide services to members on a non-profit basis. This would appear to exclude corporations with non-member stockholders. Moreover, membership organizations (the words used in Section 278) are defined elsewhere in the code and this definition excludes corporations with stockholders. The AAA has no stockholders, but it is in competition with motor clubs operated by corporations which do have stockholders—and we mean stockholders other than the members.

These organizations, many of which are owned and operated by giant, well-financed corporations with access to the securities market for capital, compete directly with the AAA. Like the AAA, they have members and their purpose is to provide services to their members similar to those provided by the AAA to its members.

If organizations engaged in competition with the AAA, but which have a non-member stockholder interest, are to the excluded from application of Section 278

while the AAA is subjected to this provision, it is obvious that our ability to compete would be severely restricted. Our competitors may well be perfectly willing to render membership services at a loss simply as a "loss leader" because of other business (such as automobile insurance, gasoline, oil and other product sales) that can be obtained profitably from persons desiring these membership services.

If the AAA's competitors are permitted to deduct their membership operation losses while we are not, the unfairness of the proposed Section 278 is obvious.

Accurate prediction of membership service costs is impossible

Members pay dues to the AAA and its affiliated clubs for one year in advance. It is not practical to collect dues monthly or less than annually because of the small amounts involved. The dues charged are intended to be sufficient to cover the costs of providing services to the membership as a whole. In setting the annual dues, however, the Association and its affiliates have to deal with many variables which cannot always be predicted accurately. For example, one of the principal services provided to members is emergency road service. The demand for this service increases sharply in periods of bad weather, particularly in severe winters. If a particularly bad winter should occur, the cost to a club in carrying out its services often substantially exceeds the dues income for that year.

Under the provisions of Section 278 of this Bill, no deduction is to be permitted for the costs of serving members in excess of the income derived from the members. If a net operating loss results in any year, the loss would be disallowed forever. Under this Bill, the AAA and its affiliated clubs would be penalized the most in situations where, by reason of adverse weather conditions or other unforeseeable conditions, they have provided their services when they were needed the most. The AAA cannot predict motoring service demands and weather conditions a year in advance—yet we must set our dues this far ahead. We fail to see the justification for not allowing our organization a deduction for such costs simply because they may exceed dues in a given year.

If we guess incorrectly as to severity of the weather or the demand for other services by our membership, we bear the entire loss. If we guess correctly, income taxes will take away more than half our net income.

To illustrate that the question is not theoretical, we might point out that the AAA itself incurred a net operating loss in 1968 due in part to higher than expected emergency road service costs. If Section 278 were the law, this loss would have been disallowed forever.

Investment income—dues paid in advance

In 1960, Congress recognizing the problem faced by the AAA and similar organizations, enacted Section 456 so that an organization such as the AAA, which was obligated to render services beyond the close of a taxable year, would not be required to prepay its tax before it had performed the services for which the member had paid his dues. Thus, at the end of any taxable year, the AAA and its affiliates are obligated to render services after the close of this taxable year to their members with respect to dues previously paid.

These dues, having been collected in advance, are in the possession of the AAA and its clubs. Good business judgment requires that these funds, which are held for the benefit of the member until expiration of his membership, be invested at the best possible return. Under proposed Section 278, any income resulting from these invested funds is subject to tax without any offset even though this income results from the fact that dues are paid in advance of the receipt of services by the member.

Here is another instance of discrimination as taxable newspapers and magazines have received subscription income in advance and may invest these funds. Yet these publications are not required to be taxed on their investment income separately from the remainder of their operations.

Advertising and other income used to reduce publication costs

In carrying out its corporate purposes, as explained earlier, the AAA publishes maps, tour books, and other similar material which is provided to its individual members. The tour books and other publications describe and give ratings to hotels, motels, restaurants and similar facilities which have met AAA standards. The hotels, motels, restaurants, etc., are interested in attracting AAA members to use their facilities and therefore advertise in the tour books which are distributed to members.

Additionally, the hotels, motels, restaurants, etc., wish to advertise to the general public that they have AAA approval. A charge is made by the AAA for this privilege and establishments paying this charge are designated by the AAA as an "Official Appointment". The amounts paid by advertisers and official appointments are used to pay part of the publication costs of the tour books and to reimburse the AAA for the costs incurred in making inspections, assigning ratings, etc.

Thus, we have, in effect, a single integrated transaction much like the receipt of advertising revenue by a newspaper which is used to lower the cost of the publication to its subscribers. The hotels, motels, etc., pay for the privilege of publicizing their approved status to the membership. The members are interested in obtaining information regarding the facilities, their rates, their ratings, etc.

Under Section 278 of this Bill, this single integrated transaction may have to be divided into two parts; a transaction with members in providing them with tour books, maps, etc., and secondly, a transaction with non-members (hotels, motels, restaurants, etc.) in charging them for the advertising and for the "Official Appointments" by which they publicize their status to the members.

The AAA could be required by the Bill to pay taxes on the advertising and related revenue by which the hotels identify themselves to the membership without reduction of that revenue for the cost of the very publication which contains the advertising.

Yet a newspaper can apply its advertising revenue to its production cost without penalty in order to reduce the ultimate price to its subscriber. But the AAA would be penalized in a similar transaction.

Affiliated AAA clubs publish more than 136 periodicals for their members. Advertising revenue, which is obtained from non-member advertisers would be treated under this Bill as a separate taxable activity. Once again, a clear case of discrimination.

Allocation of costs between members and non-members is impractical

AAA and its clubs provide some services to non-members as mentioned earlier. AAA and its affiliated clubs could not provide certain services to its members unless it were willing to provide the same services to the general public. For example, the AAA is one of the few organizations permitted to issue international driving permits. The rules prescribed by the United Nations Convention on Road Traffic, covering such permits, provide that their issuance may not be limited to members but must be available to anyone.

Similar regulations are enforced by the Air Traffic Conference and the International Air Transport Association as well as the various steamship organizations. Thus, clubs cannot sell airline tickets, steamship tickets, and other forms of transportation to members only. But under the provisions of Section 278, we would be required to segregate dealings with members from non-members and compute taxes separately for non-member transactions. It would be difficult and expensive, if not impossible, to develop a cost accounting system that would make a reasonable allocation of costs between non-members and members. Even if such a system were developed, the costs of operation would place an additional financial strain on the clubs and the system would be a source of continual argument between the Internal Revenue Service and the individual clubs.

We understand that the Revenue Service has had difficulty in applying costing principles in the regulations issued pursuant to Section 482 (allocation of income and deductions among taxpayers). Our accountants advise that there would be similar if not greater difficulties in the allocation of costs between member and non-member activities.

In addition, unless similar rules would be applied to competitors of AAA clubs, Congress would be favoring some taxpayers over others. We refer specifically to oil companies which operate motor clubs.

The AAA and its affiliates spend considerable sums of money each year on public service activities as those outlined earlier in this statement.

Expenditures of this type are basic to the very nature of our organization. If we were a different type of organization, we might have used these monies to reduce members' costs or to provide additional services to them. But our objectives are much broader. There is no measurable financial gain from such public service activities. They benefit the public, including our members. Does Section 278 require us to allocate these costs in some fashion between members and non-members?

Section 278 is too broad in scope

We appreciate the effort to close the loopholes in unrelated business income of tax-exempt organizations while at the same time trying to prevent them from escaping by adopting a non-exempt status.

In our case, our investment and other income is clearly related to the stated purpose of our organization. Unlike social or other organizations in which the membership has direct control, our dues structure is not based upon the whims of the membership but is determined by competitive conditions and costs in the marketplace.

Therefore it is vitally necessary for the AAA, to develop supplementary income because sharply increasing its dues would price it out of business. In effect, what this provision of the bill would do would be to force us to curtail our many public service oriented activities in order to remain competitive.

The all-encompassing scope of Section 278, is we submit, too broad for the apparent purpose for which it was designed. This is demonstrated by the fact that only banking and insurance institutions were specifically excluded.

Recommendation

As previously explained, it appears that proposed Section 278 was aimed at certain specific abuses, actual or anticipated, by some organizations. However, its language is such that it also penalizes organizations, such as the AAA, which are not guilty of these abuses.

We therefore strongly recommend that the Committee carefully consider the full implications of this section. After a full and complete study, if the Committee still agrees that Section 278(a) is required as presently worded, then we would urge that Section 278(b) be amended so that Section (a) would not apply to non-abusers such as the American Automobile Association.

Senator ANDERSON. Mr. Janetatos.

STATEMENT OF JACK P. JANETATOS, ATTORNEY, NATIONAL CLUB ASSOCIATION AND CLUB MANAGERS ASSOCIATION OF AMERICA; ACCOMPANIED BY KENNETH EMERSON, EXECUTIVE DIRECTOR, NATIONAL CLUB ASSOCIATION; E. GUENTER SKOLE, CHAIRMAN, GOVERMENTAL AFFAIRS COMMITTEE, CLUB MANAGERS ASSOCIATION; AND WALTER A. SLOWINSKI, COUNSEL

Mr. JANETATOS. Mr. Chairman and members of the committee, I am Jack P. Janetatos of the law firm of Baker & McKenzie of Washington, D.C. I am appearing on behalf of the National Club Association and the Club Managers Association of America. With me today is Mr. Kenneth Emerson, executive Director of the National Club Association; E. Guenter Skole, manager of the Cosmos Club and chairman of the Governmental Affairs Committee of the Club Managers Association of America; and my partner, Walter A. Slowinski of Baker & McKenzie.

The National Club Association is a trade association comprising more than 700 of the private, bona fide social clubs in the Nation, including country clubs, athletic clubs and town clubs. The Club Managers Association of America is an association of nearly 2,000 professional managers of bona fide social clubs in every State and nearly every metropolitan area of the United States.

We are here today as spokesmen for the clubs, their managers, and most importantly, for the several million members of these clubs. Our purpose is to give you our views on H.R. 13270, the Tax Reform Act of 1969, as it pertains to social clubs exempt from Federal income tax under section 501(c)(7) of the Internal Revenue Code of 1954.

THEORY OF EXEMPTION

Congress included the predecessor of the present section 501(c)(7) in the Revenue Act of 1916. It was explained at that time that social clubs were being exempted from the income tax because the Treasury Department had found the securing .ax returns from social clubs was "a source of expense and annoyance and has resulted in the collection of either no tax or an amount which is practically negligible."

Clearly, the drafters of the bill before us today understand the nature of the social club tax exemption. As stated in the Ways and Means Committee report (H. Rept. No. 91-413 (pt. 1) 43): "the tax exemption for social clubs * * * is designed to allow individuals to join together to provide recreational or social facilities on a mutual basis, without tax consequences." This is and always has been the theory of exemption and the basic operating principle of these clubs.

PROBLEMS UNDER PRESENT LAW

The report on this bill, after describing the theory of exemption, goes on to state that "the tax exemption operates properly only when the sources of income of the organization are limited to receipts from the membership." This is a concise reiteration of the most significant problem faced by the Internal Revenue Service in administering the social club exemption. The subject of nonmember business in social clubs has been taken up in numerous court cases and Revenue rulings spanning a long period of time. The chief problem has been to determine what constitutes nonmember business and how much of it is permissable.

At the outset it must be made clear that the exemption contemplates that clubs raise their operating funds in many ways in addition to fees, dues and assessments paid by members. In many cases the principal operating income of a club is derived from the operation of food and beverage facilities. No violence is done to the exemption where the food and beverage sales are made to members. This is not the operation of a bar and restaurant business. It is no more than a convenient method of dividing the cost of operation of the club among the members in accordance with the quantity of services, goods and facilities consumed and used by each member. To the extent of uniform charges to all members, they bear the cost equally. To the extent of individual charges made to each member for consumables and use of facilities, essential fairness in cost allocation is achieved.

Consistent with the theory described, clubs are permitted to allow use of facilities not only by members but also by the guests of the members. Most of our clubs permit members to entertain guests at the club in a manner similar to the way the member would entertain a guest in his own home. This is the simplest case of nonmember use of club facilities and is certainly permissable under present law. Further, the bill would not seek to impose a tax in this situation and this is proper.

But beyond this member and guest of member situation, there are categories of nonmember use of social club facilities which are impossible to avoid and which provide a definite benefit to the communities involved. Many of our clubs permit nonmembers to use the club facilities in ways that further exempt purposes and do not amount

to doing business with the public. The Red Cross, hospitals and similar organizations use social club facilities for fund-raising drives. Schools use country club golf courses for their golf teams. Civic organizations use clubrooms for meetings for governmental, educational and community functions. To tax this use will be to deny these civic and charitable benefits to our communities with small benefit to the revenue and a senseless waste of a useful and beneficial asset.

The necessity for this type of activity is and has long been apparent. The Internal Revenue Service has, however, recognized that abuses may occur, and has adopted a guideline. Revenue Procedure 64-36 stated that when nonmember receipts were less than 5 percent of total gross receipts, a club would not be considered as having an intent to do business. When nonmember receipts exceeded that amount, the IRS would take a closer look at a club's operation, examine each function to see if it did indeed qualify with the standards of exemption. When the guideline was exceeded the IRS had no choice but to revoke the exemption of the offending club and collect taxes from it just as if it were an ordinary business corporation.

EFFECT OF THE NEW LAW

The new bill seeks to eliminate at least this last problem. The IRS will now be permitted to tax this unrelated business and leave the exempt operations undisturbed. This new procedure will enable the IRS to police the activities of clubs and to levy an appropriate tax on the now-exempt activity only when it is found that operations are improper. It avoids the necessity for revocation of exemption. The new law, we believe, will permit clubs to engage in business with the general public and be taxed on the profits, so long as the principal purpose of the club remains social and recreational. We urge that this committee explain this change in its report to avoid needless complexity and expensive litigation.

Our industry feels that the imposition of this tax on activities which are motivated by charitable and civic intent would be harmful. We would urge that this committee preserve the present availability of club facilities for these purposes by giving legislative authority to the present 5-percent rule which has worked well over the past 5 years. The tax would then be levied on the true unrelated business activity of those clubs which actually do business with the public.

The Tax Reform Act, in extending the tax on unrelated business income to social clubs, begins by imposing the tax on gross income. Then the bill permits to be subtracted from gross income those deductions "directly connected" with the earning of the income less "exempt function income." The important words here are "directly connected." More care must be taken to see that the term is clarified. Clearly the cost of goods sold and direct labor are directly connected. But beyond this it would appear that the bill leaves it to the IRS and the courts to interpret the meaning of the words. This interpretation is necessary and should be made now by this committee, for both the obligation and the opportunity are here.

It is our understanding that the intention of the bill is to tax profits made by a club, earned from sources other than members and their guests. There is no intention to tax anything other than the net prof-

its—it is a tax, not a penalty. This being so, we urge this committee to insure that all deductions are allocated and permitted to be set off against this gross income. By this we include all items of overhead, administrative expenses, depreciation, and capital charges which helped to produce the income being taxed.

After the directly connected expenses are deducted from gross income, the taxpaying club then deducts its "exempt function income." This is defined as "gross income from dues, fees, charges, or similar amounts paid by members of the organization as consideration for providing such members or their guests goods, facilities, or services in furtherance of the purposes constituting the basis for the exemption of the organization to which such income is paid."

This definition, as it stands, incorporates numerous existing problems and unresolved issues. Some of these are: What are dues, fees, and charges? What amounts are paid by members? Who are guests? What is the basis for exemption? and What activities are in furtherance of this basis.

We see no necessity for so complex a definition. We would propose dropping the words "dues, fees, charges, or similar," as not essential or helpful to the definition. Exempt function income would then include "gross income from amounts paid by members. * ** *" To retain these words invites an attempt to exclude items of income as being something other than of the categories described. It is felt that the intent of this bill is more accurately expressed by the simpler language urged here.

The definition incorporates another issue: how to determine what activities are in furtherance of the exempt purposes. We feel that this is a needless complication. If the organization qualifies for exemption, then all receipts from members should be part of the exemption.

As an example, some clubs maintain rooms where members may reside, either temporarily or as permanent residents. There are cases now pending, we understand, where the IRS contends that this is not in furtherance of the exempt purposes of the club. That this activity is exempt seems to us beyond question, but as in many areas, what is clear to taxpayers and even this committee when drafting legislation can become very unclear when the administrators take the opportunity to put their inventiveness to bear on the statute. Perhaps it is worth noting that social clubs have been providing lodging to their members continuously since long before 1909 when the tax on corporations began.

We propose then that the words "in furtherance of the purposes constituting the basis for the exemption of the organization to which such income is paid," be eliminated. This simplifies the definition, does not detract from any beneficial aspects of the section, and avoids harmful and needless confusion and litigation.

Our association, many clubs, and the Internal Revenue Service have worked hard over the past 10 years in an attempt to define the term "guest." We must admit that we have had small success; we have been unable to agree upon a satisfactory definition to be applied even in relatively common situations. As an example, it is clear that when the father of the bride holds his daughter's wedding reception at his club, all of the funds are from a member. But when the function is held at the club of the father of the groom and the bride's father pays

the bill or reimburses the groom's father, the nature of the funds is not clear. It appears that, under present law, this is treated as a member function. Under the bill as it is written an opposite result may be possible. Yet another issue occurs when the member pays the bill for use of the club and is later reimbursed by his guest or by his employer. What does the bill mean by "paid by members"? Can the club be expected to look behind every payment made to it? We think not in most situations. In some cases, however, the answer is clear. If a member, the sales manager of a company, holds a party for 300 customers, the club now inquires whether he is being reimbursed and if so the receipts are considered outside income for purposes of the 5-percent rule.

Numerous other questions have arisen and will continue to arise. The wording of the bill gives new significance to these questions and indeed serves to further confuse an already complex issue.

Unlike the treatment given to other exempt organizations, the new bill allows very few of the modifications allowed generally by section 512(b) of the code. The bill will permit clubs to deduct only the net operating loss, charitable contributions, and the $1,000 specific deduction. This will have the effect of taxing all dividends, interest, rents, royalties, and gain from the sale of property.

We feel that the authors of this bill have given little thought to the effect of this tax and less thought to the reasons for it. It may well be that clubs should not have their operations supported by the proceeds from investments. This is forbidden under present law. Investment income in any significant amount will cause loss of exempt status.

None of our clubs are speculators or traders in real estate or investors in the stock market. Any capital gains which occur are the result of adverse occurrences in a club's history and investment income is usually a further result.

Gains from the sale of property by clubs sometimes occur when governments take property from clubs for public purposes by right of eminent domain. Perhaps a highway is to be built through the golf course. Another reason for sale is that property taxes may make continued holding of land economically impossible. As the cities expand to surround clubs, adjacent intensive land use causes large increases in property tax assessments. Only a few of our more progressive taxing authorities have provided relief in this situation. Where no legal relief is available, the club must sell its old land and facilities and move on to a location farther away from the intensively developed areas.

Should a tax be imposed upon the proceeds of such a sale, many of our clubs would be unable to reinstitute operations and would have to liquidate. With the cost of acquisition of rural land so high, and the costs of construction so great, the expenses of moving and rebuilding equal the proceeds of sale. Such a tax as is here proposed will in the long run prove destructive to an honorable and worthwhile segment of our Nation's recreational activities. It does not seem that the purpose of the income tax should be to destroy.

But if this tax on gain must be, then it must be tempered with fairness. In this event, exemption from the tax must be provided where the funds are used within a relatively short time, perhaps 5 years, for the reacquisition of new facilities.

Further, many of our clubs have been in the same location for a hundred years or more. When computing their basis they should not go back to 1913. When the tax on gain was instituted, that year of imposition was used to measure basis. If a tax on gain should be imposed on a new class of property owners, their basis should be measured just as in other case—from the time of the imposition of the tax.

Once the proceeds from such a sale are in hand, there is a timelag before the money can be paid out for new facilities. This may be a period of from 3 to 5 years. The funds cannot be allowed to sit idle and are usually invested in Government securities or bank accounts. The interest yield on these funds barely keep pace with inflation and perhaps the pace of inflation even causes the worth of funds to decrease. A tax on this income compounds an already bad situation. An exemption from this tax should be provided for funds held for use in rebuilding the club.

CONCLUSION

We are then not wholly opposed to the Tax Reform Act and its aims. Much good can come from this bill and our industry is willing to pay its just share of taxes. We do not shirk this duty. What we ask is a statute that does not force our clubs into needless and expensive litigation and administrative proceedings. We ask clarity and sensible precision of legislative language. We hope that our comments today will contribute to this end.

Senator MILLER. Just one question. If a governmental organization condemns a golf club for the purposes of a highway, and there is a profit involved in that capital gain, do you not come within the exemption of the reinvestment provisions?

Mr. JANETATOS. In many cases in the case of condemnation, some clubs may.

Senator MILLER. Thank you very much.

Senator ANDERSON. Our next witness will be Denvel D. Adams. I am very happy to welcome Mr. Charles Huber, whom I have known for many years.

STATEMENT OF DENVEL D. ADAMS, NATIONAL ADJUTANT, THE DISABLED AMERICAN VETERANS; ACCOMPANIED BY RAYMOND NEAL, NATIONAL COMMANDER; CHARLES L. HUBER, NATIONAL DIRECTOR OF LEGISLATION; AND DONALD C. ALEXANDER, COUNSEL

Mr. HUBER. Mr. Chairman, I would like to introduce our new national commander, Mr. Raymond Neal from Daly City, Calif., on my right.

On my left, Mr. Don Alexander, our tax counsel; on my immediate right, Mr. Denvel Adams, who is our main administrative officer, and who is also responsible for our fund-raising, and he will give our summary.

Mr. ADAMS. Mr. Chairman, the DAV has submitted a detailed statement to this committee relating to the subject of tax reform, and in the light of the extreme pressure of time on you and on the committee, I shall be very brief.

I would, however, like to begin by stating in one short sentence just what the DAV is. The Disabled American Veterans is a nonprofit corporation chartered by an Act of Congress in 1932.

Its principle purpose under that charter is to render free assistance to veterans and their families, whether such veterans are members of the DAV or not.

The nationwide staff of national service officers who render this assistance are certified by the Veterans Administration as attorneys-in-fact to represent the veteran in all matters pertaining to his claim.

We employ 140 full-time officers for this purpose. In the past year we represented over 220,000 veterans and their dependents. We made over 108,000 appearances before Veterans Administration rating boards, and we assisted in the securing of over $186 million in benefits for the veterans and their dependents.

In order to sustain this vast program we must depend upon charitable contributions received from the general public. The dues paid by our membership of over 270,000 are grossly insufficient to fulfill our chartered task.

Therefore, substantially all the funds supporting our program of service to the wartime disabled are derived from direct mail solicitations, principally the auto owners of the United States.

Mr. Chairman, we submit that these fund-raising activities of the DAV are not competitive with private enterprises. Therefore, it has no income which should be considered unrelated to the purpose for which it was congressionally chartered.

Thus, the DAV does not oppose enactment of section 121(a) of H.R. 13270. However, Mr. Chairman, enactment of the tax on unrelated business income without clarification of its scope might encourage the Internal Revenue Service to interpret quite broadly the terms "unrelated business."

This could happen in spite of the statement of the Assistant Secretary of the Treasury in explaining the extension to this committee. He stated:

> The business income of churches and other exempt organizations from commercial transactions in direct competition with tax-paying businesses would no longer be tax-exempt.

DAV urges this committee to make it quite clear that any extension of the unrelated business income provision is intended only to impose a tax upon the commercial activities involving direct competition with tax-paying businesses which have heretofore been beyond its reach.

Briefly and finally, Mr. Chairman, the DAV conducts no commercial transactions or competitive activities. It is not in direct competition with tax-paying enterprises. It has long relied upon he familiar Idento-tag and other traditional forms of fund-raising to support its extensive program of service to veterans.

The imposition of a tax on funds so raised would diminish to the point of disaster the DAV's ability to assist America's wartime disabled. Such a diminution would occur as our service is even more vitally needed by those returning from the battlefield of Vietnam.

An extension of the unrelated business income tax through the charitable solicitation program of the DAV would, therefore, not be in the public interest.

We urgently request this distinguished committee to prevent specifically any extension of the unrelated business income tax to DAV's historic sources of revenue.

I thank you, Mr. Chairman. That is the extent of our statement.

Senator ANDERSON. Thank you very much for being brief.

(The prepared statement of Mr. Adams follows:)

STATEMENT OF DENVEL D. ADAMS, NATIONAL ADJUTANT, DISABLED AMERICAN VETERANS

Mr. Chairman and members of the committee, The Disabled American Veterans appreciates this opportunity to express its views on the important subject of tax reform.

The Disabled American Veterans is a non-profit corporation charactered by Act of Congress (P.L. 72-186) on June 17, 1932. Eligibility for membership is restricted to those who have been wounded, injured or otherwise disabled while serving in the Armed Forces of the United States during time of national emergency.

The DAV was chartered by Congress to uphold and maintain the Constitution and the laws of the United States; to realize the true American ideals and aims for which its membership fought; and to aid and assist disabled veterans, their widows, orphans and dependents. It cooperates with the United States Veterans' Administration and all other public and private agencies devoted to advancing the interests and working for the betterment of all disabled veterans, DAV members and nonmembers alike.

Empowered by statute to establish state and local units, the Disabled American Veterans has approximately 1900 local chapters throughout all 50 states. As of June 30, 1969, 282,045 active members were on its rolls.

The DAV devotes the major portion of its efforts to providing free representation and assistance to hundreds of thousands of disabled veterans and their dependents in the complicated task of establishing legal entitlement to veterans' benefits. In this work, our National Service Program employs 140 full-time National Service Officers.

In the fiscal year ending on June 30, 1969; DAV National Service Officers, who are stationed in all of the 64 Veterans' Administration Regional Offices, represented 220,358 claimants, made 108,507 appearances before Veterans' Administration Rating Boards, and assisted in securing $186,434,275.94 in monetary benefits for veterans and their dependents.

The advantages of the National Service Program—which costs the DAV in excess of $2,000,000 per year to provide—are offered free of charge to all veterans and their dependents, without regard to membership in the organization. The DAV, a non-profit organization, must depend upon charitable contributions received from the general public to finance its service activities.

TAX REFORM

In view of the importance which this nation has long attached to private philanthropy, the Congress has made special tax provisions for charitable, religious and social welfare organizations. Since circumstances may change, it is entirely appropriate that these provisions be re-examined from time to time to make certain that they promote the values for which enacted and do not permit abuse or undeserved advantage.

During the course of these hearings, a broad range of proposals for tax reform, both those contained in H.R. 13270 and others, will be considered. The DAV wishes to make known its views on some of these.

UNRELATED DEBT-FINANCED INCOME

The DAV supports the enactment of legislation that would tax the unrelated debt-financed income of all tax-exempt organizations.

Through the loophole revealed by the *Clay Brown* case, tax-exempt organizations have been enabled to compete unfairly for the acquisition of commercially competitive businesses. Enactment of Section 121(d) of H.R. 13270 would effectively prevent a tax-exempt organization from trading on its exemption. It would place such organizations in the same position as other would-be purchasers.

SELF-DEALING

Section 101(b) of the Tax Reform Bill strengthens the Government's hand in combating self-dealing. The DAV supports this provision. Further, the Committee is invited to note that Article XVII—Section 17.0, of our National By-Laws states:

Para. 1: "This corporation is not organized for profit. It shall issue no stock. No part of its net earnings shall inure to the benefit of any individual. No member shall have any pecuniary interest in any of the income, earnings, assets or property of this corporation, nor shall any part thereof be withdrawn or distributed to any of its members."

Para. 2: "Upon final, dissolution or liquidation of this corporation, and after the discharge or satisfaction of all outstanding obligations and liabilities, the remaining assets shall be distributed to such charitable corporation as a court of competent jurisdiction determines to have purposes closest to those of this corporation."

FULL PUBLIC DISCLOSURE

The DAV approves the new provisions dealing with disclosure and publicity, although the affairs of the Disabled American Veterans could hardly become more public than now is the case.

In accordance with P.L. 88-504, the accounts of the DAV—as one of the few non-profit organizations established under Federal law—are audited annually by independent certified public accountants and these audit reports are submitted to Congress. Each report contains a full statement of income and expenses for the year.

Additionally, on December 18, 1967, the DAV's Congressional Charter was amended by P.L. 90-208, which provides:

(b)(1) "That said corporation shall as soon as practicable after the close of each of its fiscal years make and transmit to the Comptroller General a report of its proceedings for the preceding fiscal year, including a full, complete and itemized report of receipts and expenditures of whatever kind, which report shall be duly audited by the Comptroller General."

In its report (No. 898) on the bill, H.R. 2152, the Senate Judiciary Committee said, in part:

. . . "Of all the various congressionally chartered organizations engaged in veterans' service activities, only the Disabled American Veterans and the American National Red Cross have nationwide service programs financed and paid for by the national organizations. The Disabled American Veterans specific orientation is toward the disabled veterans and its service program is devoted exclusively to the welfare of disabled veterans. To carry out its purpose the Disabled American Veterans operates on a national rather than a State or departmental level having full-time nationally paid professional representatives stationed in every Veterans' Administration regional office to provide free service to the veterans of every state. This service is provided withotu regard to membership or affiliation."

Moreover, by resolution adopted at the beginning of each Congress, the House Committee on Veterans' Affairs is authorized to determine whether additional supervision of the fund-raising activities of veterans' organizations chartered by Congress is necessary or desirable.

UNRELATED BUSINESS INCOME TAX

The activities of the DAV are not competitive with private enterprises. Therefore, it has no income which should be considered unrelated to the purpose for which it was Congressionally chartered. The DAV thus does not oppose enactment of Section 121(a) of H.R. 13270.

Extension of the tax on unrelated business income without clarification of its scope, however, might encourage the Internal Revenue Service to interpret the term "unrelated business income" very broadly. This could happen in spite of the statement of the Assistant Secretary of the Treasury in explaining this extension to this Committee; "The business income of churches and other exempt organizations from commercial transactions in direct competition with taxpaying business would no longer be tax exempt."

Such a broad interpretation might encompass a major portion of the funds used to operate the DAV, though they are contributions obtained by traditional fund-raising rather than revenue of a commercial business.

The DAV urges this Committee to make it quite clear that any extension of the unrelated business income provisions is intended only to impose the tax

upon the *commercial* activities of those who until now have been beyond its reach. As the House Report (H.R. Rep. No. 91-413 (Part 1) 91st Cong., 1st Sess. 47) on this provision notes, "There is inequity in taxing certain exempt organizations on their 'unrelated business income' and not taxing others." However, the extension should not be interpreted by the Internal Revenue Service as a license to attack every source of funds for an exempt organization.

The Committee is undoubtedly aware that the primary objective of the adoption of the unrelated business income tax in 1950 was to eliminate unfair competition by placing the commercial activities of tax-exempt organizations upon the same tax basis as the taxpaying business enterprises with which they compete. The activities intended to be taxable were regular competitive businesses operated by exempt organizations, such as a macaroni factory, a tire factory and the sale of spark plugs and ceramics.

The proposed extension simply would ensure that income from such commercial activities would be taxed in the hands of all exempt organizations. The House Report on this bill notes the various full-scale businesses that have been engaged in by organizations until now not subject to the tax on unrelated business income: bookstores, hotels, factories, radio and TV stations, record companies, groceries, bakeries, cleaners, etc.

The DAV conducts no activities such as these. It has long relied, however, upon mailing idento-tags (a small tag bearing the recipient's automobile license plate number) to individuals as a method of seeking contributions. The commercial value of the tag is negligible and it is not marketed by private enterprise. The recipient is told that he may keep the tag whether or not he contributes and, in fact, many recipients do not contribute. The tag simply is a way to gain the attention of the potential contributor in much the same way as paper flowers sold on streets corners and Salvation Army musical groups.

The DAV also sends out other mailings describing its work, requesting donations for it, and suggesting that various books, usually with patriotic themes, will be sent upon receipt of a contribution in a certain amount. The amount of the contribution is far in excess of the commercial value, if any, of the particular book. The response of the contributor arises not from a commercial judgment of the value to him of the book, but from his charitable impulses. His decision upon contributing is that the goals of the DAV, which has succeeded in bringing itself and its purposes to his attention, are ones which he desires to support. Such a solicitation technique is not a commercial business transaction where the motive of the individual in parting with money is the receipt of a quid pro quo in material goods.

Like so-called "passive" investments—rents, royalties, capital gains and dividends—which will continue to be nontaxed sources of revenue if not subject to the tax on debt-financed income, such methods of soliciting contributions present no competitive threat of significance to taxable enterprises. An individual seeking to obtain a particular article will rely upon commercial sources where the cost to him will approximate the value of the item obtained. If, instead, he makes a contribution as a result of the mailing of an idento-tag to him or if he makes a contribution in the amount requested to receive a particular book, such contribution, above the commercial value, if any, of the token or item to him, must be based upon charitable motivation.

If the Internal Revenue Service were to attack successfully these traditional fund-raising techniques, it would be disastrous to the DAV. A drastic curtailment of DAV's national service activities would occur and at a time when they are vitally needed by the wounded and disabled veterans returning in ever-increasing numbers from the battlefields of Viet Nam.

Unlike profit-making corporations, the DAV has no prices that can be increased to offset the assessment of income tax. It has no consumer, only a prospective contributor whose benevolence enables the DAV to provide vitally-needed assistance for disabled veterans, their widows and their orphans.

The United States Congress has provided much in the way of rehabilitation benefits for this nation's veterans. None of these benefits are given automatically, however. In every case, a claim must be filed and proved. It is thus as necessary for the disabled veteran to have expert representation in the development and presentation of his claim as it is for any citizen to have a lawyer represent him in an action in court. National Service Officers of the DAV, as "Attorneys in Fact," represent their claimants before the Veterans' Administration Rating Boards in a manner similar to that of an attorney presenting a case for his client.

It should be pointed out in this connection that, because of the $10.00 limitation

on legal fees imposed by Section 3404(c) of Title 38, United States Code, it is virtually impossible for a veteran to retain an attorney to represent him in a claim for veterans' benefits.

Imposing of tax on DAV's funds would greatly diminish its ability to assist America's veterans in the preparation, presentation and prosecution of claims under laws administered by the Veterans' Administration.

If the Government undertook the financial burden of replacing our services, the taxpayers would have to bear a greatly increased cost; but if the Government did not do so, the disabled veterans of the United States would suffer greatly. An extension of the unrelated business income tax to the charitable solicitation programs of the DAV would therefore not be in the public interest.

We urgently request this distinguished Committee to make certain that any extension of the unrelated business income tax does not apply to the Disabled American Veterans' traditional sources of revenue.

Senator ANDERSON. Mr. Riddell, go ahead.

STATEMENT OF JAMES W. RIDDELL, TAX COUNSEL, VOLUME FOOTWEAR RETAILERS OF AMERICA

Mr. RIDDELL. Mr. Chairman, my names is James W. Riddell. I am a member of the firm of Dawson, Quinn, Riddell, Taylor & Davis, and I appear here on behalf of the Volume Footwear Retailers of America and the Committee of Consumer Finance Companies.

While this is my formal representation, in effect I speak, together with the other witness who appears here on this subject today, for what is truly the main street of virtually every American town. In other words, we are speaking on behalf of what? One small retailer and small service operation. These operations produce a relatively small profit on a fixed investment that is relatively high, and because the people who engage in this sort of business specialize they get no benefit out of vertical integration.

These operations spread from geographic location to geographic location to make a relatively small amount of profit.

We oppose the provisions of the House bill which would repeal the privilege of claiming multiple surtax exemptions—of filing multiple tax returns.

We recognize, however, that the House's position can be lived with only if a phaseout period is permitted which will permit a readjustment in methods of doing business, and to that end we urgently request this committee to permit us a phaseout period of 10 years, and that during the phaseout period of 10 years we be permitted a 100-percent dividend received credit and 100 percent of our intercorporate losses.

In other words, the same privileges which are accorded the businesses which claim consolidated returns.

In addition, we would hope that the effective date of the bill would be changed from taxable years beginning on or after December 31, 1968, that is, taxable years 1969 to taxable years beginning after December 1, 1969. That is to say, 1970 taxable years.

I will be happy to answer any questions you have, Senators and otherwise that concludes my statement.

Senator ANDERSON. You are suggesting 10 years?

Mr. RIDDELL. Yes, sir.

Senator ANDERSON. Any questions?

Senator BENNETT. I will pass until I get this question clearly in my mind.

Senator MILLER. I have no questions.

Senator JORDAN. I have no questions.

Senator BENNETT. The question that has been suggested to me is why shouldn't you ask the same rate of exemption in this tax as you now get from the reduction in the multiple surtax?

Mr. RIDDELL. Well, the purpose of the phaseout period, if I understand it, is to give people who have utilized multiple surtax exemptions an opportunity to put themselves in a position to consolidate. That is the whole purpose of the bill.

Now, that is going to require the flow of funds from the various subsidiary corporations back to the principal or parent company and is going to require a redistribution of funds.

The retail industry in the case of shoes may change completely because of this provision in order to maintain any form of competition with say, Sears & Roebuck, J. C. Penney, and other companies which are selling a whole lot more shoes than we are. Of what interest is it to either the Treasury or to the Ways and Means Committee or the Finance Committee, if that is the objective. It would appear that to permit us to accomplish the objective as soon as possible and with as little disruption as possible would be the objective of Congress.

Senator BENNETT. And your estimate is 10 years.

Mr. RIDDELL. Yes, sir.

Senator BENNETT. In other words, you want to postpone the tax for 10 years. The ordinary concept of a phasein is that you change it 10 percent a year for 10 years. But, as I understand your testimony, you want to, in effect, postpone the tax for 10 years.

Mr. RIDDELL. No, no. Under the House bill it would be changed proportionately over a 10-year period.

Senator BENNETT. Yes.

Mr. RIDDELL. Now, with the change in the tax we ask an additional benefit, that is to say, that during the 10-year period we be permitted to shift our losses, and we incur many losses, not over the same proportionate period, that is ratable but be permitted to do it at once.

In other words, the corporation A has a $100 loss and corporation B has $200 worth of profits. A consolidated return would today permit an immediate shift.

Now, I say I would like the same privilege without having to spread it over the 10-year period. Similarly, with the corporate dividend received credit. I would have to wait for the 10th year under the House bill to get a 100-percent credit. I would like to take it at once, to get ready for whatever adjustment this bill is going to force us to as a matter of business necessity.

Senator BENNETT. Well, the ordinary corporation gets 85 percent corporate exemption. Are you talking about 100 percent of the 85 percent?

Mr. RIDDELL. Yes.

Senator BENNETT. And not 100 percent—when you testify for 100 percent it sounds as though you are testifying for a complete elimination.

Mr. RIDDELL. I am talking about 100 percent of the credit.

Senator BENNETT. OK. No further questions.

Senator ANDERSON. Thank you very much and your complete statement will be placed in the record.

(Mr. Riddell's statement and exhibit follow:)

STATEMENT ON BEHALF OF THE VOLUME FOOTWEAR RETAILERS OF AMERICA AND OF THE COMMITTEE OF CONSUMER FINANCE COMPANIES

My name is James W. Riddell of the law firm of Dawson, Quinn, Riddell, Taylor & Davis, 723 Washington Building, Washington, D.C. I appear as tax counsel for the Volume Footwear Retailers of America and the Committee of Consumer Finance Companies to state the opposition of these groups to the multiple surtax exemption provisions contained in H.R. 13270, the Tax Reform Act of 1969.

Under existing law, every member of an affiliated group of corporations which was formed for purposes of expanding a growing business is permitted to file a separate tax return and claim a surtax exemption. This privilege is accorded at the price of an additional six percentage points of corporate tax. Under the provisions of H.R. 13270, this privilege would be withdrawn over a period of eight years.

Under existing law, members of an affiliated group which files a consolidated return are entitled to only one surtax exemption, but they are permitted, without penalty, to claim the losses of unprofitable corporations within the affiliated group against the earnings of profitable corporations within the group. Additionally, they are permitted a 100% credit for intercorporate dividends received. H.R. 13270 would permit an increasing intercorporate dividends received credit and, in addition, would provide a limited ability whereby intercorporate losses could be claimed against intercorporate profits.

My clients oppose the repeal of the privilege of claiming a multiple surtax exemption. We do not believe that the result put forth in H.R. 13270 can be supported in fact and we believe that the increase in tax which will result therefrom can only be reflected in increased prices for goods and services. The legislative history of the policy of permitting multiple surtax exemptions is as follows:

LEGISLATIVE HISTORY

The Revenue Act of 1950

This legislative policy was first enunciated in the Revenue Act of 1950 when the surtax exemption was first allowed by the law. As you will recall, up to that time the corporate rate structure provided for graduated rates which resulted in a notch problem. The notch rate or 53% bracket rate applied to the income of corporations between $25,000 and $50,000 and was objected to on the grounds that corporations normally having incomes somewhat over $25,000 had little incentive to increase their earnings since 53¢ out of each additional dollar earned until they reached the $50,000 income tax level was taken by the Federal Government in taxes, leaving only 47¢ for the other needs of the corporation. On the other hand, corporations with incomes over $50,000 had a much greater incentive to expand their earnings since the rate schedule took only 38¢ out of each additional dollar in their case, leaving 62¢ for the other purposes of the corporation. The Congress decided to eliminate this 53% marginal or notch rate and the device chosen for this purpose was the allowance of a surtax exemption on the first $25,000 of taxable income earned by a corporation.

House Report No. 2319, accompanying H.R. 8920, which became the Revenue Act of 1950, specifically states that the exemption would be available to all corporations. The Report provides as follows:

"The bill eliminates the notch rate by providing a flat $25,000 surtax exemption which would be available to all corporations. This will provide tax advantages to small businesses without introducing a system which is readily adaptable to a drastic graduation of rates.

"The particular exemption plan in your committee's bill provides only a single exemption which it is believed best expresses the idea of a flat tax rate modified by a concession for small businesses. It is also believed that this single exemption plan has a number of advantages over a multiple exemption system First, the single-exemption system is much simpler and could be presented on the tax form in a way which would make it easier for the taxpayer to compute its tax. It should also be pointed out that the single-exemption system would make it possible to consolidate the normal tax and surtax computation. While this might also be possible in the case of a multiple-exemption plan or a graduated rate plan, difficult problems would, in any case, be presented under such plans in the handling of such items as partially tax-exempt interest and the special tax treatment accorded Western Hemisphere trade corporations and dividends paid by public utilities on certain preferred stock."

The Revenue Act of 1951

The policy of allowing the surtax exemption to all corporations was reviewed by the Congress again in connection with the Revenue Act of 1951. At that time a provision was added to the House bill which would have eliminated the multiple surtax exemption in the case of corporations which were members of an affiliated group. The policy embraced in the provision and the terms of the provision itself were very close to that which we today find in the current recommendations. This provision was added to the House bill without hearings and passed the House. However, it was the subject of strenuous objection before the Senate Finance Committee when its terms became known.

The Senate, acting on the recommendation of the Senate Finance Committee, eliminated the provision of the bill. The reasons for this action are stated in Senate Report No. 781, which accompanied H.R. 4473, the bill which became the Revenue Act of 1951, as follows:

"Your committee realizes that there may be some opportunities for tax avoidance under present law through the use of multiple corporations, although it should be pointed out that sections 45 and 129 of the code now afford the Government protection in cases where the principal purpose of the formation of multiple corporations can be shown to be the avoidance of taxes.

"However, the House bill is so broad in its attack on this problem that, if enacted, it could result in substantial injury to many businesses whose present corporate organization has not been motivated by tax avoidance.

"Many businesses were organized in the form of multiple corporations long before the present surtax exemption and minimum excess profits tax credit were introduced. A business may be required to incorporate separately in each State in which it carries on its activities. Furthermore, State laws sometimes prohibit the chartering of a corporation for more than one business purpose. A related corporation frequently will be formed for the purpose of limiting liability with respect to the development of a new and risky enterprise. All of these are traditional and legitimate purposes for the creation of new and separate corporations, yet the House bill would strike at these bona fide corporate entities in the same manner as it would treat cases of true tax avoidance.

"Corporations defined as 'related' under the House bill may, in fact, be carrying on entirely unrelated types of business with few or no transactions between the members of the related groups. In such cases, failure to extend the full surtax exemption and the full excess profits tax credit to each corporation could affect seriously its competitive position with respect to other corporations of similar size carrying on the same type of business.

"The provisions of the House bill would apply to corporations without regard to when they were formed. This would work a particular hardship on those related corporations which were organized in the past for legitimate business reasons. It should be noted that the denial of the full surtax exemption and the full minimum excess profits tax credit can result in a very substantial increase in tax liabilities, especially in the case of small corporations. On the other hand, to limit a provision such as that of the House bill to corporations created in the future would give rise to numerous competitive discriminations between new and old corporations.

"For these reasons, your committee had eliminated entirely this provision of the House bill. Any future study undertaken to develop methods of limiting avoidance in this area should emphasize the importance of correcting the true cases of avoidance without working a hardship on legitimate business organizations."

The House concurred in this action of the Senate and offered an amendment, Section 15(c) of the Internal Revenue Code of 1939, which was designed to prevent the artificial split up of existing businesses for the purpose of obtaining additional corporate surtax and excess profit tax exemptions.

As a result of the conference on H.R. 4473, it was agreed that the one case which should be prevented as an abuse was the case of a split-up of an existing business and for that reason, Section 15(c) of the Internal Revenue Code of 1939 was enacted. The Conference Report on the Revenue Act of 1951 is silent as to the reasons for enacting Section 15 (c) and contains only an explanation of the terms of the amendment. However, the summary of the provisions of the Revenue Act of 1951, as published by the Staff of the Joint Committee on Internal Revenue Taxation, at pages 21 and 22, contained a discussion, the final paragraph of which explained the scope of the section in the following language:

"This provision of the bill does not prohibit or discourage expansion of an existing business accompanied by the formation of new corporations, as distin-

guished from the mere split-up of an existing business nor does it prevent an individual or a 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 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."

The regulations issued by the Internal Revenue Service under Section 15(c) reflect the same policy stated by the summary of the Joint Committee on Internal Revenue Taxation. Section 1551(d) provides as follows:

"(d) *Nature of Transfer.* A transfer made by any corporation of all or part of its assets, whether or not such transfer qualifies as reorganization under section 368 is within the scope of section 1551 except that section 1551 does not apply to a transfer of money only. For example, 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 1551 irrespective of whether the new corporation uses the cash to purchase from the transferor corporation stock in trade or similar property"

The scope of the regulations issued under Section 15(c) and the differences between the regulations as proposed and as finally issued are put forth in a letter from Mr. Edwin L. Kahn, then Director, Technical Planning Division of the Internal Revenue Service, to Mr. Wilbur H. Friedman, attached hereto as Exhibit A. The letter states, in part:

"Under the regulations as finally issued, section 15(c) will not be applicable to a transfer of cash from one corporation to a newly formed corporation where the new corporation is formed in connection with the expansion, as distinguished from the mere split-up, of an existing business. This will be so even though the new corporation uses the cash which was obtained from the transferor corporation to buy inventory, fixtures, or similar property from the transferor corporation. The test under the regulations is not the nature of the property purchased from the transferor corporation but whether the formation of the new corporation is in connection with the expansion of a business or the mere split-up of an existing business."

The Revenue Act of 1964

The Congress was again presented by the Treasury Department with an opportunity to clearly change the legislative policy and direction of Section 1551 on Wednesday, February 6, 1963. The Honorable Douglas Dillon, then Secretary of the Treasury, appeared before the Committee on Ways and Means of the House of Representatives and proposed the following with respect to multiple surtax exemptions:

"The proposed reduction in the corporate normal tax rate from 30 to 22 percent would not be feasible in the absence of appropriate changes in related parts of the tax structure.

"Under existing law, multi-corporate groups, whether formed for good business reasons or not, are in position to derive multiple tax benefits from the $25,000 surtax exemption. They can obtain a substantial reduction in their effective tax rate as compared with enterprises having equal income but organized as a single corporate entity. Consequently, the reduced tax rate designed to assist small business would confer unintended benefits on medium-sized and large businesses operating through a series of separately incorporated units.

"The fact that there are valid business reasons for many of these multiple corporate structures does not justify treating each corporate unit in the group as if it were an independently controlled small business. Under existing law, in the case of these multiple corporate structures an incentive for small business is converted into a large bonus for middle and big business. The present rules do more than misdirect the tax benefits intended for small businesses; in some situations, they even provide an incentive for uneconomic corporate arrangements and deliberate abuse through proliferation of corporate units.

"The President has, therefore, recommended that provisions be adopted to limit related corporations subject to 80 percent common ownership and control to a single surtax exemption. Related corporations for this purpose would include 80-percent-owned corporations which are subsidiaries of the same corporate parent (parent-subsidiary type) or which are owned by the same five or fewer individuals (brother-sister type). Also included would be corporations which are 80

percent owned by five or fewer corporations (commonly controlled subsidiaries).

In order to prevent any abrupt financial impact from the proposed limitation of the surtax exemption, the denial of multiple surtax benefits should be made effective gradually over a 5-year transition period beginning with 1963.

"Enactment of this proposal will add $120 million annually to tax receipts."

It should be noted that the Treasury's recommendation was brought forth notwithstanding an admission that there are valid business reasons for maintaining multiple corporate structures. Reams of supporting material were supplied by the Treasury Department, setting forth in detail the tax saving inherent in the multiple corporate structure. Thus the Congress was fully informed as to the facts surrounding the existence of and the inherent tax savings available to multiple corporate structures which file separate corporate tax returns and claims surtax exemptions with respect to corporate subsidiaries.

It is well known that the Congress did not adopt the Treasury Department's proposals in the Revenue Act of 1964. Instead, the Congress took the pains to enact Part II of Subchapter B of Chapter 6 of the Internal Revenue Code of 1954. Subchapter B, which takes up approximately ten pages of the Internal Revenue Code and which is just a little bit shorter than the original income tax statute enacted in 1913, provides elaborate machinery for electing the use of multiple corporations. The subchapter does provide, however, that affiliated corporate groups who utilize a multiple corporate structure and elect multiple surtax exemptions must pay a 6% penalty for the privilege of doing so. The action of Congress with respect to multiple surtax exemptions is explained in House Report No. 749, 88th Congress, 1st Session, at page 117:

"* * * The method of taxing controlled corporations in the bill will, in your committee's opinion, when coupled with the repeal of the 2 percent additional tax on consolidated returns, encourage some controlled groups to file consolidated returns, while leaving groups which do not choose to file consolidated returns in approximately the same relative position they are in under present law.

"While your committee recognizes the advantages of use of multiple corporations, your committee believes, as it has in the past, that, where corporations owned and controlled by the same interests engage in different businesses in the same area or conduct the same type of business in different geographical locales, 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. Of course, nothing in this bill is intended as changing the application of sections 269, 1551 or 482 if the multiple corporation form of organization is adopted to avoid taxes."

As a part of its legislative proposals with respect to multiple surtax exemptions, having failed in its attempt to do away with them altogether, the Treasury Department proposed that the exception for cash transfers be repealed. On June 12, 1963, the Committee on Ways and Means considered and tentatively adopted an amendment to Section 1551. The press release issued by the Committee on June 12, 1963, explained the tentatively-adopted amendment in the following language:

"The Committee also tentatively adopted an amendment to section 1551 of the Internal Revenue Code of 1954 to provide that there will be a disallowance of a surtax exemption in certain cases where a corporation transfers property in the form of money to another controlled corporation (as well as, under present law, where it transfers property other than money in such a case). Under the committee's decision, the provision would also be expanded to make it applicable to transfers by individuals (present law applies only to corporations)."

Immediately, memoranda were filed with the Treasury Department and with the Committee on Ways and Means, which pointed out that the effect of such an amendment would be to effectively grandfather the right to surtax exemptions in view of the history of the Treasury Department's endeavors to do away with multiple surtax exemptions and the existing requirement that taxpayers must establish by clear preponderance of the evidence that the securing of a surtax exemption was not a major purpose of a transfer. It was also pointed out in these memoranda that the proposed amendment would successfully preclude the expansion of growing businesses.

The Committee's tentative decision was subsequently rejected and insofar as we can determine was never reduced to a legislative draft. Substituted therefor was the amendment which added the word "indirectly" to Section 1551.

This amendment was explained in House Report No. 749 at pages 210 through 213. Nothing in this Committee Report, or in the Committee Report of the Senate Finance Committee, reveals an intent to change the legislative policy under Section 1551 from one against split-ups to one against expansion. However, Example No. 1[1] on page 211 of the House Report was so ambiguous that it was thought that the report required explanation. For that reason, the floor statements of Chairman Mills of the Committee on Ways and Means and Senator Long of the Committee on Finance contained the following language in explanation:

"* * * Under existing law, if a corporation transfers property other than money directly to a corporation which it controls and the transferee corporation was created for the purpose of acquiring this property, or was not actively engaged in business at the time of this acquisition, the Secretary of the Treasury or his delegate my disallow the $25,000 surtax exemption or the $100,000 accumulative earnings credit, unless the transferee corporation establishes by the clear preponderance of the evidence that the securing of the exemptior or credit was not a major purpose for the transfer.

"Thus, present law applies only to direct transfers of property other than money. The bill amends the section to include indirect transfers of property other than money. Cases have been presented to the conferees where a newly-organized subsidiary—created by expanding, rather than merely changing the location of the business—in the ordinary course of its business purchases merchandise from a centralized warehouse maintained by the parent corporation. In such a case, it is not intended that any surtax exemption or accumulated earnings credit be disallowed under the amendment where a major purpose of the separate incorporation was not the securing of an additional surtax exemption." (*Congressional Record*, February 25, 1964, Congressman Mills, pages 3428–29; Senator Long, page 3401.)

In view of the floor statements of Senator Long of the Senate Finance Committee and Chairman Mills of the Ways and Means Committee, negotiations with officials of the Treasury Department looking toward regulations under the amended Section 1551 were immediately undertaken. These negotiations resulted in the recently adopted regulations under Section 1551 which were initially proposed in the *Federal Register* of July 19, 1966. The regulations were adopted as proposed. They are shown for convenience as proposed rather than as they were adopted so that the changes can more clearly be shown. These regulations provide as follows:

"1. *Nature of transfers to which section 1551 applies.*

"Section 1.1551-1(d) should be amended to read as follows (omitted material is bracketed; added material is underlined):

"(d) *Nature of Transfer.* A *direct* or indirect transfer made by any corporation of all or part of its assets, whether or not such transfer qualifies as a reorganization under section 368 is within the scope of section 1551 except that section 1551 does not apply to a transfer of money only. [For example, 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 1551 irrespective of whether the new corporation uses the cash to purchase from the transferor corporation stock in trade or similar property.] *For example, if a transferor corporation transfers property to its shareholders or a subsidiary, the transfer of that property by the shareholders or the subsidiary to a transferee corporation is a transfer of property by the transferor corporation to which section 1551 applies. A purchase of property by a transferee corporation from a transferor corporation or five or fewer individuals controlling the transferee corporation is a transfer within the scope of section 1551, whether or not the purchase follows a transfer of cash from the controlling corporation or individuals.*"

"2. '*Major Purpose.*' Section 1.1551-1(e) should be amended to read as follows (added material is underlined):

"(e) *Purpose of Transfer.* In determining, for the purpose of section 1551, whether the securing of the exemption from surtax or the accumulated earnings credit constituted 'a major purpose' of the transfer, all circumstances relevant to the transfer shall be considered. '*A major purpose' will not be inferred from the mere purchase of inventory by a subsidiary from a centralized warehouse*

[1] "Example (1).—On June 15, 1963, corporation X organizes corporation Y (a wholly-owned subsidiary) and transfers cash to such corporation which it then uses to purchase stock in trade from corporation X. The exception for transfers of money does not apply to the transfer by corporation X to corporation Y. X has made an indirect transfer of property (other than money) within the meaning of subsection (a) (2) of Section 1551."

maintained by its parent or by another subsidiary of the parent. For disallowance of the surtax exemption and accumulated earnings credit under section 1551, it is not necessary that the obtaining of either such credit or exemption or both have been the 'sole or principal purpose of the transfer of the property.' It is sufficient if it appears, in the light of all facts and circumstances, that the obtaining of such exemption or credit, or both, was one of the major considerations that prompted the transfer. Thus, the securing of the surtax exemption or the accumulated earnings credit may constitute 'a major purpose' of the transfer notwithstanding that such transfer was effected for a valid business purpose and qualified as a reorganization within the meaning of section 368. The taxpayer's burden of establishing by the clear preponderance of the evidence that the securing of either such exemption or credit or both was not 'a major purpose' of the transfer may be met, for example, by a showing that the obtaining of such exemption, or credit, or both, was not a major factor in relationship to the other consideration or considerations which prompted the transfer."

TWIN LEGISLATIVE POLICIES

Thus it can be said it has been the policy of the Congress to encourage legitimate and normal expansion of growing businesses by the allowance of a surtax exemption to every corporation within a controlled group which is established for sound business purposes. It has also been the firm legislative policy of Congress to deny the surtax exemption and all other deductions or exclusions to corporations which are formed for the purpose of tax avoidance without sound business purposes. This is evidenced by the terms of Section 269 of the Internal Revenue Code which deals with business acquisitions made to evade or avoid income taxes, and Section 1551 of the Code which deals specifically with the problem here under consideration by disallowing a surtax exemption and accumulated earnings tax credit in the case of corporations which are created for the purpose of acquiring property, unless it can be established by the transferee corporation by the clear preponderance of the evidence that the securing of a surtax exemption or accumulated earnings tax credit was not a major purpose for the transfer of the property.

The legislative history and intent set forth above have been summarized and reinforced in the floor statement of Chairman Wilbur D. Mills of the Committee on Ways and Means before the House on August 6, 1969. While we submit that these legislative policies of permitting the legitimate expansion of business while denying the fruits of tax avoidance have worked well and that no meaningful reasons have been advanced for changing them, nevertheless, we urge this Committee, if it is to accept the results put forth in the House bill, to change the results in the following ways:

(1) That the effective date be changed so that the provision becomes applicable with respect to taxable years beginning after December 31, 1969. That is to say, that the phase-out period begin in 1970 rather than in 1969. In this connection, we point out that this provision of the bill is the only one which would have industry-wide impact for 1969.

(2) We urge that the phase-out period be increased from 8 years to 10 years.

(3) In view of the fact that the bill continues the six percent penalty during the phase-out period, corporations claiming the benefits of the phase-out be permitted a 100% dividends received credit and the same benefits with respect to intercorporate losses as are today permitted to those affiliated corporations which file consolidated returns.

[EXHIBIT A]

NOVEMBER 20, 1953.

Mr. WILBUR H. FRIEDMAN,
Proskauer, Rose, Goetz, & Mendelsohn,
New York 4, N.Y.

DEAR MR. FRIEDMAN: This is in further reply to your letters dated January 26, 1953, and February 24, 1953, in which you protested certain portions of the proposed regulations under section 15(c) of the Internal Revenue Code, as added by section 121(f) of the Revenue Act of 1951.

Section 15(c) in effect disallows the $25,000 surtax exemption and the $25,000 minimum excess profits credit where, after December 31, 1950, a corporation splits up into two or more corporations in order to obtain additional surtax exemptions and minimum excess profits credits. Section 15(c), however, does not apply to a transfer of money from one corporation to a second corporation.

In the proposed regulations, as published with the notice of proposed rule making in the Federal Register of January 3, 1953, the statement was made that the exception involving transfers of money shall apply only if the transaction is in substance a transfer of money. The proposed regulations gave as an example the situation where Corporation A transfers to a new Corporation B cash in exchange for the stock of Corporation B, and, as part of the same transaction, Corporation B purchases a part of Corporation A's assets. The proposed regulations took the position that such a transfer to Corporation B is in substance one of property other than money and that, therefore, section 15(c) would be applicable.

Your letters in effect state that the proposed rule would make section 15(c) applicable to the expansion of a business as well as to the mere split-up of an existing business. The Summary of the Provisions of the Revenue Act of 1951 as Agreed to by the Conferees, prepared by the Staff of the Joint Committee on Internal Revenue Taxation, states, at page 22, that section 15(c) "* * * does not prohibit or discourage expansion of an existing business accompanied by the formation of new corporations, as distinguished from the mere split-up of an existing business * * *." After careful consideration of the problem, the proposed regulations were changed before they were promulgated as final regulations. The final regulations (which appear as Treasury Decision 6024 in the Federal Register for July 1, 1953, at page 3752) provide that "* * * the transfer of cash for the purposes 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), irrespective of whether the new corporation uses the cash to purchase from the transferor corporation stock in trade or similar property."

Under the regulations as finally issued, section 15(c) will not be applicable to a transfer of cash from one corporation to a newly formed corporation where the new corporation is formed in connection with the expansion, as distinguished from the mere split-up, of an existing business. This will be so even though the new corporation uses the cash which was obtained from the transferor corporation to buy inventory, fixtures, or similar property from the transferor corporation. The test under the regulations is not the nature of the property purchased from the transferor corporation but whether the formation of the new corporation is in connection with the expansion of a business or the mere split-up of an existing business.

In the memorandum that you submitted with your letter of February 24, 1953, you also stated that you were joining in the protest of the Commerce and Industry Association of New York, Inc., with respect to the definition in the proposed regulations of the term "major purpose." After careful consideration, changes were made with respect to this problem before the proposed regulations were promulgated as final regulations. It is believed that these changes will satisfactorily take care of the issue raised in the protest.

A copy of this letter is being sent to Mr. David W. Herrmann, President of the National Association of Shoe Chain Stores.

Very truly yours,

EDWIN L. KAHN,
Director, Technical Planning Division.

Senator ANDERSON. Mr. Walter Pozen.

STATEMENT OF WALTER POZEN, COUNSEL, NATIONAL RETAIL MERCHANTS ASSOCIATION AND PARTNER, STROOCK, STROOCK & LAVAN, WASHINGTON AND NEW YORK CITY

Mr. POZEN. Senator Anderson and members of the committee, my name is Walter Pozen and I am the Washington resident partner of the law firm of Stroock, Stroock & Lavan of New York City.

I am appearing on behalf of the National Retail Merchants Association in opposition to the proposed elimination of the corporate multiple surtax exemptions.

In view of the testimony you have already received from Mr. Riddell and the testimony you will be hearing in reference to the multiple surtax exemption, I would just like to present myself for ques-

tions the committee might have on this subject and I would like my statement to be made a part of the record.

Senator ANDERSON. Your statement will be inserted in full in the record.

Senator BENNETT. You associate yourself completely with the previous witness?

Mr. POZEN. I do not.

Senator BENNETT. You do not?

Mr. POZEN. Mr. Riddell has fairly and accurately described the history of the multiple surtax and I share his view that we are really talking about "Main Street America"—not about the large national corporation.

It is our view that the corporate multiple surtax exemption is really necessary for the continued life of many of these stores providing the necessities of life; that many of them will be put out of business, Senator, or will become marginal if this privilege is denied them.

Senator BENNETT. Well, you confuse me. You are asking for the same thing that the previous witness asked for?

Mr. POZEN. No. In a sense I am asking for the "whole package"—retention of the surtax exemption. Of course, we want the phaseout period or the phasein period if it is Congress' will to change this provision as suggested by Mr. Riddell.

Senator BENNETT. Then you are asking for the continuation of the present law?

Mr. POZEN. Absolutely, Senator.

Senator BENNETT. That is fine.

Mr. POZEN. We think it is absolutely necessary to retain the multiple surtax exemption for the kind of business which has been described to continue.

Senator BENNETT. Thank you.

Senator ANDERSON. Thank you very much.

Senator MILLER. May I ask one question of this witness? You are suggesting that on $25,000 of income the difference between the lower rate and the higher rate, which would apply, will be the difference between that business, perhaps, going out of business.

Mr. POZEN. Yes, Senator Miller.

Senator MILLER. And that amounts roughly to $6,000; is that correct?

Mr. POZEN. We are talking about many situations, some unique, others more common. But let us talk about a retail clothing store—part of a chain—which has a long lease and long-term obligations. Under most conditions, if this were a separate business, and it just was not making a go of it it would go out of business. However, many marginal situations are being carried by the large national chains because of a belief in the future and the advantages of the surtax question.

Senator MILLER. Which would be roughly $6,000 more tax on $25,000 net income.

Mr. POZEN. That is correct.

Senator MILLER. Let us take a small retail store that has $25,000 of net income. Now, with the change it would be $6,000 more tax on that particular store which would be apt to go out of business——

Mr. POZEN. I think that is true. We are talking about large companies versus very small.

Senator MILLER. I just wanted to get your point clear.

Senator BENNETT. I think there is this other difference, that if a big national corporation has 10 stores that accumulates $250,000 exemption.

Mr. POZEN. Yes.

Senator BENNETT. Which it can apply against its whole total income regardless. So if it has 100 stores, it has got $2½ million worth of exemption to apply against its profit from all sources, including manufacturing or anything else.

Mr. POZEN. In Iowa, Senator Miller, there might be a particular store that is in business because of the fact that it can claim this exemption. Hopefully the area in which the concern is operating will grow and develop, and it will generate reasonable profits, but for a short period of time, let us say, that $6,000 might be terribly important.

Senator MILLER. Well, your point rings familiar to me, but I just do not know how applicable it is nationwide.

Mr. POZEN. Yes.

Senator MILLER. I do not know whether you have any statistics to show how many of these marginal stores, the $6,000 additional tax load would force out of business. Do you have figures?

Mr. POZEN. We do not have it with us, Senator, but I certainly will get it for you. We can come up with it.

Senator MILLER. I think it would be helpful if you could furnish it for the record.

Mr. POZEN. Thank you, sir.

I would be delighted.

Senator ANDERSON. Thank you very much, sir.

(The material referred to had not been received at the time of printing.)

(Mr. Pozen's prepared statement follows:)

STATEMENT OF THE NATIONAL RETAIL MERCHANTS ASSOCIATION, PRESENTED BY WALTER POZEN, ATTORNEY, STROOCK & STROOCK & LAVAN, NEW YORK CITY

My name is Walter Pozen and I am the Washington resident partner of the law firm of Stroock & Stroock & Lavan, New York City. I am appearing on behalf of the National Retail Merchants Association in opposition to the proposed elimination of corporate multiple surtax exemptions.

Prior to the Revenue Act of 1950, there was a system of progressive income tax rates applied to corporations with a "notch tax rate" of 53% applicable to taxable incomes between $25,000 and $50,000. This rate was confiscatory in the sense that it destroyed the incentive for small corporations to increase their taxable incomes above the $25,000 level. It had no effect on large corporations which paid 38% on taxable incomes in excess of $50,000.

In the Revenue Act of 1950, Congress recognized this inequity and eliminated the so-called "notch tax rate," by instituting a normal tax and a surtax. A normal tax of 25% was levied on all taxable income and a surtax of 20% applied to taxable income in excess of $25,000; thus the concept of a surtax exemption was created. Congress reviewed this concept almost annually, and except for the incorporation of sections to prevent abuses, made no significant change in the surtax exemptions until the Revenue Act of 1964.

In the Revenue Act of 1964, Congress after careful study reduced the normal tax rate on corporations from 30% to 22%, and correspondingly increased the surtax rate from 22% to 28% and later to 26%, with transition rates for fiscal year taxpayers. At this time, an additional tax of 6% was imposed on the first $25,000 of taxable income for component members of affiliated groups of corpora-

tions. However, this additional tax of 6% was imposed only if the groups elected surtax exemptions for each of their component members. The penalty tax of 2% on the filing of consolidated tax returns by affiliated groups was at the same time eliminated. These changes permitted groups of corporations to elect the method most advantageous to their economic status within reasonable limits.

Unfortunately, slogans and catch-words have replaced reasoned arguments in some of the proposals now made to close "tax loopholes." Some proposed changes are being promoted as panaceas for the excessive burdens of the present high tax rates. The effect of pending proposals to eliminate multiple surtax exemptions, if they become law, will in our judgment create a chaotic condition with potentially very serious consequences in the retailing sector of our economy.

Since World War II, there has been a complete metamorphosis in the retailing industry, almost a "retailing revolution." Prior to that time, the trend towards consolidation and the growh of large urban department store complexes had accelerated. However, the shift in population from the urban metropolises to the suburbs required the opening of a large number of stores in suburban areas. The lack of parking facilities and other inconveniences that customers had to suffer to purchase necessities made this shift to smaller suburban stores essential. In addition, great demand for improved retail services was found to exist in a large number of small communities throughout the entire country outside of great metropolitan areas. Local stores were organized in order to combine mass purchasing power with the individual service and attention to consumers demands, which the situation required. This process stimulated competition and lowered the cost of living through reduced prices to con. umers.

To accomplish this desired result, stores were incorporated separately. These separate corporations were created in order to limit the liability of their parent, to encourage relative autonomy of operation and to avoid state tax problems.

When small stores are established from time to time, the problems of administration often increase geometrically. Uniformity of merchandise, advertising, personnel policies among all the stores is impossible because of the diverse sectional differences. Local concepts and personnel must determine policy. Autonomy in operation is essential. The fact is that most national retail enterprises really operate a large number of small local businesses. The appropriate economic comparison should be with other small locally owned retail stores. It is wrong to compare a national retail operation, with a large number of small stores, with a giant industrial enterprise. If the latter were operated through a very large number of separate corporations, some tax adjustment would probably be justified. It is clearly not justified under the circumstances prevailing in the case of retail stores.

The present law is not objectionable since it places component corporations of a group at an acceptable 6% tax disadvantage as compared to individually owned stores. (See Exhibit A for comparison of tax treatment under present and proposed laws.) Probably the fairness of the present statute is demonstrated by the fact that there have been virtually no complaints from small independent retailers. It should also be pointed out that many small retailers pay no corporate taxes at all by electing to be treated as Subchapter S corporations under Sections 1371–78 of the Internal Revenue Code. This election is prohibited to affiliated groups.

The elimination of the multiple surtax exemptions would cause small marginal stores to be closed. The return on capital invested, and the business risks resulting from mistakes in location, unsuitable merchandise or personnel would appear to be overwhelming considerations if the expected small net profit were substantially reduced by increased income taxes. Business risks are assumed only if the possibility of reward under the most favorable conditions are substantial enough to justify them. In retailing, the prevailing tendency has been for large volume, small profit margins and comparatively low net profits. This has been characteristic regardless of the size of the store. The elimination of the multiple surtax exemptions would have a catastrophic effect on many small stores which cannot absorb additional taxes of great magnitude and still remain profitable to operate. Innumerable local communities would suffer from a decline in services, availability and suitability of merchandise, a decrease in competition and a loss of jobs.

The Treasury estimates that the elimination of the multiple surtax exemptions would, at the end of the phase-out period, result in $235 million of additional tax revenue. This estimate seems to us wholly unrealistic. It is not even clear what offsetting tax factors the Treasury has used for purposes of this estimate.

What does seem clear, however, is that the Treasury is relying on data four or five years old which may bear no meaningful relationship to present conditions.

Furthermore, no account has been taken of the revenue loss (both corporate and individual) resulting from the closing of marginal stores and from stores which never open as a result of the adverse tax changes in the House Bill. It is even possible that the Treasury would actually lose revenue as a result of the economic dislocations caused in the retail sector of the economy by this Bill.

Moreover, how does one measure the over-all economic effects of legislation which would so radically change the ground rules for the taxation of retail organizations? How much will the cost of living rise as a result of diminished competition? How many jobs will be lost or never created? How much will the American consumer be inconvenienced in shopping for the necessities of life if these provisions are allowed to become law?

We urge the Committee to reject the multiple surtax provisions of the House Bill. No change so disruptive of the national retail economy should be made in the absence of a thorough economic study of its effects not only on Federal revenues but of the interest of the American consumer.

EXHIBIT A

	Component unit	Independent unit
UNDER PRESENT LAW		
Assumed taxable net income	25,000	25,000
Corporate income tax:		
Normal tax at 22 percent	5,500	5,500
6 percent penalty for filing separate corporate returns	1,500	
Total tax	7,000	5,500
UNDER PROPOSED LAW AFTER PHASEOUT PERIOD		
Assumed taxable net income	25,000	25,000
Corporate income tax:		
Normal tax at 22 percent	5,500	5,500
26 percent additional tax	6,500	
Total tax	12,000	5,500
SUMMARY		
Under proposed law	12,000	5,500
Under present law	7,000	5,500
Increase under proposed law	5,000	0

Senator ANDERSON. Mr. Thomas. We admire your patience.

Senator BENNETT. We hope you admire ours.

STATEMENT OF ROBERT E. THOMAS, PRESIDENT, MAPCO, INC., REPRESENTING LP GAS INDUSTRY AND THE NATIONAL SMALL BUSINESS ASSOCIATION

Mr. THOMAS. I do very much, Senator. I think we are all probably beginning to get very hungry.

My name is Robert E. Thomas. I am president of Mapco, Inc., from Tulsa, Okla.

Mapco is a producer, transporter, and marketer of LP gas, and I appear here this morning in my capacity as president of Mapco, to testify on certain matters of interest to Mapco only, and also representing representative LP gas companies and the National Small Business Association in opposition to taking away the right to use the multiple surtax exemption.

I will address myself first to the multiple surtax exemption question.

I think our statement speaks for itself, but I would simply like to

emphasize several points connected with our prepared testimony that is in the record.

I think there has been a wide misunderstanding about the availability of these exemptions as a tax preference or as a loophole. The Senate Finance Committee, I am sure, is aware of the fact that there are adequate safeguards against the use of these multiple surtax exemptions for tax avoidance. These provisions of the Internal Revenue Code have been utilized many times by the Commissioner in disallowing surtax exemptions where there was no proper business purpose for the setting up of the corporation, and I simply want to raise the question whether Congress has been wrong for the 19 years that the present provisions of the law have been on the books?

We also maintain in the LP gas industry that this proposal if passed by Congress, will enlarge the present inequity in the tax structure.

Back in 1964 when this question was last considered by Congress, it was finally passed that companies utilizing the multiple surtax exemption would pay a tax penalty of 6 percent, that is at a tax rate of 28 percent as against 22 percent.

This, when you translate it upstairs to the parent company, results in a tax penalty of 33 percent being paid by people utilizing the multiple surtax exemption as compared with their competition which is paying basically a rate of 22 percent on the first $25,000 of earnings.

We also maintain that the LP gas industry is basically small business. There are an estimated 4,000 family-owned units. There are only 10 or fewer large multiple corporate setups such as Mapco. These multiple setups must compete with the family-owned businesses, and taxes are an essential element of the cost of business, and an essential element of the problem of competing with other businesses.

I think it would be very difficult for the multiplant LP gas operator to raise his prices to compensate for this larger tax penalty that he will suffer of 48 percent compared with 22 percent. Therefore, his profits are inevitably going to be reduced and his cash flow available for such matters as debt service and other obligations will be reduced.

Finally, I would like to suggest that the cause of small business is dealt a devastating blow by this proposed legislation, and I have here a chart which shows what happens to an LP gas business built up by an individual or a family over a lifetime of hard work.

LOSS OF VALUE OF TYPICAL SMALL LP GAS BUSINESS UPON SALE TO MAJOR LP GAS COMPANY (ASSUMING ELIMINATION OF MULTIPLE SURTAX EXEMPTIONS

	Individual or family owned	Member of multiple corporate group	Loss in value to individual or family on sale
Income before tax	$25,000	$25,000	
Federal income tax	[1] 5,500	[2] 12,000	
Income after tax	19,500	13,000	
Value of business upon sale:			
12 × earnings	234,000	156,000	[3] 78,000
15 × earnings	292,500	195,000	[3] 97,500

[1] 22-percent rate.
[2] 48-percent rate.
[3] 33-percent rate.

He has no place to go to sell that business when he wants to retire other than to a large marketer, because few individuals have the ability to raise a quarter of a million dollars or more to buy a business of that type.

This chart shows that if he sells to a multiplant operator, making use of multiple corporate exemptions, the value of his business in the hands of that multiplant operator has been reduced based upon two earnings multiples set forth in the chart, an estimated $78,000 to an estimated $97,000.

This is a reduction in value of the sales price of that business of 33 percent, and we maintain that this, by itself, is a devastating blow to the cause of small business, and I speak, I think, for some 4,000 small LP gas businesses, and I speak for some 35,000 members of the Small Business Association, representing some 500 different industries.

The LP gas industry does want to be constructive, and we do have a suggestion for the committee which we will be prepared to put into writing if it wishes, and that is that with appropriate grandfather clauses and dealing, of course, with the future, that businesses which basically are made up of small family-owned units, when acquired by a multiple-corporate setup, and when continued in operation, with no change, other than the nominal changes of such things as trade name of a product, perhaps a different corporate setup in the corporate structure, but basically this small business continues as a unit, operating in the small town where it has operated for years, that that business should be permitted to use a surtax exemption.

Now, as far as Mapco itself is concerned, the first item I would like to cover is the House proposal regarding lump sum distributions from profit-sharing plans. I speak not as president of Mapco, but as an employee of Mapco in behalf of some 1,294 Mapco employees, who are the beneficiaries of profit-sharing plans. These profit-sharing plans are essential in their planning for retirement, and I think that the legislation which proposes to tax these lump sum distributions in a manner different from the present way has been justified with examples pointing to highly paid executives who have benefited from this provision.

The facts are in the case of Mapco—and I am sure it is true of every company that has a profit-sharing plan—that for every one of our so-called high-paid executives, 15 corporate officers out of 1,294 employees, that are in a higher tax bracket, we have some 1,279 employees averaging $6,300 yearly, and I would like to point out to the committee that the capital gains treatment of lump-sum distributions from their profit-sharing plan is just as important to those 1,279 employees as it is to the 15 officers; in fact, there are 85 of those employees for every officer, and I would like to suggest that this legislation be reconsidered because it is going to diminish the incentive for Mapco employees and for the many thousands of employees everywhere who are the beneficiaries of these plans.

And, of course, it will be responsible in the long run, if passed in the present way for added cost-push to wage levels and to inflation in the years ahead.

Secondly, on behalf of Mapco, we are an oil and gas producer, we have a production company with an accumulated loss carried forward built up in good faith under the existing provisions of the loss carried

forward sections of the code, and suddenly and summarily the right to carve out a production payment is to be taken away from us as a means of dealing with the loss that we have built up.

Now, we could have dealt with this loss annually by selling the carved out production payment each year and subjected ourselves and our 50-percent partner, the U.S. Government, to all of the tremendous legal expenses of curing this annually. But we elected to let it ride along, thinking, under present law and under present accepted practice, that we could carve out a production payment, and apparently that is to be summarily denied to us, and I would like to suggest that if carved out production payments are to be outlawed that in all fairness production companies in a situation such as this should have an opportunity, say, a grace period of 3 to 6 months, to get their tax books into order.

Finally, I want to raise a question on carved out production payments as to whether the oil business is to be taxed one way when there is a well-established recent case, known as the *Hagen Advertising* case, with facts, accounting facts and legal facts remarkably similar to the oil business, where the Sixth Circuit Court of Appeals held directly opposite to this proposed tax treatment.

My final point on behalf of Mapco, we are engaged in expending $28 million this year and next in expanding our present 3,400-mile pipeline system, and construction was commenced prior to the cutoff date contained in the investment credit sections of the law.

The only point that worries me, and it is a technical point, is that while our pipeline expansion fits all of the requirements of a plant facility rule contained in the law, I am concerned with the language of one of those requirements; namely, "located on a single site."

Now, the single site in the case of a pipeline expansion is a right-of-way several hundred miles long, and I would like to appeal to the Senate Finance Committee to insert into its report on the bill some words that would point out that a single site would apply to a pipeline route or right-of-way just as is already stated in the House committee report, that it applies to a railroad bypass route.

Thank you, gentlemen.

Senator ANDERSON. Any questions? Thank you very much. I am sorry you had to wait, but we had to, also.

Senator FANNIN. Mr. Thomas, if nobody else has any questions, I did have some.

In going into the LP gas business, the history over the past, say, 10 or 15 years, haven't most of the businesses been disposed of, haven't they been family businesses which have been sold to the multiple-corporate-structured companies solely because there was not a market otherwise?

Mr. THOMAS. I believe that is correct, Senator Fannin.

It is very difficult for the average person or the average younger fellow who might possibly be interested in buying such a business to raise the necessary funds. So the result is that the only practical market is the so-called multiplant LP gas marketing company.

Senator FANNIN. And this would reduce the incentive for these companies to acquire these additional companies into their corporate structures.

Mr. THOMAS. It certainly would. If they did acquire them they would have to acquire them on the basis of the arithmetic set forth here because otherwise they could not justify the acquisition to their own stockholders.

Senator FANNIN. From the standpoint of the customers involved in most cases that customer is dependent upon that company for a service that is not available from any other source; is that correct?

Mr. THOMAS. That is true.

On the question of service, Senator Fannin, while certainly there are exceptions to this, I would hazard a guess that the multiple-plant marketing company provides far better service to its customers and is far more careful about the safety of the customer's installation than possibly some of of the smaller family-owned units.

Senator FANNIN. Too, insurance is quite a factor to protect the customer. This can best be done by the multiple-corporate-structured company in that they can have full coverage, whereas the small unit marketer has considerable difficulty in getting insurance.

Mr. THOMAS. The insurance problem is quite serious both for the small operator and the large one, and it is one of the reasons why, historically, the multiplant operator has set up separate corporations because he, too, has to be concerned about his liability, and he has an interest in limiting that liability. The only way he can do that is through a smaller company.

Senator FANNIN. Thank you very much.

Senator MILLER. May I ask a question, Mr. Chairman?

Senator ANDERSON. Go right ahead.

Senator MILLER. With respect to your comment on the lump-sum distributions from your qualified profit-sharing plan, could you give us any idea of what percentage of the payout in a lump sum represents the employer contribution and what percent represents the accumulation by investment in a profit-sharing trust?

Mr. THOMAS. Senator Miller, that will be very difficult to estimate, particularly because Mapco is a very young company only 9 years old, and we have not had a profit-sharing plan in existence long enough to give you a very good answer.

I am sure that over a long period of time, let us say, the business experience of the young fellow who joined the company when he was 25 or 30 and stayed until he was 65, that the proportion represented by company contributions would be, I am sure, smaller than the proportion represented by accumulated earnings and profits which would be taxable as capital gains even under the provisions of this bill.

Senator MILLER. Well, I am pleased that you recognize that the House-passed bill does continue the long-term capital gain treatment with respect to the accumulation.

I would agree with your thought that probably the greater portion of the payoff would be continued to be treated as capital gain.

Mr. THOMAS. My concern was directed more at the wording of the House report where it cited an individual, a highly paid corporate executive, earning $100,000 a year and receiving $500,000 in a lump sum distribution, and I think what the report failed to point out is that if there is such an individual in any company receiving a lump sum distribution of five times his average pay, there are also many times that one individual lower down in the company receiving a

similarly large distribution, like 5 times $5,000 a year, or 5 times $10,000 a year, and in our case we have 85 of those low-paid individuals for each high-paid individual of the type mentioned in the report.

Senator MILLER. But you do recognize that the way the House passed this bill that the impact would not be as severe as it would be if they taxed all of these accumulations at ordinary income, too.

Mr. THOMAS. I do recognize that.

Senator MILLER. I think they were trying to straddle there and preserve some additional tax and, at the same time, not make it too burdensome.

Mr. THOMAS. I do appreciate that, Senator Miller. The point I have been trying to make is that these capital gains are considered to be just as valuable to these low-bracket taxpayers. They like them, too, and we happen to have some 400 of our 1,300 employees in your home State.

Senator MILLER. Thank you very much. Thank you, Mr. Chairman.

(Mr. Thomas prepared statement follows:)

STATEMENT OF REPRESENTATIVES OF LP-GAS INDUSTRY AND NATIONAL SMALL BUSINESS ASSOCIATION BY ROBERT E. THOMAS

My name is Robert E. Thomas. I am the President and Chief Executive Officer of Mapco, Inc., a producer, transporter and marketer of LP-Gas. I appear today on behalf of representatives of the LP-Gas Industry as well as the National Small Business Association in opposition to the proposal in the House-passed bill that the corporate surtax exemption be denied to multiple corporations unded common control.

Throughout the recent months of tax reform activity, the surtax exemption, as it applies to multiple corporations, has been the subject of a great deal of misunderstanding. Many misconceptions have arisen concerning the reasons why businesses operate in multi-corporate form. Similarly, the proposal by the House to deny the exemption to multiple corporations has also been misunderstood. Analyses of the proposal have concentrated on its mechanics, with little attention being given to the effect it would have on the businesses to which it would apply.

My purpose today is to attempt to dispel what we feel are the primary misconceptions regarding the surtax exemption and the House proposal, and in doing so to indicate why we feel the exemption should not be denied to a corporation merely because it is a member of a multiple corporate group. I will show that contrary to prevailing misconceptions——

(1) the surtax exemption was enacted to aid small businesses whether they operated in single or in multiple corporate form;

(2) affiliated multiple corporations were in existence long before enactment of the surtax exemption and continue to be formed for many nontax reasons;

(3) rather than resulting in tax equity, the House proposal would be discriminatory and anti-competitive in effect; and

(4) affiliated multiple corporations are not taking advantage of some unintended tax preference or "loophole" when they use multiple surtax exemptions; there are already provisions in the tax code enabling the Commissioner of Internal Revenue to prevent abuses by use of several surtax exemptions.

Perhaps the most common misconception regarding the surtax exemption, as it applies to affiliated corporations, is that it is an unintended tax preference or "loophole." Many proponents of the House proposal readily acknowledge that the exemption is not a "loophole." Howevre, the implication still remains that affilated corporations were never intended to benefit by the surtax exemption. This implication is patently untrue.

When the exemption was enacted in 1950, the House committee report (House Report No. 2319) accompanying H.R. 8920, which became the Revenue Act of 1950, expressly provided that the exemption would be available to all corporations. Certainly Congress was aware at that time of the existence of businesses operating through affilated multiple corporations. Congressional intention in this regard is made even clearer by the fact that proposals similar to the one con-

tained in the House bill have been considered and rejected by Congress on several occasions in the past 19 years.

The fact that the purpose of the surtax exemption has been greatly misunderstood is pointed up by the statement in the committee report accompanying the present House bill that the exemption was "adopted to benefit small *corporations.*" This statement is simply not supported by the legislative history of the surtax exemption. In explaining the purpose of the surtax exemption, the House committee report in 1950 stated as follows:

"The bill eliminates the notch rate by providing a flat $25,000 surtax exemption which would be available to all corporations. This will provide *tax advantages to small businesses* without introducing a system which is readily adaptable to a drastic graduation of rates."

The report says nothing about benefiting only small corporations. To the contrary, the excerpt quoted above says that the exemption was to be available to *all* corporations, and that it should serve to provide tax advantages to "small businesses" (without a complicated structure of tax rates). There is, we believe, a very significant difference between saying that the exemption was adopted to aid small corporations and in saying that it was adopted to aid small businesses. Although the surtax exemption is a benefit to small corporations, it is also a benefit to small businesses which for legitimate nontax reasons operate in multiple corporate form. The LP-Gas business is such a business because from the standpoint of economic competition there is no such thing as a large LP-Gas company.

The rapid growth of the LP-Gas industry in the past 20 years is testimony to the fact that the surtax exemption has worked in the way intended by Congress. Today the LP-Gas marketing industry is carried on by an estimated 4,000 individual or family-owned outlets and about 10 multi-plant LP-Gas marketing companies. The multiplant LP-Gas marketers operate through small local corporations, because of the nature of the LP-Gas marketing business. To enact a limitation on the surtax exemption such as now proposed by the House would impose severe tax burdens on businesses which have grown in reliance on the availability of the exemption. The severe hardships resulting from the loss of the surtax exemption would stifle further expansion and could even destroy much of the expansion that has occurred previously.

Another misconception about the surtax exemption is the contention that it is the principal reason for businesses operating through multiple corporations. This contention ignores the fact that affiliated multiple corporations existed as businesses long before the exemption and continue to be established for many nontax reasons. A few of these reasons are as follows:

(1) *Limitation of Liability.*—This has long been recognized as a legitimate reason for separate incorporation. In fact, in the LP–Gas industry, it is virtually a necessity for a company operating in more than one locality to separately incorporate each of its branches in order to limit its liability in event of a disaster. Otherwise, insurance expense would probably be prohibitive even if obtainable.

(2) *Incentive to Local Employees.*—Granting employees profit-sharing in local corporations encourages efficient local management.

(3) *State Law.*—A business may be required to incorporate separately in each State in which it carries on its activities. In addition, some states prohibit chartering of a corporation for more than one business purpose.

(4) *State Taxation.*—Many businesses which operate in more than one State separately incorporate in each State in order to make sure that the tax laws of each State will be applied only to the income of the company from operations within the State. Separate incorporation in each State also relieves the business from the administrative burden which would otherwise arise from the application of allocation formulas.

All of these are traditional and legitimate purposes for the creation of new and separate corporations, yet the House bill would strike at bona fide corporate entities in the same manner as it would treat cases of true tax avoidance.

Another misconception regarding the surtax exemption is the allegation that its availability to affiliated multiple corporations results in a tax inequity which discriminates against their competitors. In the vast majorty of industries where some of the businesses are separately incorporated, there is no inequity in the present system. In fact, any discrimination which does exist is against the affiliated group rather than in its favor, and the House proposal would greatly increase this discrimination.

In the LP–Gas industry, for example, multi-plant marketers operate at the local level through separate corporations under common ownership. These affili-

ated corporations compete at the local level with unaffiliated LP–Gas plants—individually or family-owned. Although not linked in any formal sense, these unaffiliated LP–Gas plants or corporations are in a real sense an "economic group" with which an affiliated multiple group must compete. Under present law the unaffiliated corporations pay a tax of only 22% on their first $25,000 of taxable income. On the other hand, the affiliated corporatons, due to a 6% penalty tax enacted in 1964, pay a tax of 28% on their first $25,000. And on top of that, the parent of the affiliated multiple group pays a tax of 48% on 15% of the earnings transferred upstairs, thus raising the effective tax to 33%, a penalty of 50% over the individual or family-owned corporation.

Under the House proposal, this disparity would be increased so that after eight years, the unaffiliated corporations would (assuming no rate changes) be paying 22% while the affiliated corporations would be paying 48%. Thus, in each locality in which a multi-unit business operated, its primary competition would be paying taxes at less than half its own rate. The advantage to the unaffiliated corporation under the proposal is clear. Yet, the economic factors for both affiliated and unaffiliated corporations, at least in the LP–Gas industry, are substantially the same. Competitively, there is no such thing as a large retail LP–Gas company because the economics of distribution limit a marketing outlet to a small geographic area. In addition, affiliated corporations have no price advantage in the cost of purchased gas because of regulation by the Federal Trade Commission, or, in the level of operating expenses, due to local economic factors. Under these circumstances, the House proposal would imperil the very existence of multiple LP–Gas marketers. This would leave local LP–Gas operations solely to unaffiliated corporations, which in many areas of the country would mean that only one LP–Gas company would be serving the needs of the community. Such an absence of competition could only result in higher prices and a decrease in the quality of service to the community.

Finally, I would like to put to rest the misconception that the House proposal is necessary to end the practice of some businesses of using multiple separate corporations simply to take advantage of more than one surtax exemption. The Internal Revenue Code already contains three sections which were designed to deal with this problem. Sections 269, 482 and 1551 enable the Commissioner of Internal Revenue to end true cases of tax avoidance without harming the business practices of legitimate businesses. If these sections need to be supplemented, provisions with similar approaches should be enacted.

The House proposal takes just the opposite tack. It would end the surtax exemption for all affiliated multiple corporations, regardless of their legitimacy, the purposes for which they were established, or the effect of the denial of the exemptions on their operations. This arbitrary approach, which would remove all discretion from the Commissioner of Internal Revenue, should not, we feel, be adopted.

The most disastrous effect of the House proposal, which had no discussion or consideration by the House, is the impact on the market price of the stock or assets of small family-owned businesses. (In the LP-Gas business alone there are over 4,000 small family-owned businesses.) Obviously if the sale of the business to a corporation or to an individual who owned a substantial interest in another corporation would eliminate the business' surtax exemption, the market price for the business would be reduced substantially. The attached exhibit entitled "Loss of Value of Typical Small LP-Gas Business" shows two examples of the reduction in value upon sale ranging from $78,000 to $97,500, with the percentage of reduction being 33%. Such reduction in the market value of the business would be especially harmful in circumstances such as sale by an owner wishing to retire or sale by the estate of the principal shareholder. For this reason, we would advocate that if the Congress should be finally persuaded to eliminate the surtax exemption for affiliated multiple corporations that it not do so in circumstances where a small business had been acquired and continued in operation. To be workable and equitable, provision would have to be made for some form of "grandfather" rights to present multiple corporate businesses built up by acquisition of small businesses and for permitting such minor changes upon acquisition as name, state of incorporation and capital structure.

Such a provision could be constructive and at the very least, would not be destructive of the present value of thousands of small family-owned businesses. At the same time such a provision would deny the use of multiple surtax exemptions to large companies setting up new operating units to take advantage of the surtax exemption.

LOSS OF VALUE OF TYPICAL SMALL LP GAS BUSINESS UPON SALE TO MAJOR LP GAS COMPANY (ASSUMING ELIMINATION OF MULTIPLE SURTAX EXEMPTIONS)

	Individual or family owned	Member of multiple corporate group	Loss in value to individual or family on sale
Income before tax	$25,000	$25,000	
Federal income tax	[1] 5,500	[2] 12,000	
Income after tax	19,500	13,000	
Value of business upon sale:			
12 times earnings	234,000	156,000	[3] 78,000
15 times earnings	292,500	195,000	[3] 97,500

[1] 22-percent rate.
[2] 48-percent rate.
[3] 33 percent.

STATEMENT ON TOTAL DISTRIBUTIONS FROM QUALIFIED PROFIT SHARING PLANS DEALT WITH IN SEC. 515 OF H.R. 13270 BEFORE THE SENATE FINANCE COMMITTEE FOR MAPCO INC., BY ROBERT E. THOMAS, SEPTEMBER 12, 1969

My name is Robert E. Thomas. I am the President and Chief Executive Officer of Mapco Inc., a relatively new company but one which has been listed on the New York Stock Exchange since 1966.

Mr. Chairman, Mapco appreciates this opportunity to express the concern of its almost 1300 employees regarding the proposed change in tax treatment of lump sum distributions from a qualified profit sharing plan under Sec. 515 of H.R. 13270.

Summary of position

(1) Mapco is one of the relatively few larger American companies maintaining a profit sharing plan for its 1294 employees in addition to a pension plan.

(2) Mapco's profit sharing plan makes lump sum distributions to employees upon retirement which are an important factor in employee planning for retirement.

(3) Only 15 of Mapco's 1294 employees are officers in a higher tax bracket. The average base salary of the other 1279 employees is $6300 yearly. Present capital gains treatment for lump sum distributions would be accorded 85 Mapco employees in low tax brackets for each officer in high tax brackets.

(4) The House Ways and Means Committee appears to believe that the benefits of capital gains tax treatment of lump sums paid from profit sharing plans are derived only by high salaried corporate executives and in addition fails to recognize that low salaried fellow employees of such executives receive proportionately large lump sums at retirement.

(5) Other provisions of H.R. 13270 already propose eliminating the small benefit to a high bracket taxpayer of the maximum tax of 25% on capital gains.

(6) If enacted Section 515 will diminish for Mapco employees and employees everywhere a tremendous incentive to provide for their own future. The cost of this so-called reform will be borne by tens of thousands of small taxpayers across the country and the Congress will be responsible for giving an added cost-push to wage levels and inflation in the years ahead.

(7) On behalf of its almost 1300 employees Mapco appeals to the Senate Finance Committee to delete Section 515 from H.R. 13270.

Total distributions from qualified profit sharing plans

Mapco is an oil, gas and gas liquids producer, operator of a 3400-mile LPG and anhydrous ammonia pipeline system serving the upper Middle West and a marketer of propane and liquid plant foods in 10 states.

Maco employs about 1300 employees an is one of the relatively few larger American companies maintaining a profit sharing plan, in addition to a pension plan, for its employees. Retirement benefits from these plans have become important factors in the planning of each individual Mapco employee for his retirement.

While Mapco's pension plan provides for monthly payments after retirement, Mapco's profit sharing plan provides for a lump sum distribution to the employee upon retirement and it is this lump sum profit sharing distribution with which I am concerned today.

To get the matter in proper perspective, it is important to note that out of 1294 employees, only 15 are Mapco officers receiving more than $20,000 yearly and 1279 are employees receiving compensation of $20,000 yearly or less. The average base salary of this group of 1279 employees amounts to $6,300 yearly.

The Report of the House Ways and Means Committee on Section 515 of H.R. 13270 makes much of the supposed tax benefits currently derived by corporate executives with an average taxable income of $100,000 a year receiving a $500,000 lum sum distribution upon retirement. The Report fails to point out that if such an executive existed, fellow employees in the same company with much smaller taxable income would have similarly received at retirement sums equalling 5 times their average taxable income as well.

The Ways and Means Committee overlooks completely the fact that the present law extends the benefit of capital gains treatment of lump sum distribution from profit sharing plans to many, many people at modest income levels, reducing the rate of tax on the distribution by 50% from their normal tax bracket. Capital gains treatment would be accorded 85 Mapco employees in lower tax brackets for every company officer in higher tax brackets.

H.R. 13270 already proposes to eliminate for the high bracket taxpayer the maximum limit of 25% of capital gains and substitutes therefor a tax rate on capital gains of one-half the individual taxpayer's tax bracket. This by itself will produce additional revenue to the Treasury and if any inequity has been deemed to exist would appear to eliminate it.

The Treasury Department's own figures set forth on page 152 of the Ways and Means Committee Report on H.R. 13270 shows that out of total long term capital gains in 1962 of approximately $380,000,000, less than 20% or $70,000,000 were realized by taxpayers with $100,000 or more of gross income and $136,000 or 35% of the total were realized by taxpayers with gross income of $50,000 a year or more. My point is this—the realization of capital gains with its beneficial tax treatment is becoming more and more prevalent at lower income levels than ever before. Even the low bracket taxpayer of $10,000 a year or less realized about 20% of all capital gains in 1962.

The provision of Section 515 will have the impact of diminishing for Mapco employees the tremendous incentive of providing for their own future security by being more efficient and loyal employees during their working life and all of this is to be accomplished in the name of reform designed to close a so-called loophole for a very few very high bracket taxpayers.

The cost of this reform will be substantial for the 99% of Mapco employees who are not high bracket taxpayers and who benefit substantially by the capital gains tax treatment of lump sum distributions from Mapco's profit sharing plan. When this is multiplied by the thousands of employees across the country at similar income levels, the Congress should realize that first, Congress is hurting in a major way many tens of thousands of small taxpayers in the name of reform directed at literally a handful of high bracket taxpayers and secondly, Congress is giving an added cost-push to wage levels and inflation in the years ahead.

In behalf of its 1294 employees, Mapco appeals to the Senate Finance Committee to delete Sec. 515 from H.R. 13270, thus retaining the present tax treatment for lump sum distributions from qualified profit sharing plans.

STATEMENT ON MINERAL PRODUCTION PAYMENTS DEALT WITH IN SEC. 501(b) OF H.R. 13270 BEFORE THE SENATE FINANCE COMMITTEE FOR MAPCO INC., BY ROBERT E. THOMAS, SEPTEMBER 12, 1969

My name is Robert E. Thomas. I am the President and Chief Executive Officer of Mapco Inc., a relatively new company but one which has been listed on the New York Stock Exchange since 1966.

Mr. Chairman, Mapco appreciates this opportunity to express its concern about the proposed tax treatment of one form of mineral production payments, namely, the carved out production payments provided for in Sec. 501(b) of H.R. 13270.

Summary of position

(1) Mapco's oil and gas production subsidiary has legitimately accumulated operating losses pursuant to provisions of the Internal Revenue Code.

(2) Summarily taking away Mapco's ability to carve out a production payment for the purpose of covering accumulated losses is exceedingly unfair and a breach of good faith on the part of the United States Government because:

(*a*) Mapco's losses have been built up and carried forward under legitimate provisions of law; and

(b) Mapco has not chosen to subject itself and its roughly 50% partner—the United States Government—to the tremendous expense of annually carving out production payments to cover each year's operating loss.

(3) Mapco therefore appeals to the Senate Finance Committee to appropriately amend Section 501(b) of H.R. 13270 to provide a suitable grace period during which companies such as Mapco might get their tax books in order.

(4) Section 501(b) of H.R. 13270 is also directly contrary to a recent tax court case affirmed by the 6th Circuit U.S. Court of Appeals, known as the Hagen Advertising Case. This raises the question as to whether the manufacturer of advertising signs is to be treated one way for tax purposes and the oil business to be singled out for treatment in a directly opposite way on similar accounting and legal facts.

Carved out production payments

Mapco is an oil, gas and gas liquids producer, operator of a 3400-mile LPG and anhydrous ammonia pipeline system serving the upper Middle West, and a marketer of propane and liquid plant foods in 10 states. Mapco's production operations are carried on by a subsidiary, Mapco Production Company, which was first organized in 1963.

For the past five years Mapco Production Company has accumulated operating losses pursuant to provisions of the loss carry-forward sections of the Internal Revenue Code based upon the belief and the practice under current law that a production payment could be carved out in late 1969 or early 1970 for the purpose of covering accumulated losses.

It appears to Maco that summarily taking away of its ability to carve out a production payment for this purpose is exceedingly unfair and a breach of good faith on the part of the United States Government because Mapco's losses in its production company have been built up and carried forward under appropriate provisions of existing law. Because Mapco did not choose to subject itself and its roughly 50% partner—the United States Government—to the expense of carving out a production payment to cover each year's operating loss, it is about to be penalized for not so doing.

If carved out production payments are to be outlawed, it would seem only fair that they be outlawed with respect to future operations and not with respect to past losses accumulated under legitimate carry-forward provisions of the Internal Revenue Code.

Therefore Mapco appeals to the Senate Finance Committee at the very least to amend Section 501(b) of H.R. 13270 to give production companies with accumulated loss carry-forwards a grace period in which to get their tax books in order.

It should also be pointed out that Section 501(b) of H.R. 13270 is directly contrary to a recent Tax Court case affirmed by the 6th Circuit U.S. Court of Appeals, known as the Hagan Advertising Case, in which the Treasury Department initiated a claim against a taxpayer directly contrary to the tax treatment now being proposed to be adopted by the Ways and Means Committee for the petroleum industry. The legal and accounting circumstances of the Hagen Case are remarkably similar to carved out production payments used in the petroleum industry. Therefore I wish to raise with the Committee the question as to whether the manufacture of advertising signs is to be treated one way for tax purposes and the oil business treated in a directly opposite way on similar accounting and legal facts.

STATEMENT ON PLANT FACILITY DEFINITIONS CONTAINED IN SEC. 703 OF H.R. 13270 BEFORE THE SENATE FINANCE COMMITTEE FOR MAPCO, INC., BY ROBERT E. THOMAS, SEPTEMBER 12, 1969

My name is Robert E. Thomas. I am the President and Chief Executive Officer of Mapco Inc., a relatively new company but one which has been listed on the New York Stock Exchange since 1966.

Mr. Chairman, Mapco appreciates this oportunity to express its concern about the "plant facility definition" contained in Sec. 703 of H.R. 13270.

Summary of position

(1) Mapco is concerned about the language "located on a single site" contained in the proposed new Section 49(b) (3) (B) (ii) of the Internal Revenue Code as set forth in Section 703 of H.R. 13270.

(2) The House Ways and Means Committee's Report on H.R. 13270 enumerates specified examples of a plant facility meeting the single site rule at the bottom of page 187, one of which is "a railroad by-pass route."

(3) Mapco is expending approximately $28,000,000 for expansion of its pipeline system, the construction of which commenced prior to April 19, 1969 and on which the investment credit will amount to about $2,000,000.

(4) A narrow interpretation of the language "a single site" could only lead to unnecessary litigation not contemplated by Congress.

(5) Mapco appeals to the Committee to include in its report upon this legislation language to the effect that "a pipeline route or right-of-way" meets the single site requirement as does "a railroad by-pass route."

Plant facility definition

Section 703 of H.R. 13270 amends the Internal Revenue Code by adding a new Section 49 dealing with Termination of Credit. It is Section 49(b) (3) (B) (ii) defining a plant facility with which Mapco is concerned. Specifically we are concerned that sub-section (ii) states one of three requirements for meeting the plant facility definition to be "located on a single site."

Mapco among other business activities owns and operates a 3400-mile LPG and anhydrous ammonia pipeline system extending from southeastern New Mexico and West Texas to the upper Middle West. Prior to April 19, 1969 we had commenced construction of 600 miles of additional pipeline looping our present system.

It is clear from other provisions of the bill that this pipeline expansion is entitled to an investment credit. My concern is the possible narrow interpretation of the phrase "a single site" because the single site of our pipeline expansion stretches out over a right-of-way 600 miles long and is made up of hundreds of easements from property owners owning the land in fee. Such a narrow interpretation could lead to unnecessary dispute and litigation which, while I am confident we would win, only points to the desirability of Congress making its intent clear right now.

The Report of the House Ways and Means Committee on H.R. 13270 enumerates certain examples of a plant facility under this rule in the bottom two lines of page 187. One of the examples set forth is "a railroad by-pass route." Such a railroad route would be directly comparable to the right-of-way of a pipeline system such as Mapco's but I would be a lot happier if the report of the Senate Finance Committee on this legislation could expand the list of examples to include the words "a pipeline route."

The Committee will perhaps understand my concern better when it is realized that Mapco is expending approximately $28,000,000 for this pipeline expansion, the construction of which was commenced prior to April 19, 1969. The investment credit of 7% on $28,000,000 is approximately $2,000,000 of hard cash which, incidentally, has been counted upon to help pay for the expansion. For this reason I would appeal to the Committee to include in its report upon this legislation language to the effect that "a pipeline route or right-of-way" meets the single site requirement in the plant facility definition.

Senator ANDERSON. Now we will here from Mr. Benjamin Botwinck, CPA, on behalf of the Metropolitan Taxicab Board of Trade and the Empire State Taxicab Association. Welcome.

STATEMENT OF BENJAMIN BOTWINICK, AN INDEPENDENT CPA, REPRESENTING THE METROPOLITAN TAXICAB BOARD OF TRADE, INC., NEW YORK CITY

Mr. BOTWINICK. Thank you, Senator. My name is Benjamin Botwinick. I am an independent CPA practicing as a partner in Benjamin Botwinick & Co., and I am here representing The Metropolitan Taxicab Board of Trade, Inc., a trade association representing all of the independent taxicab fleet owners ni New York City and the Empire State Cab Association, Inc., representing taxicab owners throughout the State of New York, and have also been requested to speak for the International Taxicab Association which represents the entire country.

However, the written statement here as well as the oral presentation which will follow applies to all small business and small businessmen in every field where small businessmen still have a chance to exist.

I just received in the mail yesterday, the day before yesterday from Research Institute a special report headed "Planning for Future Growth, a Small Business Must," and I will take the privilege of reading just the first few paragraphs which bear attention.

"The growth gap between small companies and giants is widening at an alarming rate. The fact is small firms did not get their share of the recent business boom and many more companies will be forced to let opportunities pass them by in the future if the experience of the 1961 and 1966 business boom is any guide.

"In the 5-year period from 1961 to 1966 while the average small manufacturer boosted sales volume by 42 percent, the giants enjoyed a 112-percent increase. What was behind the 42-percent figure were many companies that lost out on large chunks of profitable business permanently for one or more of a combination of these reasons: production capacity could not be expanded fast enough to keep up with the growing market, and capital was not available to provide for the added receivables, inventories, equipment needed to support higher sales levels."

It is well known that small business cannot pass on income tax to the public the way big business can. In big business, and rightfully so, taxes are a part of the course of doing business and are passed on to the public. Anyone who has any familiarity with small business knows what competition is involved in small business. Taxes come out of their hides just like it does out of individuals. And therefore any change, particularly one as important as section 401 that affects hundreds of thousands of small businesses throughout the country, has to be looked at with a fine comb.

I will now comment on some of the principal points of my statement. First, sound business practices such as limited liability dictate the organization method a businessman employes. Taxes are only one of the many important factors. Secondly, the principle of having the first $25,000 of taxable income of each corporation taxable at a lower rate than all income in excess of $25,000 does not creat a loophole and does not require "reform." It has been recognized in every tax law as far back as you can go. I can refer you to nothing more authoritative than your own Senate Finance Committee hearings on the 1964 act, which bears rereading (pp. 149 to 154).

Third, sections 269 and 1551 of the present Internal Revenue Code have powerful provisions that effectively prevent the use of sham or shell corporations, or the transfer of property to new corporations not having good business purposes, to obtain the tax benefit of having a lower tax on the first $25,000 of taxable income.

Fourth, section 482 of the Internal Revenue Code provides that where two or more corporations are owned or controlled directly or indirectly by the same interests, the Secretary of the Treasury or his delegate may allocate deductions, credits or allowances between or among these corporations if he determines that this is necessary to prevent evasion of taxes or clearly to reflect the income of the corporations.

Fifth, as recently as 1964 sections 1561 to 1563 of the Internal Revenue Code went into effect imposing a penalty tax of 6 percent of income in addition to the normal tax of 22 percent for the privilege of using multiple corporation surtax exemptions. The reasons that the Senate Finance Committee gave in its explanation of the 1964 bill are just as valid today. The 6 percent penalty tax, coupled with many other tax and operating cost obstacles inherent in multiple corporation operation was deemed by the Senate Finance Committee to be a sufficient deterrent to undue use by medium and large corporations.

Sixth, those small businessmen who for valid business purposes use multiple corporations and who operate them at arm's length, as necessitated by sections 269 and 482, lose the opportunity of applying net losses of one company against the profits of another. Thus taxes are paid on a higher amount than the consolidated net income.

Seventh, the sole reason given in the report of the House Ways and Means Committee for the enactment of section 401 of the tax reform bill of 1969 (this is on page 98 of the House committee report) clearly states that their intention was to continue to help small business but restrict large organizations.

However, the impact of section 401 will be mainly against small businesses and only hurt big businesses in a very limited number of cases. It is not necessary to destroy a time-honored and proven equitable provision of law essential to the existence and growth of small business to accomplish what the Ways and Means Committee intended to accomplish.

And finally, section 401 should be eliminated from the bill in its entirety, and in lieu thereof there should be adopted simple provisions that will effectively prohibit only big corporations from utilizing undue multiple surtax exemptions.

One possibility would be a requirement limiting multiple corporation surtax exemptions to a maximum of $500,000 of pretax income, or perhaps even a lower amount. As to what constitutes small business, it is difficult to define. It is different in different industries. This I leave to the good judgment of the Senate. I am just giving this as a suggestion.

But I do not think there is a single section in this so-called reform bill that is going to have more serious impact on the economy of this country than if section 401 is enacted. This is not the first time certain Treasury people who prepare suggested tax laws have tried to do this.

If we go back in history, the same thing happened in 1951 when section 123 of that bill passed the House but the Senate knocked it and prevailed in conference.

What in the world has changed since 1964 when your Senate Finance Committee thoroughly studied this particular subject, and imposed a 6-percent penalty tax to limit the number of companies that would use it and to limit large chains?

I plead that this committee study its 1964 reports, and I am sure that when they see what their own conclusions were in 1964, and what the effects of this section will be, that section 401 will be eliminated. If further penalties are necessary other than the 6 percent, by all means enact them. If it is necessary to put in a provision to stop very large chains from using it, by all means put them in. I have given one possible suggestion in my formal statement, but you do not burn down the house when a storm door will suffice.

I have been asked by the International Taxicab Association to include in the record a letter which they just sent to me yesterday that covers the problems of their people throughout the country.

Senator WILLIAMS. That will be incorporated in the record.

Mr. BOTWINICK. Yes. I do not have 50 copies and therefore I am going to read this.

Senator WILLIAMS. That is all right.

Mr. BOTWINICK. This is addressed to me:

"DEAR MR. BOTWINICK: The International Taxicab Association has reviewed your position pertaining to tax reform bill H.R. 13270, section 401 on multiple corporations. This Association joins with the Metropolitan Taxicab Board of Trade and the Empire State Taxicab Owners Association in requesting that the Senate Finance Committee reconsider the proposed changes in multiple corporation tax structure. The International Taxicab Association concurs with the views of the Metropolitan Taxicab Board of Trade in all respects. The taxicab industry throughout the country has many multiple corporations due to special circumstances and requirements regarding insurance ordinances and in some cases State governmental commissions controlling taxicab operations.

"The diversification has been the key to survival in the taxicab industry. Utilization of inside personnel in garage facilities, maintenance of equipment, purchasing, accounting and land use has resulted in economies that have allowed taxicab operators to remain the only segment of passenger transportation that does not receive direct or indirect subsidies. Many companies may be involved in rent-a-car and leasing operations, trucking and delivery service, garage operations, parking limousine service, and local bus service.

"The very nature of these diverse businesses, although having some common characteristics require that they be held in separate corporations. Liability insurance, local, State and Federal laws often set the standards of employment for personnel in each one of these classifications.

"We concur with the view of the Metropolitan Taxicab Board of Trade that section 401 of H.R. 13270 should be eliminated and a simple provision that will effectively prohibit only big corporations from utilizing undue multiple surtax exemptions be written into the law."

Incidentally, I happen to be a member of the Tax Committee of Commerce and Industry Association of New York, the members of that committee are mainly treasurers and vice presidents in charge of the finance of big corporations. At a board of directors' meeting of Commerce and Industry Association held this past Monday they unanimously decided that section 401 in their viewpoint should be eliminated from the bill, in the interests of keeping small business alive.

I happen to have a copy of their report with me.

Senator WILLIAMS. If you could put that in the record—if you have it there, if you want to put it in the record, it will be OK. If not, you could supply it later.

Mr. BOTWINICK. I will submit it. It is so common for a small businessman who goes into a few businesses to organize each in a separate corporation. If he has a piece of real estate, it is usually in a separate corporation. He cannot have access in normal times to the sources of

credit that medium and large businesses have. You can t ake it from me they are at the bottom of the pile not only in normal times but also to a greater degree during the tight financial conditions that you have right now. It is not even a question of interest. They cannot get the loans, nor can they pass the interest cost on as easily as big business. They have not got access to public capital.

The only way in which they can possibly grow and keep up with inflation is by putting some seed money away, by holding on to some reasonable portion of the first $25,000 of income of each corporation. But these are not the reasons they organize more than one corporation. There are good business reasons, other than taxes, why multiple corporations are organized and we should not put further obstacles in their way.

Thank you.

Senator ANDERSON. Thank you, sir.

We will adjourn until Monday morning at 10:00 a.m.

(There follows, written testimony received by the committee expressing an interest in the subject of multiple corporations:)

STATEMENT OF MOSES MASTER, C.P.A., LOUISVILLE, KENTUCKY

SECTION 401 OF THE BILL AND SECTIONS 1561–1564, 46, 179, 821 AND 823 OF THE INTERNAL REVENUE CODE

Summary: Retain the multiple surtax exemptions for a maximum of five component members of a controlled group of corporations, eliminating from this provision any component member that has Retained Earnings (Earned Surplus) in excess of $100,000 at the beginning of the taxable year, thus permitting successful small business to have reasonable growth.

The present law provides for a tax on corporations of 22 percent normal tax (section 11(b)) and 26 percent surtax (section 11(c)) with a surtax exemption (section 11(d)) on the first $25,000 of taxable income. By paying an additional 6 percent penalty on the first $25,000 of taxable income, a controlled group of corporations may elect multiple surtax exemptions (section 1562).

Section 401 of the bill allows one surtax exemption for a controlled group of corporations, with the limitation to be phased out over an 8-year period. The report of the Committee On Ways and Means states: "General reason for change.—Although the surtax exemption, and the other tax provisions discussed above, were designed to help small businesses, large organizations have been able to obtain substantial benefits from the exemption by dividing the organization's income among a number of related corporations. Your committee does not believe that large organizations which operate through multiple corporations should be allowed to receive the substantial and unintended tax benefits resulting from the multiple use of the surtax exemption and the other provisions of present law."

It is strongly urged that section 401 permit the surtax exemption for a maximum of five members of a controlled group of corporations, eliminating from this provision any component member that has Retained Earnings (Earned Surplus) in excess of $100,000. Since one surtax exemption is provided by section 11, this would provide a maximum additional tax benefit of $20,000 (20 percent (difference between 48 percent and 28 percent) on the first $25,000 for four component members). Such a savings is insignificant to big business but it can be all the difference between the stifling of small, successful business (supposedly the grass roots of our free enterprise system and what has helped make our nation great) and permitting it to grow reasonably.

Section 269 of the Internal Revenue Code will still require a good business purpose for the separate corporations before each can obtain the benefit of the surtax exemption.

My experience has proven that when over half of the earnings (remember that there are state income taxes and various local and other taxes) are taxed away, small, successful business is not left with sufficient working capital to grow. As a rule, the small successful business mainly builds up additional accounts

receivable and inventories which require additional working capital, and the small business is tremendously handicapped in its borrowing ability. Accounts receivable and inventories do not form a security for long-term loans. When loans are made on inventories or receivables, because of the requirement of bonded warehouse receipts in the case of inventories and time-consuming accounting for receivables, higher interest rates than normal are charged. Such higher interest rates prevent the small business from being able to be competitive.

My proposal meets the objections of the Committee On Ways And Means, large organizations getting substantial and unintended benefits from multiple surtax exemptions, has no great tax impact, and makes the difference between business life and death to my clients who are all small business, in fact tiny business on the national scale. As you know, my type of clients are a vital part of free enterprise system.

SECTION 515 OF THE BILL AND SECTIONS 402(A), 403(A) AND 72(N) OF THE INTERNAL REVENUE CODE

Summary: Retain the provision for capital gains treatment for lump-sum distributions to an employee from qualified pension and/or profit sharing plans, in order to not unduly penalize the small business entrepreneur and to be fairer to widows and orphans and retired employees.

The present law permits capital gains treatment (under section 402(a(2) or section 403(a)(2) of the Internal Revenue Code) for lump-sum distributions to an employee from qualified pension, profit sharing or annuity plans.

Section 515 of the bill proposes taxing such lump-sum distributions as ordinary income to the extent of employer contributions to the plan beginning January 1, 1970, although allowing the tax limitations of section 72(n) (2)—now applicable to distributions to self-employed taxpayers under H.R.—10 plans—in these situations. The capital gains treatment is retained, in lump-sum distributions, on the net taxable portion of the distribution in excess of the contributions made by the employer.

There are various other provisions in section 515 but my only quarrel is with taxing the employer contribution portion of the distribution as ordinary income.

In its report, the Committee on Ways and Means states, in part: "The capital gains treatment afforded lump-sum distributions from qualified pension plans allows employees to receive substantial amounts of what is in reality deferred compensation at a more favorable tax rate than other compensation received for services rendered. Moreover, it appears that the more significant benefits accrue to taxpayers with adjusted gross incomes in excess of $50,000."

It is my understanding that this section of law had no public hearings prior to promulgation. In any event, it is an obvious inequity to not consider the lump-sum distribution as earned income and subject to the maximum 50 percent limit proposed for earned income instead of the 70 percent limit. The example shown by the Committee On Ways And Means of the corporate executive with an average taxable income of $100,000 indicates that distributions from pension and/or profit sharing plans are not treated as earned income despite the Committee calling it in reality deferred compensation. Also Regulations 1.404(a)-2(b) pertaining to the Internal Revenue Code require that employer payments to profit sharing and/or pension plans be added to salaries and other compensation in the consideration of reasonableness of compensation.

There are vast numbers of employees other than highly paid corporate executives benefiting from approved pension and/or profit sharing plans and the lump-sum distributions mainly are paid out on an employee's death, although payments because of retirement and separation from service are numerous. Accordingly, the ordinary income treatment proposed for employer contributions penalizes widows and orphans primarily, and, frequently, retired employees when their income is greatly reduced.

The small businessman is unduly penalized. It is my experience that it takes years for him to acquire the necessary capital and business experience, so that he is usually middle-aged, before he can afford to install a pension and/or profit sharing plan and that he generally dies, or more rarely retires, at his earning peak. Accordingly, his tax is unduly aggravated by the addition of a substantial amount of ordinary income. His interest in the plan accumulates earnings subject to capital gains over a relatively short period of time in contrast to the ordinary corporate executive who goes to work for a large corporation immediately upon

leaving school and is immediately a participant in a pension and/or profit sharing plan.

It is my experience that the small businessman, and self-employed, who is usually the orignator of the business and a major stockholder, is reluctant to enter into an approved plan from which he will get little benefit, thus leaving out the employees, who are frequently not members of a union, from beneficial approved pension and/or profit sharing plans.

As a compromise, you may consider limiting the capital gain treatment of the lump-sum distributions from qualified pension and/or profit sharing plans to the first $100,000.

NATIONAL RETAIL FURNITURE ASSOCIATION,
Chicago, Ill.

Senator RUSSELL B. LONG,
Chairman, Committee on Finance,
Washington, D.C.

DEAR SENATOR LONG: As spokesman for over 9,000 independent home furnishings stores, the National Retail Furniture Association supports the continuation of the multiple surtax exemption as an aid to small business.

Small home furnishings retailers have used the multiple surtax exemption because other methods of tax relief available to giant corporations have not been available to smaller businesses. Elimination of the exemption could mean an annual tax increase as high as $5,000 for each store in a firm's group, and could mean the difference between success and failure to many owners of small stores.

Home furnishing retailing has been conducted by thousands of individual, family-owned furniture stores serving individual communities or neighborhoods. The multiple surtax exemption was written into the tax law to provide incentive to permit these small businesses to expand. Complete elimination of the multiple surtax exemption, as proposed in the House-passed version of the tax reform bill, will destroy this incentive.

Retail home furnishings stores operate with a relatively low investment in capital equipment and with relatively small volume stores. Because of the low ratio of investment in capital equipment to sales volume, these smaller firms are unable to take advantage of other tax advantages available to giant corporations. In fact, for many small home furnishings retailers, the multiple surtax exemption is the only practical tax incentive available to them under IRS regulations. Elimination of multiple surtax exemptions could cause severe hardships for many home furnishings retailers.

Abuse of the privilege of using multiple surtax exemptions has been put forward in Congress as one of the reasons for eliminating multiple exemptions. If abuses do actually occur, there are several methods currently in the tax law that the IRS can use to prevent tax avoidance through the use of multiple surtax exemptions. The mutliple surtax exemption is available only to businesses that have sound business reasons for organizing as multiple corporations.

In the home furnishings industry there are many reasons retailers organize as multiple corporations. They may set up multiple corporate structures to: Secure closer identification of the store with the local community; permit store-by-store employee profit-sharing plans; limit liability so that a new store, if not profitable, does not jeopardize the operation of the existing business; or retain manufacturer's franchises for exclusive distribution of brand-name lines of furniture.

The National Retail Furniture Association supports the concept of multiple surtax exemptions. If abuses of the use of the privilege do occur, they can be policed by IRS under existing regulations. Without continuation of the multiple surtax exemptions, many small home furnishings retailers will be deprived of the incentive to grow and to provide additional jobs once the earnings of their firms reach the $25,000 level.

We urge your Committee to retain the concept of multiple surtax exemptions and we request that this letter be made a part of the formal record of the hearings of your Committee.

Sincerely,

M. E. WEATHERBY, Jr.,
Chairman, NRFA Tax Committee.

NATIONAL RETAIL FURNITURE ASSOCIATION,
Chicago, Ill.

Senator RUSSELL B. LONG,
Chairman, Committee on Finance,
Washington, D.C.

DEAR SENATOR LONG: The National Retail Furniture Association is the spokesman for over 9,000 independent home furnishings stores throughout the Nation. At a recent Board of Directors meeting, NRFA reaffirmed its support for the continuation of the multiple surtax exemption.

As used in the home furnishings industry, the multiple surtax exemption has enabled many small retailers to expand to more than one store. Under the exemption, stores qualifying have been able to pay taxes at the rate of 22% (plus a 6% penalty) for each corporate unit rather than a 48% tax. Elimination of the multiple surtax exemption could mean an annual tax increase as high as $5,000 for each unit within a firm's group. This additional tax would severely curtail the growth of many small retailers while doing little harm to the giants who have other tax incentives at their disposal.

As one of the relatively few tax advantages available to the small retailer, the multiple surtax exemption has given the small home furnishings retailer the opportunity to compete with many of the giants in the retail industry. Without the exemption, many of the small retailers would be unable to mount such competition. While other tax advantages are available to giant corporations, the multiple surtax exemption is often the only opportunity for tax relief available to small stores.

As originally planned, the multiple surtax exemption offered the individual, family-owned store an opportunity to expand. Complete elimination of the exemption would destroy this incentive to the small retailers of the Nation.

For his reason, the National Retail Furniture Association supports continuation of the exemption for the first five corporate units within a group of stores and an extension of the phase-out period for other exemptions to ten years rather than eight.

Such an incentive would enable the small retailer to continue to make use of the multiple surtax exemption as it was originally planned. Established as an incentive, the multiple surtax exemption has aided small retailers in all fields. Alleged abuses of the exemption could be handled under present tax law. Currently, the law states that the multiple surtax exemption is available only to businesses that have a sound business reason for organizing as multiple corporations. Home furnishings retailers have used the multiple surtax exemption as an aid to closer identification with the local community, and to permit store by store profit sharing and incentive pay plans.

The National Retail Furniture Association feels that without the incentive of the multiple surtax exemption, many small home furnishings stores will be deprived of the incentive to grow and provide additional jobs once earnings of the firm reach $25,000.

NRFA urges the Committee to allow a floor of five exemptions for the benefit of the small retailer and to extend the phase-out period for other exemptions to ten years instead of eight years. We request that this letter be made a part of the formal record of the hearings of your Committee.

Sincerely,

M. E. WEATHERBY, Jr.,
Chairman, NRFA Tax Committee.

(Whereupon, at 1:05 p.m., the committee adjourned, to reconvene at 10 a.m., Monday, September 15, 1969.)

APPENDIX A

WRITTEN TESTIMONY RECEIVED BY THE COMMITTEE OF A GENERAL NATURE

Written Testimony Received by the Committee of a General Nature

STATEMENT BY SENATOR EDMUND S. MUSKIE ON TAX REFORM, SUBMITTED TO THE SENATE COMMITTEE ON FINANCE, FRIDAY, OCTOBER 3, 1969

Mr. Chairman and Members of the Committee: I am submitting, today, a series of proposals for your consideration in connection with your deliberations on H.R. 13270, "The Tax Reform Act of 1969." I cannot express too strongly my support for enactment of a tax reform act, this year, and my earnest hope that the Finance Committee will report such a measure to the Senate by October 31, 1969. We have an obligation to the citizens of the United States to redress the imbalances which have developed in our internal revenue system. We may not be able to achieve all the reforms we might desire, but we can at least take a major step in that direction.

My recommendations are designed primarily to present specific reform proposals which will tend to increase progressivity in the tax structure and reduce revenue losses in the bill as passed by the House.

I. TAX RELIEF FOR INDIVIDUALS

A. Rate reduction

I support, in principle, the rate reduction for all taxpayers, as contained in H.R. 13270, as it passed the House, but I believe relief should be centered in low- and middle-income groups. The tax reform proposals contained in the bill are the first serious attempt to enforce progressivity in stated tax rates. Progressivity should not, at the same time, be dissipated by large cuts for top income groups. Therefore, I support the House Bill's cuts in lower brackets (up to $10,000 of taxable income on joint return), recommend moderate cuts in intermediate brackets and suggest leaving the rates where they are at top end of the 50% bracket and in higher brackets. The following table provides, for joint returns, a comparison of present rates, rates under the House bill and those which I propose:

Taxable income bracket (joint return)	Present rate	House rate	Proposed rate
0 to $1,000	14	13	13
$1,000 to $2,000	15	14	14
$2,000 to $3,000	16	15	15
$3,000 to $4,000	17	16	16
$4,000 to $6,000	19	18	18
$6,000 to $8,000	19	18	18
$8,000 to $10,000	22	21	21
$10,000 to $12,000	22	21	22
$12,000 to $14,000	25	23	23
$14,000 to $16,000	25	23	24
$16,000 to $18,000	28	27	27
$18,000 to $20,000	28	27	28
$20,000 to $24,000	32	30	31
$24,000 to $28,000	36	34	35
$28,000 to $32,000	39	37	38
$32,000 to $36,000	42	40	41
$36,000 to $40,000	45	42	44
$40,000 to $44,000	48	44	46
$44,000 to $48,000	50	47	48
$48,000 to $52,000	50	47	50
$52,000 to $64,000	53	49	53
$64,000 to $76,000	55	50	55
$76,000 to $88,000	58	52	58
$88,000 to $100,000	60	54	60
$100,000 to $120,000	62	58	62
$120,000 to $140,000	64	60	64
$140,000 to $160,000	66	60	66
$160,000 to $180,000	68	61	68
$180,000 to $200,000	69	61	69
$200,000 to $240,000	70	62	70
$240,000 to $300,000	70	63	70
$300,000 to $400,000	70	64	70
$400,000 and over	70	65	70

I favor the principle embodied in the House provision to limit tax on earned income to a maximum of 50%. In light of extensive preferences still available to investment income, the ordinary rate on earned income should be limited. Because of the need to maintain progressivity in the tax structure, I believe the 50% rate should apply only to taxable income (on joint returns) from $48,000 to $160,000, with the rate set at 55% on income from $160,000 to $240,000 and 60% on amounts in excess of $240,000.

I would favor the Administration's recommendations for treatment of single taxpayers as providing a desirable reform, without the artificial age distinction contained in the House Bill, and with a reduction in the revenue loss inherent in the House version.

B. Low income allowance

I support the House proposal for a "low income allowance" through the minimum standard deduction of $1,100. The revenue loss is relatively large, but the minimum standard deduction concept affords relief at levels where income is still barely adequate. I would prefer to recoup revenue losses by maintaining rates at the upper and middle ranges of the rate structure and by raising substantial additional revenues through more effective reform measures.

C. Standard deduction

I support the House Bill on the standard deduction. The liberalization of standard deduction is needed to simplify reporting for the large number of low- and middle-income taxpayers and to improve relative equity between those who itemize deductions, principally home owners, and those without large itemized deductions, principally renters. This does involve a substantial revenue loss, but, as I noted earlier, I would prefer to recoup losses through tightening of reform measures and maintenance of tax rates in the high and middle ranges.

II. CORPORATE TAX RATE CUT

I am opposed to the Administration's proposal for corporate tax rate cuts. Present corporate taxes (without surcharge) are below levels which have existed since World War II. The Administration has made no showing that the rate of investment by corporations will be inadequate without these cuts. A rate reduction would be less efficient and less related to national goals than the investment credit device, which the Administration agrees should be terminated. That credit is at least directly tied to modernization or expansion of productive capacity. A rate cut would give no assurance that the proceeds would be applied to these ends.

III. CAPITAL GAINS

A. Rates

I support the House proposals on capital gain rates. The changes contained in H.R. 13270 will still leave capital gains as a strongly preferred item. I believe the Administration has exaggerated the potential effect of changes on risk capital. I am certain the market is well enough organized to handle without disruption any effects on liquidity resulting from the House passed reform.

The increase in the rate applied to corporations can also be justified because some corporations receive a disproportionately large share of their total income as capital gains.

B. Holding period

I support the provision on the holding period required before a gain becomes a long-term capital gain. Investors providing capital for new ventures cannot, under normal circumstances, look for a return in less than a year. The principal effect of the House Bill, in moving from a six-month to a twelve-month holding period, is to cut off unjustifiable preference for in-and-out traders. As in the case of capital gain rates, there is ample evidence that the market is well enough organized to handle without disruption any effect the reform would have on the liquidity in the market.

IV. REFORM

A. Limited tax preference

The House Bill has provided a constructive solution to the complex problem of [illegible] relative merits of specific tax preferences by introducing the concept of a limited tax preference (LTP). I believe, however, that the reform program would be improved by requiring the taxpayer to include $\frac{2}{3}$ rather than

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½ of all total economic income. I recommend that preference items include the excess of percentage over cost depletion, intangible drilling expenses, and accelerated depreciation on net leases of equipment. I suggest that farm losses be removed as preference item. I am proposing in a later section of this statement to disallow certain farm losses on a current basis.

I am concerned by the proposed change in treatment of interest on municipal bonds, as written in the House Bill, because of the potential adverse effects of the proposed change on the municipal bond market. The House version does provide for a Federal subsidy of the interest payments, but I am reluctant to see such a step taken in the absence of a thorough-going study of appropriate means by which the Federal government can assist in strengthening the market for these bonds—perhaps including broader subsidy arrangements. I think we must recognize the importance of this issue, because other arrangements may be preferable in light of (a) the necessity for tax equity; and (b) the inefficiency of subsidies provided. Some economists estimate that each $2 of tax revenue foregone provides only a $1 saving in interest costs, because, among other things, individual tax rates vary and the interest cost is not effectively reduced by the full amount of the tax saving.

B. Allocation of deduction

Although I am reluctant to support taxation of interest from municipal bonds, I believe the tax reform bill should require allocation of personal exemptions and deductions to all municipal bond interest, excess percentage depletion, intangible drilling expenses and accelerated depreciation on net equipment leases. I would eliminate allocation to farm losses if my proposals in this area are accepted.

C. Natural resources

1. *Percentage Depletion.*—I believe reform of the percentage depletion allowance is long overdue. This is another area where tax equity could be achieved by reduction or elimination of a preference. If a subsidy is required for petroleum exploration to protect the national interest, there is a strong argument for providing it through direct payments made out of appropriated funds.

I am a co-sponsor of the amendment which would introduce a sliding scale of depletion rates on oil and gas income: 27½% on the first $1 million of such income, 21% on $1.5 million and 15% on income over $5 million. Proportionate reductions should be made in percentages on other minerals. This approach, while not going as far as I think we might, would allow independents to continue to operate much as they now do, but it would reduce the enormous benefits to the major oil companies, whose giant resources assure their ability to continue with a reduced tax preference. If this is not adopted by the Committee, there should be no retreat from the provision of the House Bill.

2. *Foreign tax credits.*—There is clearly a need for reform in the treatment of foreign royalties, masquerading as taxes. The House Bill deals with the problem, but there is evidence of some inequities in the provisions of the House Bill. I am not expert enough to propose a specific solution, and I suspect that it may require detailed study by the Finance Committee. I feel strongly, however, that the problem should not be deferred to some indefinite future. I urge the Finance Committee to report out a provision to meet the problem.

3. *Coverage under LTP and allocation of deductions.*—As I have noted earlier, I believe both excess of percentage over cost depletion and deducted intangible drilling expenses of a capital nature should be considered preference items for both LTP and allocation of deductions provisions. As in the case of other preference items, an over-all limit should be placed on the extent to which these items can reduce taxable income. Clearly, in addition to the small start made by the proposals to reduce percentage depletion, an over-all limitation on these artificial tax write-offs is required.

D. Farm losses

Reform of tax treatment of hobby farms and farm operations carried on as a tax-saving device is long overdue. I recommend outright denial of the allowance of farm losses as a deduction against other income for taxpayers with non-farm adjusted gross income over $25,000 on farm losses in excess of $5,000 each year. The expenses in excess of income should be added to the basis of the farm assets and recovered at the time of sale.

E. Residential and other loan deductions for financial institutions

I am opposed to the Administration proposal for a special deduction for banking and thrift institutions as an incentive to make residential real property loans, student loans and certain other loans. It provides a tax reduction for many loans which would be made anyway; because of this, the windfall effect and inefficiency would be great. It is probably more expensive to encourage loans in this manner than it would be to create an agency such as the FHA to guarantee such loans. The Administration proposal also does nothing about controlling interest rates or otherwise policing use, which could be done through other subsidy techniques.

F. Tax treatment of charitable organizations and foundations

H.R. 13270 includes a major attempt to assure that tax exempt funds are applied to charitable purposes, to require more complete reporting by tax exempt organizations and to provide more effective safeguards against abuses of tax exemption through self-dealing or control of businesses. I support those objectives. At the same time, I think we must recognize that the concept of privately supported charitable activity often requires initiative and unorthodoxy which cannot be supplied by large publicly supported charities. Therefore, in seeking to curb documented abuses, care must be taken not to impinge on the freedom of the private foundations to undertake imaginative or controversial projects, so so long as they are clearly devoted to the charitable purposes for which the tax exemption is granted. I support the following steps to deal with the problem:

(i) I believe we should retain the House Bill provision relating to taxation of unrelated business income and unrelated debt-financed income.

(ii) Several charitable organizations, including several well known research organizations, have questioned whether the House Bill's definition of private foundation is not too broadly drawn. In light of the substantial restrictions applied to private foundations but not to public charities, it is important that this definition be limited to those cases in which special controls against self-dealing and other abuse situations are required. The foundations have submitted extensive testimony concerning ther problems to this Committee, and this should be carefully weighed to frame the public-private distinction on grounds which meet the abuse situations, but which do not unnecessarily restrict organizations which have not presented the problems at which the legislation is aimed.

(iii) I am opposed to the imposition of a 7½% tax on the investment income of private foundation, since this will breach the traditional principles of income tax exemption for charitable organizations and would reduce the funds to be applied to charitable use. I do support the proposal made by some foundations to the Finance Committee for the imposition of a user charge, to cover cost of IRS supervision, in the form of an excise tax equal to about 1/10 of 1% of the value of each private foundation's assets. This would provide reimbursement to the Government of the cost of an expanded supervisory program, but it would not introduce the concept of an income tax on charitable organizations. Moreover, unlike the income tax, it would not penalize foundations earning higher investment income, a factor which has little or nothing to do with the relative costs of supervision.

(iv) I support the amendment recommended by foundations to the House Bill to make it clear that a private foundation terminating its existence or its status as a tax-exempt organization has the right to avoid the confiscatory tax imposed by the House Bill on such a termination by distributing its assets to public charities. This should not be left to the discretion of the Internal Revenue Service, so long as the application of the assets to charitable use is assured.

(v) I believe the definition of taxable expenditures in the House Bill, which would, in effect, subject a private foundation making such an expenditure to a 100% excise tax, should be clarified. The definition, as written, is so broad that legitimate areas of charitable and educational activity could be subjected to a confiscatory tax. Insofar as the purpose is to prohibit the use of tax-exempt funds for lobbying activities—that is, the support of or opposition to specific items of legislation or the election of specific candidates—the provisions of the House Bill should be supported.

On the other hand, the definition of the prohibited expenditures should be refined and clarified to make it clear that the penalty tax will not result from: (a) any presentation of discussions of general policy problems and issues, in-

cluding programs for adult or public education and public television programming, even where a specific point of view is presented; (b) any research concerning policy issues and the publication of the results of such research; and (c) the furnishing of technical assistance to any legislator or other public official at his request. The rules for tax exemption should not be applied in such a way as to stifle free exposure of even controversial ideas, where this is done in a mannr designed to educate and inform the public and not to lobby on behalf of a particular interest. Moreover, the benefits of know-how in policy-related areas should be freely available to legislators and other public officials, so long as they want such technical assistance. The foundations have submitted extensive materials to this Committee outlining statutory language and supporting material for inclusion in the Committee report which would help to clarify this distinction. I believe their submissions provide a basis for improving the Bill.

(vi) I would support a cut-back in the self-dealing rules applicable to private foundations: (a) to assure that foundation managers and substantial contributors are not unknowingly penalized for transactions which are deemed "self-dealing" transactions only by reason of complex attribution rules; and (b) to scale down tax penalties imposed on foundation managers and relieve them of any tax liability where they have not knowingly participated in self-dealing transactions.

(vii) I support the "force-out" principle applied by the House Bill to private non-operating foundations. I would suggest that, in light of the difficulties which have been encountered in striking the distinction between operating and non-operating foundations, the "force-out" principle be applied to all private foundations. Furthermore, since the objective of the "force-out" rule is to assure that investment income of tax-exempt organizations is applied with relative promptness to the charitable uses for which tax exemption is granted, I would apply such a rule equally to publicly supported charities. Such an extension of the "force-out" principle should include a "safety valve" provision allowing accumulation for specified projects.

The resulting system would operate as follows: Each tax-exempt charitable organization would compute each year its net investment income. A tax of 15% (the rate set in the House Bill) would be applied to that portion, if any, of the net investment income which is not expended for the charitable purposes for which the organization is granted tax exemption, within one year after the close of the year in which the income is received. Expenditure for charitable use would include the following:

(a) direct expenditure by the tax-exempt organization in carrying out its charitable purpose (for example, the operation of a university, hospital or a research activity);

(b) expenditure by the tax-exempt organization to meet ordinary and necessary overhead expenses (including depreciation) incurred in carrying out its charitable activities;

(c) making a grant to another qualifying tax-exempt charitable organization; or

(d) segregation of such income into a special account in which funds are accumulated by the tax exempt organization, without prior IRS approval, for a specifically planned and budgeted program requiring a build-up of funds over a reasonable period not exceeding 5 years.

Where a tax-exempt organization wants to count as a distribution of net investment income a grant made to another charitable organization, it would be required, at the time it made the grant, to notify the recipient organization that the grant constitutes net investment income. If such notification is properly furnished, the granting organization would no longer be responsible for the application of the funds. However, this amount would be considered net investment income of the recipient organization, with the result that the recipient organization would have to expend that amount in one of the ways enumerated above or become liable for the 15% tax.

Amounts of net investment income insulated from the 15% tax by segregation into an accumulation account for a specific project would be required to be expended in one of the other manners enumerated above within a maximum of 5 years. If the initially planned project became infeasible by reason of later developments, such amount would be required to be expended on a substantially similar project within the 5 year period. If any amount insulated from the 15% tax by segregation in an accumulation account is not expended in a qualifying manner within the allotted time, a tax would be imposed equivalent to 25% of such amount, plus 6% for each

year from the time the investment income otherwise would have been taxed to the time when the 25% tax is paid.

In order to enforce the "accumulations" rule, a tax-exempt organization distributing accumulated funds by way of a grant to another tax-exempt charitable organization would be required to notify such other organization of the project for which the funds are to be expended and the date by which they must be so expended. If such notification were properly given, the granting organization would be freed from further responsibility for making the actual expenditure, but the recipient organization would be liable to the additional tax of 25% plus 6% per year if the funds were not expended for the prescribed purpose within the prescribed period.

This system would allow grant-making and operating foundations, universities, hospitals, research organizations and similar institutions to allot freely among themselves the responsibility for seeing that tax-exempt investment income is expended for charitable purpose. Thus, it would make no difference whether the Ford Foundation, for example, decided to accumulate investment income for a program to be implemented by a university or whether the Ford Foundation currently distributed income to the university and the university accumulated it for a similar purpose.

V. REFORM ISSUES NOT COVERED BY THE BILL

As I said in my opening comments, it is urgent that the Tax Reform Bill be enacted this year. The substantial reforms it embodies should not be deferred. We should remember, however, that enactment of this legislation would not end the need for a fairer and more efficient tax system. I would hope that, in addition to passing a sound tax reform bill, the Senate would put on its agenda for the next session, and urge the House to take action to initiate, a reassessment of the tax law in several major areas, I suggest that such an agenda include the following:

1. Consideration of a minimum tax on corporations which benefit from tax preferences embodied in the Internal Revenue Code. In concept, this would be similar to the LTP provision applied to individuals in the present Bill.
2. An approach to a complete overhaul of estate and gift taxes and action on the critical related question of taxing capital gains on appreciated property held by a taxpayer at death.
3. Consideration of a tax law mechanism, such as a "cost-of-living credit", which would automatically adjust individual tax burdens as the cost of essential goods and services rises while inflated dollar income pushes taxpayers ever higher in the progressive rate structure.
4. Assessment of means by which the discrepancy in effective tax burdens between homeowners and those who rent their residences, a discrepancy resulting principally from the deductibility of homeowners' real property taxes and mortgage interest, can be ended or removed.
5. A comprehensive review, not only of deferred compensation arrangements as the Administration suggests, but of the whole range of fringe benefits for executives and employees, including qualified and non-qualified pension and profit-sharing plans, deferred compensation arrangements, stock options and stock purchase plans, employee loans or credit facilities, certain employee medical and insurance plans and related areas.
6. Reappraisal of the whole field of excises and user charges and their proper function in the tax system, including those which are not imposed, some which are now proposed and some which should be considered.

TESTIMONY OF SENATOR NELSON BEFORE THE SENATE FINANCE COMMITTEE ON H.R. 13270, AN ACT TO REFORM THE TAX LAWS, OCTOBER 3, 1969

Last January, outgoing Secretary of the Treasury Joseph Barr prophesied a "taxpayers revolt" if tax reform did not come soon. This prediction was not based on fantasy but upon a realization that there were serious inequities in our tax code.

The tax loopholes that have cleverly been devised over the years have meant tax avoidance for too many for too long

Public disenchantment has increased recently with the disclosure that more than 24,000 individuals with adjusted gross incomes of $10,000 or more paid not

one cent in federal taxes in 1964. The amount of income involved exceeded half a billion dollars.

In 1967, the most recent year for available information, taxes paid by millionaires averaged only 25% of their total incomes. Yet the same year, 2.2 million taxpayers with incomes below the government-designated poverty level paid $100 million in income taxes.

Also, 21 millionaires and 134 other wealthy individuals whose incomes exceeded $200,000 paid no federal taxes whatsoever in 1967.

It is not surprising, then, that demands for tax reform have grown in recent years and that public confidence in the basic fairness of the tax system has steadily eroded.

The proposed Tax Reform Act passed by the House falls far short of being an ideal blueprint for equality in taxation. Some of the gaping loopholes in the present tax code are not affected at all, and others are narrowed inadequately. Though some meaningful steps have been taken, the tax reform measure does not go far enough. The need for sweeping reform is evident, and to do less would be an abdication of our responsibilities to our constituents.

While a comprehensive tax package will eliminate the inequities in the code, it would also raise much-needed revenue for the government, thus eliminating the need for the income tax surcharge. In addition, such reform would make it possible eventually to have lower rates on the resulting broader tax base. Genuine reform could also help check inflation while easing the burden on the ordinary taxpayer. This is a combination of benefits that is both politically attractive and economically sound.

On May 1, 1969, I introduced a bill entitled "the Tax Reform Act of 1969." This measure was authored by Congressman Henry Reuss of Wisconsin, a well-known and distinguished economist and member of the Joint Economic Committee. The bill is designed—by closing 13 of the most flagrant loopholes in the tax system—to help restore fairness to our tax code. It would also make possible the elimination of the surtax by raising $9 billion in added revenues.

Mr. Chairman, I would appreciate it if the Tax Reform Act of 1969 were printed in the hearing record at this point, along with an explanation of each of its titles.

I submit this proposal for consideration of the Committee.

[S. 2039, 91st Cong., first sess.]

A BILL To amend the Internal Revenue Code of 1954 to raise needed additional revenues by tax reform.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

TITLE I—GENERAL PROVISIONS

SEC. 101. SHORT TITLE, ETC.

(a) Short Title.—This Act may be cited as the "Tax Reform Act of 1969".

(b) Amendment of 1954 Code.—Except as otherwise expressly provided, whenever in this Act an amendment or repeal is expressed in terms of an amendment to or repeal of, a section or other provision, the reference shall be considered to be made to a section or other provision of the Internal Revenue Code of 1954.

SEC. 102. TECHNICAL AND CONFORMING CHANGES.

The Secretary of the Treasury or his delegate shall, as soon as practicable but in any event not later than 90 days after the date of the enactment of this Act, submit to the Committee on Ways and Means of the House of Representatives a draft of the technical and conforming changes in the Internal Revenue Code of 1954 which are necessary to reflect throughout such Code the changes in the substantive provisions of law made by this Act.

TITLE II—CAPITAL GAINS UNTAXED AT DEATH

SEC. 201. CARRYOVER OF BASIS AT DEATH.

(a) Amendment of Section 1014.—Section 1014 (relating to basis of property acquired from a decedent) is amended by adding at the end thereof the following new subsection:

"(d) DECEDENTS DYING AFTER JUNE 30, 1969.—In the case of a decedent dying after June 30, 1969, this section shall not apply to any property for which an adjusted carryover basis is provided by section 1023."

(b) ADJUSTED CARRYOVER BASIS.—Part II of subchapter O of chapter 1 (relating to basis rules of general application) is amended by redesignating section 1023 as section 1024 and by inserting after section 1022 the following new section:

"SEC. 1023. ADJUSTED CARRYOVER BASIS FOR CERTAIN PROPERTY ACQUIRED FROM A DECEDENT DYING AFTER JUNE 30, 1969.

"(a) GENERAL RULE.—Except as otherwise provided in this section, if—

"(1) carryover basis property is acquired from a decedent dying after June 30, 1969, and

"(2) the gross estate at death of the decedent exceeds $60,000,

then the basis of such property in the hands of the person so acquiring it shall be the adjusted basis of the property immediately before the death of the decedent, further adjusted as provided in this section.

"(b) CARRYOVER BASIS PROPERTY DEFINED.—For purposes of this section, the term 'carryover basis property' means any property acquired from a decedent dying after June 30, 1969, which is property described in paragraph (1), (2), (3), (4), (6), or (9) of section 1014 (b), other than—

"(1) property acquired by the decedent before January 1, 1951,

"(2) property (not including property of extraordinary value) which is a personal or household effect.

"(3) property acquired by any person from the decedent before his death which was disposed of by such person before the decedent's death,

"(4) property described in section 2042 (relating to proceeds of life insurance), and

"(5) property which constitutes a right to receive an item of income in respect of a decedent under section 691.

"(c) INCREASE IN BASIS.—

"(1) IN GENERAL.—The basis of carryover basis property in the hands of the person acquiring it from the decedent shall be increased by its proportionate share of the Federal and State estate taxes attributable to the net appreciation in value of all carryover basis properties.

"(2) MINIMUM INCREASE.—In the case of any decedent, the aggregate increase under paragraph (1) shall not be less than whichever of the following amounts is the greater:

"(A) the amount (if any) by which $60,000 exceeds the aggregate bases of all property included in the gross estate (such bases to be determined after the application of section 1014 but before any adjustment under this section), or

"(B) the amount (if any) by which $15,000 exceeds the amount by which the aggregate bases of all property to which section 1014 applies (such bases to be determined after the application of section 1014) is greater than the aggregate adjusted bases of such property immediately before the death of the decedent.

"(3) MANNER OF ALLOCATION.—

"(A) IN GENERAL.—Except as provided in subparagraph (B), the increase under this subsection in the basis of each carryover basis property shall be that amount which bears the same ratio to the aggregate increase determined under paragraphs (1) and (2) as the appreciation in value of such property bears to the aggregate appreciation in value of all carryover basis properties having appreciation in value.

"(B) SPECIAL RULE FOR SECTION 303 REDEMPTIONS.—To the extent the decedent provides by will, the increase in basis under this subsection shall be allocated first to stock which is carryover basis property and which after his death is redeemed under section 303 (relating to distributions in redemption of stock to pay death taxes). Any remaining increase in basis under this subsection shall be allocated among the other carryover basis property in accordance with subparagraph (A).

"(4) FAIR MARKET VALUE LIMITATION.—The increase under this subsection in the basis of any property shall not exceed the increase necessary to produce a basis equal to the fair market value of such property.

"(d) FURTHER INCREASE IN BASIS FOR CERTAIN STATE SUCCESSION TAX PAID BY TRANSFEREE OF PROPERTY.—If—

"(1) any person acquires carryover basis property from a decedent, and

"(2) such person actually pays an amount of estate, inheritance, legacy, or succession taxes with respect to such property to any State or possession of the United States or to the District of Columbia for which the estate is not liable,

then the basis of such property (after any adjustment under subsection (c)) shall be increased (but not above its fair market value) by the portion of such amount which is attributable to the appreciation in value of such property.

"(e) TREATMENT OF COMMUNITY PROPERTY.—

"(1) IN GENERAL.—The surviving spouse's interest in all community property.—

"(A) for purposes of subsection (a)(2) and (c)(2), shall be treated as included in the gross estate of the decedent,

"(B) for purposes of this section (other than subsection (d)), shall be treated as property acquired from the decedent, and

"(C) for purposes of subsections (b)(1) and (e), shall be treated as property held by the decedent.

"(2) COMMUNITY PROPERTY DEFINED.—For purposes of paragraph (1), the term 'community property' means property—

"(A) held by the decedent and the surviving spouse as community property under the laws of any State or possession of the United States, or any foreign country, and

"(B) at least one-half of the whole community property interest in which was includible in determining the value of the decedent's gross estate under chapter 11.

"(f) SPECIAL RULES AND DEFINITIONS FOR APPLICATION OF SUBSECTION (c).— For purposes of subsection (c)—

"(1) FEDERAL AND STATE ESTATE TAXES.—The term 'Federal and State estate taxes' means only—

"(A) the tax imposed by section 2001 or 2101, reduced by (i) any credit allowable with respect to a tax on prior transfers by section 2013 or 2102, and (ii) any credit allowable with respect to State death taxes under section 2011 or 2102, and

"(B) any estate, inheritance, legacy, or succession taxes, for which the estate is liable, actually paid by the estate to any State or possession of the United States, or to the District of Columbia.

"(2) FEDERAL AND STATE ESTATE TAXES ATTRIBUTABLE TO NET APPRECIATION IN VALUE.—The term 'Federal and State estate taxes attributable to the net appreciation in value of all carryover basis properties' means that amount which bears the same ratio to the Federal and State estate taxes as the net appreciation in value of the carryover basis properties bears to the value of the gross estate (as defined in section 2031 or section 2103).

"(3) NET APPRECIATION.—The net appreciation in value of all carryover basis properties is the amount by which the fair market value of all such property exceeds the adjusted basis of such property immediately before the death of the decedent.

"(4) GIFTS.—In the case of carryover basis property acquired from the decedent by gift, the increase in basis under subsection (c) shall not exceed the amount by which the increase under such subsection is greater than the increase allowable under section 1015(d).

"(5) CHARITABLE GIFT.—If—

"(A) a deduction is allowable under section 2055 or 2106(a)(2) with respect to any property, and

"(B) such property is specifically identifiable as passing from the decedent to a use specified in such section,

then, to the extent of such deduction, such property shall be treated as property which is not carryover basis property.

"(g) OTHER SPECIAL RULES AND DEFINITIONS.—

"(1) FAIR MARKET VALUE.—For purposes of this section, when not otherwise distinctly expressed, the term 'fair market value' means fair market value determined under chapter 11 (including section 2032, relating to alternate valuation).

"(2) PROPERTY PASSING FROM THE DECEDENT.—For purposes of this section, property passing from the decedent shall be treated as property acquired from the decedent.

"(3) DECEDENT'S BASIS UNKNOWN.—If the facts necessary to determine the basis (unadjusted) of carryover basis property immediately before the death of the decedent are unknown to the person acquiring such property

from the decedent, such basis shall be treated as being the fair market value of such property as of the date (or approximate date) at which such property was acquired by the decedent or by the last preceding owner in whose hands it did not have a basis determined in whole or in part by reference to its basis in the hands of a prior holder.

"(4) CERTAIN MORTGAGES.—For purposes of subsections (c) and (d), if—

"(A) there is an unpaid mortgage on, or indebtedness in respect of, property,

"(B) such mortgage or indebtedness does not constitute a liability of the estate, and

"(C) such property is included in the gross estate undiminished by such mortgage or indebtedness,

then the value of such property to be treated as included in the gross estate shall be the value of such property, diminished by such mortgage or indebtedness.

"(5) DECEDENTS NONRESIDENT AND NOT CITIZENS.—In the case of a decedent nonresident not a citizen of the United States—

"(A) this section shall be applied by substituting for the figure '$60,000' wherever it appears the amount of the exemption determined under section 2106(a)(3), and

"(B) subsection (c)(2)(B) shall be applied by substituting for the figure '$15,000' the amount which is equal to ¼ of the amount of the exemption determined under section 2106(a)(3).

"(h) REGULATIONS.—The Secretary or his delegate shall prescribe such regulations as may be necessary to carry out the purposes of this section."

(c) AMENDMENT OF SECTION 1016(a).—Section 1016(a) (relating to adjustments to basis) is amended by striking out the period at the end thereof and by inserting in lieu thereof a semicolon and by adding at the end thereof the following new paragraph:

"(2. to the extent provided in section 1013, relating to adjusted carryover basis for certain property acquired from a decedent dying after June 30, 1969."

(d) AMENDMENT OF SECTION 691(c).—

(1) Section 691(c)(2)(A) (relating to deduction for estate tax in case of income in respect of decedents) is amended to read as follows:

"(A) The term 'estate tax' means Federal and State estate taxes (within the meaning of section 1023(f)(1))."

(2) Section 691(c)(2)(C) is amended to read as follows:

"(C) The estate tax attributable to such net value shall be an amount which bears the same ratio to the estate tax as such net value bears to the value of the gross estate."

(e) INFORMATION REQUIREMENT.—

(1) IN GENERAL.—Subpart A of part III of subchapter A of chapter 61 (relating to information concerning persons subject to special provisions) is amended by inserting after section 6039 the following new section:

"SEC. 6039A. INFORMATION REGARDING BASIS OF PROPERTY ACQUIRED FROM A DECEDENT.

"(a) IN GENERAL.—Every executor (as defined in section 2203) shall furnish with respect to the property of the decedent such information as the Secretary or his delegate may prescribe by regulations relating to—

"(1) the name and last address of the decedent;

"(2) the name and address of each person acquiring property from the decedent or to whom the property passed from the decedent, and a description of each item of such property;

"(3) the adjusted basis (within the meaning of section 1011) of each such item in the hands of the decedent immediately before his death; and

"(4) any other information similar or related in nature to that specified in this paragraph.

If an executor is unable to furnish all of the information required under this subsection with respect to an item of property, he shall include in his return as much of such information as he is able to, including a description of such item and the name of every person holding a legal or beneficial interest therein, and, upon notice from the Secretary or his delegate, such person shall be treated with respect to such item as if he were an executor for purposes of this section.

"(b) STATEMENTS TO BE FURNISHED TO PERSONS WHO ACQUIRE PROPERTY

FROM A DECEDENT.—Every executor who is required to furnish information under subsection (a) shall furnish in writing to each person described in subsection (a)(2) such information with respect to each item of property acquired from the decedent or passing from the decedent to such person as is required under subsection (a) and which the Secretary or his delegate may prescribe by regulations."

(2) PENALTIES.—Subchapter B of chapter 68 (relating to accessable penalties) is amended by adding at the end thereof the following new section:

"SEC. 6684. FAILURE TO FILE INFORMATION WITH RESPECT TO BASIS OF PROPERTY ACQUIRED FROM A DECEDENT.

"(a) INFORMATION REQUIRED TO BE FURNISHED TO THE SECRETARY.—Any executor who fails to furnish information required under section 6039A(a) on the date prescribed therefor (determined with regard to any extension of time for filing) shall pay a penalty of 1 percent of the fair market value of the property described in section 6039A(a)(2), or $5,000, whichever is less, for such failure, unless it is shown that such failure is due to reasonable cause and not to willful neglect.

"(b) INFORMATION REQUIRED TO BE FURNISHED TO BENEFICIARIES.—Any executor who fails to furnish in writing to each person described in section 6039A (a)(2) the information required under section 6039A(b), unless it is shown that such failure is due to reasonable cause and not to willful neglect, shall pay (upon notice and demand by the Secretary or his delegate and in the same manner as tax) $50 for each such failure, but the total amount imposed for all such failures shall not exceed $1,000."

(f) DISCHARGE OF EXECUTOR FROM PERSONAL LIABILITY.—Section 2204 (relating to discharge of executor from personal liability) is amended by striking out "notified," where it appears in the second sentence of such section and inserting in lieu thereof "notified or on furnishing of a bond pursuant to section 6165 in circumstances in which the Secretary or his delegate is satisfied that such payment will be made,".

SEC. 202. EFFECTIVE DATE.

The amendments made by section 201 shall apply only with respect to decedents dying after June 30, 1969.

TITLE III—REPEAL OF UNLIMITED CHARITABLE DEDUCTION

SEC. 301. REPEAL OF DEDUCTION.

Sections 170(b)(1)(C) (relating to unlimited deduction for certain individuals) and 170(g) (relating to application of unlimited deduction) are repealed.

SEC. 302. EFFECTIVE DATE.

Section 301 shall apply with respect to taxable years ending after June 30, 1969.

TITLE VI—REPEAL OF STOCK OPTION PROVISIONS

SEC. 401. REPEAL OF PROVISIONS.

(a) QUALIFIED STOCK OPTIONS.—Section 422 (relating to qualified stock options) is repealed.

(b) RESTRICTED STOCK OPTIONS.—Section 424 (relating to restricted stock options) is repealed.

SEC. 402. EFFECTIVE DATE.

Section 401 shall apply with respect to options granted after June 30, 1969.

TITLE V—REPEAL OF DIVIDEND EXCLUSION

SEC. 501. REPEAL.

Section 116 (relating to partial exclusion from gross income of dividends received by individuals) is repealed.

SEC. 502. EFFECTIVE DATE.

Section 501 shall apply with respect to taxable years ending after June 30, 1969.

TITLE VI—MULTIPLE SURTAX EXEMPTION

SEC. 601. REPEAL OF PRIVILEGE OF GROUPS TO ELECT EXEMPTION.

Section 1562 (relating to privilege of groups to elect multiple surtax exemptions) is repealed.

SEC. 602. EFFECTIVE DATE.

Section 601 shall apply with respect to taxable years ending after June 30, 1969.

TITLE VII—MUNICIPAL INDUSTRIAL DEVELOPMENT BONDS

SEC. 701. ELIMINATION OF EXEMPTION.

(a) IN GENERAL.—Section 103(c) (relating to industrial development bonds) is amended to read as follows:

"(c) INDUSTRIAL DEVELOPMENT BONDS.—

"(1) SUBSECTION (a)(1) NOT TO APPLY.—Any industrial development bond (as defined in paragraph (2)) issued after June 30, 1969, shall not be considered an obligation described in subsection (a)(1).

"(2) INDUSTRIAL DEVELOPMENT BOND DEFINED.—

"(A) IN GENERAL.—For purposes of this subsection, the term 'industrial development bond' means an obligation the payment of the principal or interest on which is—

"(i) secured in whole or in part by a lien, mortgage, pledge, or other security interest in prope"ty of a character subject to the allowance for depreciation, or

"(ii) secured in whole or in part by an interest in (or to be derived primarily from) payments to be made in respect of money or property of a character subject to the allowance for depreciation which is or will be used, under a lease, sale, or loan arrangement, for industrial or commercial purposes.

"(B) EXCEPTIONS.—For purposes of subparagraph (A), property shall not be treated as used for industrial or commercial purposes if it is used—

"(i) to provide entertainment (including sporting events) or recreational facilities for the general public;

"(ii) to provide facilities for the holding of a convention, trade show, or similar event;

"(iii) as an airport, dock, wharf, or similar transportation facility;

"(iv) in the furnishing or sale of electric energy, gas, water, or sewage disposal services; or

"(v) in an active trade or business owned and operated by an organization described in subsection (a)(1).

"(3) EXCEPTION.—Paragraph (1) shall not apply to any obligation issued before January 1, 1969, for a project assisted by the United States under title I of the Housing Act of 1949 (42 U.S.C. 1450 and following, relating to slum clearance and urban renewal) or under title I or title II of the Public Works and Economic Development Act of 1965 (42 U.S.C. 3131 and following)."

(b) CERTAIN URBAN RENEWAL BONDS.—Section 102(g) of the Housing Act of 1949, as amended (42 U.S.C. 1152(g)), is amended to read as follows:

"(g) Obligations, including interest thereon, other than industrial development bonds (within the meaning of section 103(c) of the Internal Revenue Code of 1954), issued by local public agencies for projects assisted pursuant to this title, and income derived by such agencies from such projects, shall be exempt from all taxation now or hereafter imposed by the United States."

SEC. 702. EFFECTIVE DATE.

The amendments made by section 701 shall apply with respect to taxable years ending after June 30, 1969, but only with respect to obligations issued after such date.

TITLE VIII—MUNICIPAL BOND GUARANTEE CORPORATION

SEC. 801. ESTABLISHMENT OF A GOVERNMENT CORPORATION TO ASSIST IN THE EXPANSION OF THE CAPITAL MARKET FOR MUNICIPAL, SECURITIES WHILE DECREASING THE COST OF SUCH CAPITAL TO MUNICIPALITIES.

SEC. 802. FINDINGS AND DECLARATION OF PURPOSE.

SEC. 2. (a) The Congress finds that the municipal security market, as now constituted, is forcing the Nation's municipalities and States to pay such a high rate of interest on their securities that they cannot afford to finance many needed public facilities. This high rate of interest is directly attributable to (1) the limited supply of private capital available in the present municipal securities market, (2) the institutional rigidities within such market, and (3) the failings of the existent municipal securities rating system which discriminates against most of the Nation's smaller communities and many of the larger cities and which fails to reflect the infinitesimally low rate of actual security defaults since World War II.

(b) It is the purpose of this title to expand the municipal capital market and thereby enable State and local public bodies to borrow private capital funds at net interest costs lower than are now obtainable through the issuance of securities and to provide Federal financial assistance to achieve such lower net interest costs at a net gain to the United States Treasury.

SEC. 803. DEFINITIONS.

As used in this title—

(1) The term "Corporation" means the "Municipal Bond Guarantee Corporation".

(2) The term "State" means the several States, the District of Columbia, the Commonwealth of Puerto Rico, and the territories and possessions of the United States.

(3) The term "State or local public body" means any public corporate body or political subdivision; any public agency or instrumentality of one or more States, municipalities, or political subdivisions of one or more States (including any public agency or instrumentality of one or more municipalities or other political subdivisions of one or more States); any Indian tribe; and any board or commission established under the laws of any State to finance specific capital improvement projects.

(4) The term "needed public facilities" means any public work, public facility, or equipment relating thereto deemed necessary by a State or local public body; but does not include any industrial or commercial facility for private use, by lease, conditional or installment sales contract, or other means of transfer, where such facility is or will be used primarily for the mining, maufacturing, assembling, fabricating, storing, processing, or sale of articles or commodities.

PART I—MUNICIPAL BOND GUARANTEE

SEC. 811. ESTABLISHMENT OF CORPORATION.

There is hereby established a body corporate to be known as the "Municipal Bond Guarantee Corporation". The Corporation shall have its principal offices in the District of Columbia and shall be deemed, for purposes of venue in civil actions, to be a resident of the District of Columbia. The Corporation may establish offices in such other places as it deems necessary or appropriate in the conduct of its business.

SEC. 812. BOARD OF DIRECTORS.

(a) (1) The Corporation shall have a Board of Directors (hereinafter referred to as the "Board") consisting of nine members to be appointed by the President, not more than three of whom shall be regular full-time officers or employees of the Federal Government. The Board shall be responsible for overall policy-making and general supervision of the Corporation.

(2) The President shall designate a Chairman and a Vice Chairman of the Board.

(3) Each member of the Board shall serve for a term of four years or until his successor has been appointed; except that any member appointed to fill a vacancy occurring prior to the expiration of the term for which his predecessor was appointed shall be appointed for the remainder of such term.

(4) The Board shall meet at the call of the Chairman which shall be not less often than four times a year.

(b) Members of the Board, other than members who are regular-full-time officers or employees of the Government, shall receive for their services, as members, the per diem equivalent to the rate for GS-18 when engaged in the performance of their duties, and each member of the Board shall be allowed travel expenses, including per diem in lieu of subsistence, as authorized by section 5703 of title 5, United States Code, for persons in the Government service employed intermittently.

SEC. 813. EXECUTIVE DIRECTOR.

(a) Subject to the general supervision and overall policymaking of the Board, the management of the Corporation shall be vested in an Executive Director who shall be appointed by the President, by and with the advice and consent of the Senate.

(b) Section 5315 of title 5, United States Code, is amended by inserting at the end thereof a new paragraph as follows:

"(90) Executive Director, Municipal Bond Guarantee Corporation."

SEC. 814. GENERAL POWERS OF CORPORATION.

(a) For the purpose of carrying out its functions under this title, the Corporation shall have power—

(1) to have a corporate seal which may be altered at pleasure and to use the same by causing it, or a facsimile thereof, to be impressed or affixed or in any other manner reproduced;

(2) to sue and be sued;

(3) to enter into and perform contracts, leases, co-operative agreements, or other transactions, on such terms as the Corporation may deem appropriate, and consent to modification thereof, without regard to sections 3648 and 3709 of the Revised Statutes, as amended (31 U.S.C. 529 and 41 U.S.C 5), and section 322 of the Act of June 30, 1932, as amended (40 US.C. 278a);

(4) to appoint and fix the compensation of such personnel as may be necessary for the conduct of its business in accordance with the provisions of title 5, United States Code, governing appointment in the competitive service, and chapter 51 and subchapter III of chapter 53 of such title relating to classification and General Schedule pay rates, and to obtain the services of experts and consultants in accordance with section 3109 of title 5, United States Code, at rates for individuals not to exceed the per diem equivalent for GS-18;

(5) except as may be otherwise provided in this part, in the Government Corporation Control Act, or in any other laws specifically applicable to Government corporations, to determine the necessity for and the character and amount of its obligations and expenditures and the manner in which they shall be incurred, allowed, paid, and accounted for;

(6) to issue such rules and regulations as may be deemed necessary or appropriate to carry out the purposes of this title; and

(7) to exercise all powers specifically granted by the provisions of this title and such incidental powers as are necessary to carry out the purposes of this title.

(b) All suits of a civil nature at common law or in equity to which the Corporation shall be a party shall be deemed to arise under the laws of the United States, except that no attachment, injunction, garnishment, or other similar process, mesne or final, shall be issued against the Corporation or its property.

SEC. 815. SERVICES AND FACILITIES OF OTHER AGENCIES—UTILIZATION OF PERSONNEL, SERVICES, FACILITIES, AND INFORMATION.

The Corporation may, with the consent of the agency concerned, accept and utilize on a reimbursable basis, the officers, employees, services, facilities, and information of any agency of the Federal Government, except that any such agency having custody of any data relating to any of the matters within the jurisdiction of the Corporation shall, to the extent permitted by law, upon request of the Corporation, make such data available to the Corporation without reimbursement.

SEC. 816. FINALITY OF CERTAIN FINANCIAL TRANSACTIONS.

Notwithstanding the provisions of any other law, any financial transaction authorized under this Act shall be final and conclusive upon all officers of the United States.

SEC. 817. TAXATION.

The Corporation, including its reserves, surplus, and income, shall be exempt from all taxation now or hereafter imposed by the United States, or by any State, or any subdivision thereof, except any real property acquired by the Corporation shall be subject to taxation by any State or political subdivision thereof, to the same extent, according to its value as other real property is taxed.

SEC. 818. GOVERNMENT CORPORATION CONTROL ACT.

Section 101 of the Government Corporation Control Act is amended by inserting after "Federal Housing Administration," the following: "Municipal Bond Guarantee Corporation,".

SEC. 819. ANNUAL REPORT.

The Corporation shall submit to the President, for transmission to the Congress, a comprehensive annual report of its activities under this title.

SEC. 820. APPROPRIATIONS.

Except as otherwise specifically provided for in this title, there are authorized to be appropriated such sums as may be necessary to enable the Corporation to carry out its functions under this title.

PART II—FUNCTIONS OF THE CORPORATION

SEC. 821. COMPREHENSIVE ECONOMIC AND FISCAL REPORTS.

(a) Upon the request of any State or local public body which intends to issue bonds or other securities to finance needed public facilities, or by any bond underwriting firm or bank planning to submit a bid for such bonds or other securities, or by any Federal agency that has received an application from a State or local public body for assistance in financing a public facility under a Government direct loan or loan guaranty program, the Corporation is authorized to provide a comprehensive report detailing the public body's economic and fiscal resources. Such report shall include, but not be limited to—

(1) a review of the economic circumstances of the area served by such body, such as demographic factors, business activity, construction patterns, income, employment, and public facilities infrastructure;

(2) an examination of such body's fiscal position including trends of revenues, expenditures, tax levies and collections, property valuations, Federal and State aids, direct and overlapping indebtedness;

(3) if revenue-producing facilities are involved, an analysis of the relevant financial statements, rate schedules and users, and other financial developments; and

(4) appropriate economic, fiscal, and financial ratios, averages, and indices and comparisons of such measures with national and regional averages.

Such report shall exclude qualitative judgments or comparable comments that in any way involve an evaluation of the investment merits of a prospective bond issue or reflect a credit evaluation of the State or local public body concerned.

(b) The Corporation is authorized to charge and collect a fee for reports provided under this section to cover administrative and other necessary expenses. Such fee shall not exceed, in the case of any such report, one-tenth of 1 per centum of the amount of the bonds or other securities to be issued or loans to be made, but in no event shall the fee for any such report be less than $100 or more than $5,000.

(c) All fees received in connection with reports provided under this section, all funds in the form of gifts, bequests, or demonstration grants received from private foundations or associations, Federal agencies, or other public bodies seeking to improve the quality and availability of information relating to the economic and fiscal circumstances of State and local public bodies, and all other receipts of the Corporation in connection with the performance of its functions under this section, shall be deposited in a revolving fund to be established by the Corporation which shall be known as the "Municipal Economic

and Fiscal Reports Fund". All administrative and other expenses incurred by the Corporation in connection with the performance of its functions under this section shall be paid from such fund.

(d) Notwithstanding any other provision of law, no application by a State or local public body for a loan under title II of the Housing Amendments of 1955, section 201 of the Public Works and Economic Development Act of 1965, section 306 of the Consolidated Farmers' Home Administration Act of 1961, or the Small Reclamation Projects Act of 1956 shall be approved unless there has been received by the administering Federal agency a comprehensive economic and fiscal report prepared under this section. Any fee paid in connection with any such report, as prescribed in subsection (b), may be included in the amount covered by the Federal loan or loan guarantee.

SEC. 822. DEBT SERVICE GUARANTEE CONTRACTS.

(a) Upon the application of any State or local public body, the Corporation is authorized to enter into a debt service guarantee contract to guarantee the payment of principal and interest on bonds or other securities to be issued by such body to finance one or more needed public facilities. Any such contract shall obligate the Corporation, during any period in which the bonds or other securities are outstanding, to pay to a trustee under an indenture securing such bonds or other securities (or to a paying agent where no trustee is provided for), such amounts as may be needed, when added to the moneys available from the taxes, revenues, or other funds pledged by such body as security for such bonds or other securities (including all reserve funds therefor), to make payments of principal and interest when due.

(b) No guarantee contract shall be entered into under this section unless—

(1) a comprehensive economic and fiscal report has been prepared by the Corporation, pursuant to section 821, with respect to the State or local public body applying for the guarantee;

(2) the interest income from the bonds or other securities with respect to which the guarantee is entered into is subject to Federal taxation, and such bonds or other securities are to be issued and sold to persons or entities other than the United States or any agency thereof; and

(3) the Corporation determines that (A) such bonds or other securities contain satisfactory amortization provisions not in excess of the debt paying capacity of the borrower, and (B) the public facility project to be financed is economically sound.

In making the determination under clause (3), the Corporation shall rely, to the fullest extent possible, upon the data contained in the comprehensive economic and fiscal report referred to in clause (1), and upon the borrower's debt repayment record during the twenty-five-year period preceding the date of application for a guarantee under this section.

(c) The Corporation is authorized to charge and collect an annual fee, as consideration for a guarantee of bonds or other securities under this section, to cover necessary administrative expenses and to provide a reserve for losses. Such fee shall not exceed two-tenths of 1 per centum per annum of the aggregate amount of bonds or other securities covered by the guarantee contract which are outstanding at the beginning of each year.

SEC. 823. MUNICIPAL DEBT SERVICE GUARANTEE FUND.

(a) There is hereby established in the Treasury a revolving fund to be known as the "Municipal Debt Service Guarantee Fund" (hereinafter referred to as the "fund") which shall be used by the Corporation in carrying out section 822. Initial capital for the fund shall be obtained through the issuance by the Corporation of debenture notes, and notes so issued shall be subscribed to as follows:

(1) The Federal Deposit Insurance Corporation shall subscribe to such notes in a principal amount of $1,000,000.

(2) The Federal Savings and Loan Insurance Corporation shall subscribe to such notes in a principal amount of $100,000.

(3) Each Federal Reserve bank shall subscribe to such notes in a principal amount equal to two-tenths of 1 per centum of the surplus of such bank on January 1, 1968.

Subscriptions shall be accompanied by a certified check payable to the fund in an amount equal to one-half of the subscription. The remainder of such subscription shall be subject to call from time to time by the Corporation upon ninety days' notice. Notes so issued shall bear interest at a rate to be deter-

mined in accordance with subsection (c), and shall be repayable in annual installments, commencing not earlier than ten years from the date of receipt of the subscription price.

(b) All fees received in connection with guarantees issued under section 822, all receipts from the issuance of debenture notes, all funds borrowed from the Secretary of the Treasury pursuant to subsection (c), all earnings on the assets of the fund, and all other receipts of the Corporation in connection with the performance of its functions under section 822 shall be deposited in the fund. All payments to trustees (or paying agents) under section 822(a), repayments of debenture notes issued pursuant to subsection (a), repayments to the Secretary of the Treasury of sums borrowed pursuant to subsection (c), and all administrative expenses and other expenses of the Corporation in connection with the performance of its functions under section 822 shall be paid from the fund.

(c) (1) The Corporation is authorized to issue to the Secretary of the Treasury from time to time notes or other obligations for purchase by the Secretary in amounts sufficient, together with moneys in the fund, to make payments of principal and interest on all bonds or other securities guaranteed under section 822 in accordance with a debt service guarantee contract. Such obligations shall be in such forms and denominations, have such maturities, and be subject to such terms and conditions as may be prescribed by the Secretary, with the approval of the Secretary of the Treasury. Such notes or other obligations shall bear interest at a rate determined by the Corporation reflecting the average annual interest rate on all interest-bearing obligations of the United States then forming a part of the public debt as computed at the end of he fiscal year next preceding the issuance by the Secretary and adjusted to the nearest one-eighth of 1 per centum.

(2) The Secretary of the Treasury is authorized and directed to purchase any notes or other obligations of the Corporation issued under this subsection, and for such purpose the Secretary of the Treasury is authorized to use as a public debt transaction the proceeds from the sale of any securities issued under the Second Liberty Bond Act; and the purposes for which securities may be issued under such Act are extended to include the purchase of any such notes or other obligations. The Secretary of the Treasury may at any time sell any of the notes or other obligations acquired by him under this section. All redemptions, purchases, and sales by the Secretary of the Treasury of such notes or other obligations shall be treated as public debt transactions of the United States.

SEC. 824. INTEREST REDUCTION GRANTS.

(a) In order to achieve a decrease in the interest costs burdens arising in the financing of needed public facilities, the Corporation is authorized to enter into contracts to make interest reduction grants to any State or local public body in connection with bonds or other securities issued by such body to finance needed public facilities; except that no grant shall be made hereunder in the case of any bonds or other securities the interest income from which is exempt in whole or in part from Federal taxation.

(b) The amount of any grant made under this section shall not exceed the sum of (1) the guaranty fee prescribed in section 822(c), and (2) 33⅓ per centum of the annual interest charge payable each year by the State or local public body on the bonds or other securities with respect to which such grant is made. Any such grant shall be payable for each of the years in which any of the bonds or other securities covered by the contract are outstanding.

(c) No grant shall be made under this section unless (1) the State or local public body has entered into a debt service guaranty contract pursuant to section 822, and (2) the Corporation finds that the interest charges on the bonds or other securities are reasonable, after taking into account the taxable status of the bonds or other securities, the availability of a Government guarantee, and the general level of interest rates then prevailing.

(d) The Corporation may make advance or progress payments on account of any contract entered into pursuant to this section, notwithstanding the provisions of section 3648 of the Revised Statutes.

(e) There are authorized to be appropriated such sums as may be necessary to carry out the provisions of this section. Any sums so appropriated shall remain available until expended.

SEC. 825. INVESTMENT OF FUNDS.

Moneys in the Municipal Economic and Fiscal Reports Fund and in the Municipal Debt Service Guarantee Fund may be invested in obligations of the United States or in obligations guaranteed as to principal and interest by the United States, or in obligations eligible for investment of public funds. Such obligations may be sold and the proceeds derived therefrom may be reinvested in other obligations of the type herein prescribed. Income from such investment or reinvestment shall be deposited in the respective funds.

SEC. 826. CONFORMING AMENDMENTS.

(a) Section 202(b)(1) of the Housing Amendments of 1955 is amended by striking the comma after "reasonable terms" and inserting in lieu thereof "with due allowance for the debt service guarantees authorized by title VIII of the Tax Reform Act of 1969,".

(b) Section 201(a)(2) of the Public Works and Economic Development Act of 1965 is amended by inserting after "on terms" the following: ", with due allowance for the debt service guarantees authorized by title VIII of the Tax Reform Act of 1969,".

TITLE IX—PERCENTAGE DEPLETION RATES FOR OIL, GAS, AND CERTAIN OTHER MINERALS

SEC. 901. REDUCTION IN RATES.

Section 613(b) (relating to percentage depletion rates) is amended—

(1) by striking out "27½ percent" in paragraph (1) and inserting in lieu thereof "15 percent"; and

(2) by striking out "23 percent" in paragraph (2) and inserting in lieu thereof "15 percent".

SEC. 902. EFFECTIVE DATE.

Section 901 shall apply with respect to taxable years ending after June 30, 1969.

TITLE X—INCREASE IN GIFT TAX RATES TO ESTATE TAX LEVEL

SEC. 1001. INCREASE IN RATES.

The table in section 2502(a) (relating to computation of tax) is amended to read as follows:

"RATE SCHEDULE

"If the taxable gifts are—	The tax shall be—
Not over $5,000	3% of the taxable gifts.
Over $5,000 but not over $10,000	$150, plus 7% of excess over $5,000.
Over $10,000 but not over $20,000	$500, plus 11% of excess over $10,000.
Over $20,000 but not over $30,000	$1,600, plus 14% of excess over $20,000.
Over $30,0 but not over $40,000	$3,000, plus 18% of excess over $30,000.
Over $40,000 but not over $50,000	$4,800, plus 22% of excess over $40,000.
Over $50,000 but not over $60,000	$7,000, plus 25% of excess over $50,000.
Over $60,000 but not over $100,000	$9,500, plus 28% of excess over $60,000.
Over $100,000 but not over $250,000	$20,700, plus 30% of excess over $100,000.
Over $250,000 but not over $500,000	$65,700, plus 32% of excess over $250,000.
Over $500,000 but not over $750,000	$145,700, plus 35% of excess over $500,000.
Over $750,000 but not over $1,000,000	$233,200, plus 37% of excess over $750,000.
Over $1,000,000 but not over $1,250,000	$325,000, plus 39% of excess over $1,000,000.
Over $1,250,000 but not over $1,500,000	$423,200, plus 42% of excess over $1,250,000.
Over $1,500,000 but not over $2,000,000	$528,200, plus 45% of excess over $1,500,000.
Over $2,000,000 but not over $2,500,000	$753,200, plus 49% of excess over $2,000,000.
Over $2,500,000 but not over $3,000,000	$998,200, plus 53% of excess over $2,500,000.
Over $3,000,000 but not over $3,500,000	$1,263,000, plus 56% of excess over $3,000,000.
Over $3,500,000 but not over $4,000,000	$1,543,200, plus 59% of excess over $3,500,000.
Over $4,000,000 but not over $5,000,000	$1,838,200, plus 63% of excess over $4,000,000.
Over $5,000,000 but not over $6,000,000	$2,468,200, plus 67% of excess over $5,000,000.
Over $6,000,000 but not over $7,000,000	$3,138,200, plus 70% of excess over $6,000,000.
Over $7,000,000 but not over $8,000,000	$3,838,200, plus 73% of excess over $7,000,000.
Over $8,000,000 but not over $10,000,000	$4,568,200, plus 76% of excess over $8,000,000.
Over $10,000,000	$6,088,200, plus 77% of excess over $10,000,000.".

SEC. 1002. EFFECTIVE DATE.

Section 1001 shall apply with respect to calendar years after 1969.

TITLE XI—USE OF UNITED STATES BONDS TO PAY ESTATE TAX

SEC. 1101. REPEAL OF AUTHORITY TO USE BONDS FOR TAX PAYMENTS.

(a) REPEAL.—Section 14 of the Second Liberty Bond Act (31 U.S.C. 765) is repealed.

(b) PROHIBITION AGAINST USE OF BONDS.—Notwithstanding any other provision of law, no bond or other obligation of the United States may be accepted by the Secretary of the Treasury in satisfaction of any amount of Federal estate tax liability greater than the fair market value of such obligation at the time it is presented as payment of such liability.

SEC. 1102. EFFECTIVE DATE.

Section 1101 shall apply with respect to obligations acquired after June 30, 1969.

TITLE XII—USE OF FARMING DEDUCTIONS TO OFFSET NONFARM INCOME

SEC. 1201. LIMITATION ON DEDUCTIONS.

Part IX of subchapter B of chapter 1 (relating to items not deductible) is amended by adding at the end thereof the following new section:

"SEC. 277. LIMITATION ON DEDUCTIONS ATTRIBUTABLE TO FARMING.

"(a) GENERAL RULE.—In the case of a taxpayer engaged in the business of farming, the deductions attributable to such business which, but for this section, would be allowable under this chapter for the taxable year shall not exceed the sum of—

"(1) the adjusted farm gross income for the taxable year, and

"(2) the higher of—

"(A) the amount of the special deductions (as defined in subsection (d)(3)) allowable for the taxable year, or

"(B) $15,000 ($7,500 in the case of a married individual filing a separate return), reduced by the amount by which the taxpayer's adjusted gross income (taxable income in the case of a corporation) for the taxable year attributable to all sources other than the business of farming (determined before the application of this section) exceeds $15,000 ($7,500 in the case of a married individual filing a separate return).

"(2) EXCEPTION FOR TAXPAYERS USING CERTAIN ACCOUNTING RULES.—

"(1) IN GENERAL.—Subsection (a) shall not apply to a taxpayer who has filed a statement, which is effective for the taxable year, that—

"(A) he is using, and will use, a method of accounting in computing taxable income from the business of farming which uses inventories in determining income and deductions for the taxable year, and

"(B) he is charging, and will charge, to capital account all expenditures paid or incurred in the business of farming which are properly chargeable to capital account (including such expenditures which the taxpayer may, under this chapter or regulations prescribe thereunder, otherwise treat or elect to treat as expenditures which are not chargeable to capital account).

"(2) TIME, MANNER, AND EFFECT OF STATEMENT.—A statement under paragraph (1) for any taxable year shall be filed within the time prescribed by law (including extensions thereof) for filing the return for such taxable year, and shall be made and filed in such manner as the Secretary or his delegate shall prescribe by regulations. Such statement shall be binding on the taxpayer, and be effective, for such taxable year and for all subsequent taxable years and may not be revoked except with the consent of the Secretary or his delegate.

"(3) CHANGE OF METHOD OF ACCOUNTING, ETC.—If, in connection with a statement under paragraph (1), a taxpayer changes his method of accounting in computing taxable income or changes a method of treating expenditures chargeable to capital account, such change shall be treated as having

been made with the consent of the Secretary or his delegate and, in the case of a change in method of accounting, shall be treated as a change not initiated by the taxpayer.

"(c) CARRYBACK AND CARRYOVER OF DISALLOWED FARM OPERATING LOSSES.—

"(1) IN GENERAL.—The disallowed farm operating loss for any taxable year (hereinafter referred to as the 'loss year') shall be—

"(A) a disallowed farm operating loss carryback to each of the 3 taxable years preceding the loss year, and

"(B) a disallowed farm operating loss carryover to each of the 5 taxable years following the loss year,

and (subject to the limitations contained in paragraph (2)) shall be allowed as a deduction for such years, under regulations prescribed by the Secretary or his delegate, in a manner consistent with the allowance of the net operating loss deduction under section 172.

"(2) LIMITATIONS.—

"(A) IN GENERAL.—The deduction under paragraph (1) for any taxable year for disallowed farm operating loss carrybacks and carryovers to such taxable year shall not exceed the taxpayers' net farm income for such taxable year.

"(B) CARRYBACKS.—The deduction under paragraph (1) for any taxable year for disallowed farm operating loss carrybacks to such taxable year shall not be allowable to the extent it would increase or produce a net operating loss (as defined in section 172(c)) for such taxable year.

"(3) TREATMENT AS NET OPERATING LOSS CARRYBACK.—Except as provided in regulations prescribed by the Secretary or his delegate, a disallowed farm operating loss carryback shall, for purposes of this title, be treated in the same manner as a net operating loss carryback.

"(d) DEFINITIONS.—For purposes of this section—

"(1) ADJUSTED FARM GROSS INCOME.—The term 'adjusted farm gross income' means, with respect to any taxable year, the gross income derived from the business of farming for such taxable year (including recognized gains derived from sales, exchanges, or involuntary conversions of farm property), reduced, in the case of a taxpayer other than a corporation, by an amount equal to 50 percent of the lower of—

"(A) the amount (if any) by which the recognized gains on sales, exchanges, or involuntary conversions of farm property which under section 1231(a) are treated as gains from sales or exchanges of capital assets held for more than 6 months exceed the recognized losses on sales, exchanges, or involuntary conversions of farm property which under section 1231(a) are treated as losses from sales or exchanges of capital assets held for more than 6 months, or

"(B) the amount (if any) by which the recognized gains described in section 1231(a) exceed the recognized losses described in such section.

"(2) NET FARM INCOME.—The term 'net farm income' means, with respect to any taxable year, the gross income derived from the business of farming for such taxable year (including recognized gains derived from sales, exchanges, or involuntary conversions of farm property), reduced by the sum of—

"(A) the deductions allowable under this chapter (other than by subsection (c) of this section) for such taxable year which are attributable to such business, and

"(B) in the case of a taxpayer other than a corporation, an amount equal to 50 percent of the amount described in subparagraph (A) or (B) of paragraph (1), whichever is lower.

"(3) SPECIAL DEDUCTIONS.—The term 'special deductions' means the deductions allowable under this chapter which are paid or incurred in the business of farming and which are attributable to—

"(A) taxes,

"(B) interest,

"(C) the abandonment or theft of farm property, or losses of farm property arising from fire, storm, or other casualty,

"(D) losses and expenses directly attributable to drought, and

"(E) recognized losses from sales, exchanges, and involuntary conversions of farm property.

"(4) FARM PROPERTY.—The term 'farm property' means property which is used in the business of farming and which is property used in the trade or business within the meaning of paragraph (1), (3), or (4) of section 1231(b) (determined without regard to the period for which held).

"(5) DISALLOWED FARM OPERATING LOSS.—The term 'disallowed farm operating loss' means, with respect to any taxable year, the amount disallowed as deductions under subsection (a) for such taxable year, reduced, in the case of a taxpayer other than a corporation, by an amount equal to 50 percent of the amount described in subparagraph (A) or (B) of paragraph (1), whichever is lower.

"(e) SPECIAL RULES.—For purposes of this section—

"(1) BUSINESS OF FARMING.—A taxpayer shall be treated as engaged in the business of farming for any taxable year if——

"(A) any deduction is allowable under section 162 or 167 for any expense paid or incurred by the taxpayer with respect to farming, or with respect to any farm property held by the taxpayer, or

"(B) any deduction would (but for this paragraph) otherwise be allowable to the taxpayer under section 212 or 167 for any expense paid or incurred with respect to farming, or with respect to property held for the production of income which is used in farming.

For purposes of this paragraph, farming does not include the raising of timber. In the case of a taxpayer who is engaged in the business of farming for any taxable year by reason of subparagraph (B), property held for the production of income which is used in farming shall, for purposes of this chapter, be treated as property used in such business.

"(2) INCOME AND DEDUCTIONS.—The determination of whether any item of income is derived from the business of farming and whether any deduction is attributable to the business of farming shall be made under regulations prescribed by the Secretary or his delegate, but no deduction allowable under section 1202 (relating to deduction for capital gains) shall be attributable to such business.

"(3) CONTROLLED GROUP OF CORPORATIONS.—If two or more corporations which——

"(A) are component members of a controlled group of corporations (as defined in section 1563) on a December 31, and

"(B) have not filed a statement under subsection (b) which is effective for the taxable year which includes such December 31,

each have deductions attributable to the business of farming (before the application of subsection (a)) in excess of its gross income derived from such business for its taxable year which includes such December 31, then, in applying subsection (a) for such taxable year, the $15,000 amount specified in paragraph (2)(B) of such subsection shall be reduced for each such corporation to an amount which bears the same ratio to $15,000 as the excess of such deductions over such gross income of such corporation bears to the aggregate excess of such deductions over such gross income of all such corporations.

"(4) PARTNERSHIPS.—A business of farming carried on by a partnership shall be treated as carried on by the members of such partnership in proportion to their interest in such partnership. To the extent that income and deductions attributable to a business of farming are treated under the preceding sentence as income and deductions of members of a partnership, such income and deduction shall, for purposes of this chapter, not be taken into account by the partnership.

"(5) TWO OR MORE BUSINESSES.—If a taxpayer is engaged in two or more businesses of farming, such businesses shall be treated as a single business.

"(6) RELATED INTEGRATED BUSINESSES.—If a taxpayer is engaged in the business of farming and is also engaged in one or more businesses which are directly related to his business of farming and are conducted on an integrated basis with his business of farming, the taxpayer may elect to treat all such businesses as a single business engaged in the business of farming. An election under this paragraph shall be made in such manner, at such time, and subject to such conditions as the Secretary or his delegate may prescribe by regulations.

"(7) SUBCHAPTER S CORPORATIONS AND THEIR SHAREHOLDERS.——

"For special treatment of electing small business corporations which do not file statements under subsection (b) and of the shareholders of such corporations, see section 1379.

"(f) REGULATIONS.—The Secretary or his delegate shall prescribe such regulations as may be necessary to carry out the purposes of this section."

SEC. 1202. TECHNICAL AMENDMENTS.

(a) The table of sections for part IX of subchapter B of chapter 1 of the Internal Revenue Code of 1954 is amended by adding at the end thereof the following new item:

"Sec. 277. Limitation on deductions attributable to farming."

(b) Section 172(1) of such Code is amended by adding at the end thereof the following new paragraph:

"(3) For limitations on deductions attributable to farming and special treatment of disallowed farm operating losses, see section 277."

(c) Section 381(c) of such Code is amended by adding at the end thereof the following new paragraph:

"(24) FARM OPERATING LOSS CARRYOVER.—The acquiring corporation shall take into account, under regulations prescribed by the Secretary or his delegate, the disallowed farm operating loss carryovers under section 277 of the distributor or transferor corporation."

(d)(1) Subchapter S of such Code is amended by adding at the end thereof the following new section:

"SEC. 1379. ELECTING SMALL BUSINESS CORPORATIONS ENGAGED IN BUSINESS OF FARMING.

"(a) SEPARATE APPLICATION TO FARMING INCOME AND DEDUCTIONS.—Under regulations prescribed by the Secretary or his delegate, an electing small business corporation which is engaged in the business of farming during its taxable year (other than a corporation which has filed a statement under section 277(b) which is effective for such taxable year), and the shareholders of such corporation, shall apply the provisions of sections 1373 through 1378, separately with respect to—

"(1) income derived from the business of farming by such corporation and deductions attributable to such business, and

"(2) all other income and deductions of such corporation.

In computing the taxable income and undistributed taxable income, or net operating loss, of such corporation with respect to the business of farming, no deduction otherwise allowable under this chapter shall be disallowed to such corporation under section 277.

"(b) SHAREHOLDERS TREATED AS ENGAGED IN BUSINESS OF FARMING, ETC.—For purposes of section 277—

"(1) each shareholder of an electing small business corporation to which subsection (a) applies shall be treated as engaged in the business of farming.

"(2) the undistributed taxable income of such corporation which is included in the gross income of such shareholder under section 1373 and is attributable to income and deductions referred to in subsection (a)(1), and dividends received which are attributable to such income and deductions and are distributed out of earnings and profits of the taxable year as specified in section 316(a)(2), shall be treated as income derived from the business of farming by such shareholder, and

"(3) the deduction allowable (before the application of section 277 to such shareholder under sectiton 1374 as his portion of such corporation's net operating loss attributable to income and deductions referred to in subsection (a)(1) shall be treated as a deduction attributable to the business of farming.

"(c) SPECIAL RULES OF SECTION 277(e) APPLICABLE.—For purposes of this section, the special rules set forth in section 277(e) shall apply."

(2) The table of sections for subchapter S of such Code is amended by adding at the end thereof the following new item:

"Sec. 1379. Electing small business corporations engaged in business of farming."

SEC. 1203. EFFECTIVE DATE.

The amendments made by this title shall apply to taxable years beginning after the date of the enactment of this title, except that for purposes of applying section 277(c) of the Internal Revenue Code of 1954 (as added by section 1201 of this title) with respect to disallowed farm operating losses of any taxpayer for taxable years beginning after such date——

(1) such amendments shall also apply to the 3 taxable years of such taxpayer preceding the first taxable year beginning after such date, and

(2) in the case of a taxpayer to whom section 1379(b) of such Code (as added by section 1202(d) of this title) applies for any of his first 3 taxable years beginning after such date, section 1379 of such Code shall apply with respect to the electing small business corporation of which such taxpayer is a shareholder for the 3 taxable years preceding each such taxable year of such taxpayer, but only with respect to any such preceding taxable year for which the corporation was an electing small business corporation.

TITLE XIII—GAINS FROM THE DISPOSITION OF DEPRECIABLE REALTY

SEC. 1301. INCLUSION OF REALTY AS SECTION 1245 PROPERTY.

(a) AMENDMENT OF SECTION 1245.—Section 1245 (a)(3) (relating to gain from dispositions of certain depreciable property) is amended by redesignating subparagraphs (B) and (C) as subparagraphs (C) and (D), respectively, and by inserting immediately after subparagraph (A) the following new subparagraph:

"(B) any real property which is or has been property of a character subject to the allowance for depreciation provided in section 167, or".

(b) REPEAL OF SECTION 1250.—Section 1250 (relating to gain from dispositions of certain depreciable realty) is repealed.

SEC. 1302. EFFECTIVE DATE.

This title shall apply to dispositions occurring after June 30, 1969.

TITLE XIV—REPEAL OF 7 PERCENT INVESTMENT TAX CREDIT

SEC. 1401. REPEAL OF CREDIT.

Section 38 (relating to credit for investment in certain depreciable property) is amended by adding at the end thereof the following new subsection:

"(c) TERMINATION OF CREDIT.—The credit provided by subsection (a) shall apply only with respect to property placed in service by the taxpayer on or before the date of the enactment of this subsection and with respect to property placed in service after such date——

"(1) to the extent such property is attributable to construction, reconstruction, or erection by the taxpayer (A) on or before such date, or (B) after such date pursuant to the terms of a binding written contract as in effect on such date, or

"(2) such property was acquired by the taxpayer (A) on or before such date, or (B) after such date pursuant to the terms of a binding written contract as in effect on such date.

Notwithstanding section 46(b) (relating to carryback and carryover of unused credits), no amount shall be added pursuant to such section to the amount allowable as a credit by this section for any taxable year ending after the date of the enactment of this subsection."

SEC. 1402. The amendment made by section 1401 shall apply with respect to taxable years ending after the date of the enactment of this Act.

TAX REFORM ACT OF 1969

TITLE I: SHORT TITLE AND PROVISIONS FOR PERFECTING AMENDMENTS

TITLE II: TAXING CAPITAL GAINS UNTAXED AT DEATH—SAVINGS $2.5 BILLION

When shares of stock and other forms of property increases in value, the increase is subject to tax as a capital gain. However, the capital gains tax rate on property held for more than 6 months is only half of that for ordinary income, and it never goes higher than 25 percent. In addition, the tax is not assessed until the property is sold and the increase in value is realized.

But some capital gains are never taxed at all. Here is how it works. Suppose a taxpayer bought some stock in a small electronics company for $5000 back in 1958. The company has flourished and the stock is now worth $15,000. If he sells it now he will have to pay a capital gains tax on the $10,000 increase in value. For the high bracket taxpayer who pays the maximum 25 percent capital gains rate, this means a tax of $2500. But if he never sells the stock and it passes on to his heirs, neither he nor his heirs will ever have

to pay income tax on the increase in value. The heirs' only responsibility for taxes is on any future profit they receive.

This loophole greatly favors those who have large amounts of accumulated wealth to pass on to the next generation.

Moreover, many older investors who would rather see that money go to their heirs than to the Internal Revenue Service tend to hold on to investments they would normally sell. As a result, capital which would otherwise be set free to flow into sound and productive investments is locked in, distorting investment decision-making.

Closing this loophole by simply taxing these capital gains at death would increase Federal revenues by $2.5 billion a year.

TITLE III: ELIMINATING THE UNLIMITED CHARITABLE DEDUCTION—SAVINGS $60 MILLION

The unlimited charitable deduction is a little-known device that costs the Treasury some $60 million a year in lost revenues.

The ordinary taxpayer may not deduct more than 30 percent of his income for his contributions to charity, no matter how much he gives. Not so for some millionaires, however. They are allowed to deduct gifts to charity without limit if—in that year and eight of ten preceding years—their charitable contributions plus Federal income taxes paid exceeded 90 percent of taxable income.

This may sound like a hard way to escape taxation, but it really is not if you are a millionaire and a careful investor. Notice that it is only 90 percent of *taxable* income that must be given away or paid in taxes—the millionaire who receives most of his income from capital gains, tax-free state and local bonds, and oil property will have relatively little taxable income. Thus the 90 percent requirement need not be a serious obstacle—a modest annual gift to a favorite charity, which might be a foundation set up by the wealthy taxpayer himself—and the full benefits of an unlimited charitable deduction is his to reap.

TITLE IV: ELIMINATION SPECIAL TAX TREATMENT FOR STOCK OPTIONS—SAVINGS $150 MILLION

The stock option loopholes enables top executives of large corporations to pay taxes on part of their incomes at low capital gains rates.

It works this way. If the executive is rewarded by his corporation with a bonus or a raise, he pays taxes on it just like everyone else. If he is a top-level executive, however, the corporation is more likely to give him an option to purchase its stock instead. The option is simply a right to purchase the company's stock at any time the executive wants to within, say, the next ten years, at the price the stock is selling for at the time the option is granted. Thus an executive granted an option in 1960 when the company's stock is selling for $50 a share can exercise it in 1968 by buying the stock at that price, even though the stock may have risen in value to $300 a share during those eight years. Exercising the option therefore gives him a capital gain of $250 a share, taxable at the low capital gains rates. By contrast, the man who received the same amount of income in the form of salary or a bonus would pay an income tax at least double that of the option-favored executive.

If perchance the stock should decline in value the executive is no worse off. He has no obligation to buy the preferred stock, so he simply does not exercise his option.

As a result of President Kennedy's 1962 request that the stock option loophole be closed, the Revenue Act of 1964 tightened up the terms qualifying business executives for this privileged treatment. The privilege still remains, however. It is time to ring down the curtain on it.

By so doing, the saving to the Treasury could well be $150 million.

TITLE V: ELIMINATING THE $100 DIVIDEND EXCLUSION—SAVINGS $225 MILLION

Corporation stockholders are specially favored by the $100 dividend exclusion loophole. These generally high-racket taxpayers get their first $100 of dividends each year tax-free. By contrast, their neighbors who put their money in savings accounts or in government bonds pay income tax on all the interest they receive.

The dividend exclusion was first written into the tax law in 1954. The osten-

sible reason was to compensate for the "double taxation" of dividends which are taxed first to the corporation as corporate income and then again as a dividend when distributed to the taxpayer.

The logic of this double taxation argument would lead to the conclusion that all dividends should escape tax, but even the strongest proponents of the 1954 dividend exclusion did not have the temerity to push for this.

Corporations and their stockholders are separate entities—legally and in fact. The very purpose of incorporation is to limit the owner's liability by separating his income and assets from those of the corporation. Since the stockholders benefits substantially by this legal separation from the corporation, it is no injustice for the law to continue to view the stockholder and the corporation as separate entities at tax time.

Double taxation, moreover, is all around us. Excise taxes, sales taxes, and use taxes are often pyramided on top of each other. There is a sales tax on automobiles, for example, yet many of the parts in the car were already taxed at least once before when they were sold to the car manufacturer.

Closing the dividend exclusion loophole would increase Treasury revenues by $225 million.

TITLE VI. ELIMINATING THE BENEFITS DERIVED FROM MULTIPLE CORPORATIONS—SAVINGS, $200 MILLION

Dividing a business enterprise into a number of separate parts for tax purposes has long been a disorder of the corporate world. The advantages of multiple incorporation result from the way the corporation tax is set up: the first $25,000 of a corporation's earnings are taxed at 22 percent, while everything above that is taxed at 48 percent. Therefore, dividing the enterprise up into a number of separate corporations, each reporting earnings of $25,000 or less, avoids the extra 26 percent tax entirely. Since each $25,000 in earnings beyond the first $25,000 would otherwise be taxed at the full 48 percent rate, there is a tax savings of 26 percent of $25,000 (or $6,500) for each separate corporation.

Take, for example, a corporation with earnings of $100,000 a year—splitting it up into four $25,000 corporations can save $19,500 a year in taxes. There is one case on record of a corporation that divided itself into 734 separate corporations, for a tax saving that approached $5,000,000 a year.

Although Congress put some limits on the multiple corporation dodge in 1964, this loophole still costs the Treasury $200 million a year.

TITLE VII. REMOVING THE TAX EXEMPTION ON MUNICIPAL INDUSTRIAL DEVELOPMENT BONDS—SAVINGS $50 MILLION

Communities throughout the country are today issuing municipal bonds bearing taxfree interest to finance industrial plants and commercial facilities for private, profit-making corporations.

The usual technique is for the municipality to construct a plant in accordance with the corporation's specifications and then to lease the plant to the corporation, using the rental payments to retire the bond.

Although the interest on state and local bonds has long been tax-free, this privilege was not extended to industrial development bonds until 1954, and then not by law but by a Treasury ruling.

There is no justification whatever for extending the tax-exempt privilege to these bond issues. They serve no public purpose, but merely subsidize plant construction for large corporations that are fully capable of financing these plants themselves. They flood the tax-exempt bond market and drive up interest rates on all tax-exempt bonds. And they have been a prime weapon in the arsenal of rural, largely Southern, areas seeking to lure run-a-plants from other parts of the country.

This plant piracy has forced a number of industrial states to allow their local governments to issue these bonds, with the result that some 44 states now authorize them. With virtually all states issuing these bonds, this kind of financing no longer gives one state an advantage over another. The states end up caught in a beggar-thy-neighbor rat-race which benefits no one but the subsidized corporations.

Early in 1968 the Treasury Department attempted to reverse its 1954 ruling be revoking the industrial development bond tax exemption. However, Congress thwarted this attempt by passing legislation that permitted the exemption to continue for most issues. The tax exemption was first limited to issues of under

$1 million, except that larger issues for arguably public purposes (like sports arenas, airports, pollution abatement facilities, and industrial parks) would remain tax exempt. Congress then raised the upper limit on bond issues to $5 million if the issuing community was willing to work within certain restrictions. The upshot of all this is that some 87 percent of industrial development bond issues will continue to be tax exempt.

Closing this loophole for good would save the Treasury at least $50 million a year.

TITLE VIII: A MUNICIPAL BOND GUARANTEE CORPORATION AS AN ALTERNATIVE TO TAX EXEMPT BONDS—SAVINGS $900 MILLION

The interest on state and local bonds has been tax-free ever since the original income tax law of 1913. As a matter of fact, taxpayers need not even report this income on their tax returns.

As a consequence, state and local bonds have long been a favorite investment for the very rich. Although the average taxpayer perceives no great advantage in buying municipal bonds at 4 percent when he can get corporate bonds that will pay him 7 percent, the tax free bonds look very good indeed to taxpayers in the 50-percent-and-up brackets.

Not surprisingly, then, over 80 percent of tax-free bonds held by individuals are in the hands of the wealthiest 1 percent of the population.

This tax exemption does, however, have one important redeeming future—it enables hard-pressed states and cities to raise money for schools, roads, water purification plants, hospitals, and other essential public facilities at relatively low interest rates. Simply taxing the interest on municipal bonds, therefore, would force munilcipalities either to pay higher interest rates (which few of them could) or to forego badly-needed public improvements.

Fortunately there is a solution at hand that does not involve giving tax-free income to millionaire investors. The idea is this: tax the income from these bonds, but have the federal government pay a direct subsidy to states and cities to compensate them for their higher borrowing costs. The Treasury would come out comfortably ahead on the deal, since it now *loses* far more revenue ($1.8 billion in 1968) than the states and localities *save* in lower borrowing costs (about $.9 billion).

This Title therefore sets up a Municipal Bond Guarantee Corporation to guarantee State and local bond issues against default, and to pay to states and localities an interest subsidy sufficient to reduce their interest payments by one-third. The funds for the subsidy would come from general Federal revenues. In return for the guarantee and subsidy, states and localities would be required to waive the tax exempt status of the bond issues involved, thus allowing the Federal government to tax the interest.

Although municipalities could continue to issue tax exempt bonds, the Guarantee Corporation route would be more attractive in most cases. Treasury Department experts estimate that municipal borrowing costs are only reduced 25 percent because of the tax-exempt feature, while the Federal interest subsidy would reduce their borrowing costs by 33 percent. The Treasury would also come out ahead, since they would get an estimated 42 cents in extra tax revenue for every 33 cents that had to be turned over to municipalities as an interest subsidy.

TITLE IX: REDUCING THE MINERAL DEPLETION ALLOWANCE FROM 27½ PERCENT TO 15 PERCENT ON OIL AND FROM 23 TO 15 PERCENT ON 41 OTHER MINERALS—SAVINGS $900 MILLION

The most notorious tax loophole of all is the oil depletion allowance. It allows oil producers to receive 27½ percent of the gross income from their oil wells tax-free—so long as it does not exceed 50 percent of net income. In theory, this is to compensate the oil man for the fact that the oil in his well is being used up, or depleted, much as other businessmen are allowed to take deductions for the depreciation of their plant and machinery. Unlike other industries, however, the oil depletion allowance continues year after year as long as the well keeps producing—it does not stop when the cost of the well is recovered. Normal cost depreciation, by way of contrast, permits capital assets to be depreciated over their useful life, but total deductions cannot exceed the total cost of the asset.

As a result of this provision, the Treasury estimates, the cost of the average oil well is recovered 19 times over. The effect of this on oil company tax bills is

striking: in 1966 the 20 top oil companies in America cleared a total profit of more than $4¾ billion—yet they paid Federal income taxes at the rate of only 8½ percent. That is about the same rate a man and wife earning $3,000 a year must pay.

Ideally, percentage depletion should be replaced with cost depletion. But since we are not living in an ideal world, this Title provided only that the oil depletion allowance be reduced by less than one-half, from 27½ to 15 percent, the percentage now applicable to over 40 other minerals. In addition, this Title would reduce to 15 percent the mineral depletion allowance on 41 minerals now enjoying a 23 percent depletion rate. Thus these two reforms would put a 15 percent ceiling on all percentage depletion.

The revenue gain from this modest proposal would be at least $900 million a year.

TITLE X: ESTABLISHING THE SAME RATE FOR GIFT AND ESTATE TAXES—SAVINGS $150 MILLION

Present tax law places a premium on a person giving away his property during his lifetime. Property given away during a donor's lifetime is taxed at the gift tax rate, which is only three-fourths as high as the estate tax rate that applies to property transferred at death. In addition, $3000 can be given away each year to any number of individuals without paying any gift tax. Finally, over and above these yearly $3000 gifts, $30,000 can be given away by a person during his lifetime without paying a gift tax.

This Title simply raised the gift tax rates by 25 percent to bring them in line with the estate tax rates. Property given away would then be taxed at the same rate without regard to whether it is given during the donor's lifetime or at his death.

This reform would bring in $150 million in extra revenues annually.

TITLE XI: ELIMINATING PAYMENT OF ESTATE TAXES BY THE REDEMPTION OF GOVERNMENT BONDS AT PAR—SAVINGS $50 MILLION

If upon death a person faces a probable $100,000 estate tax bill and has a smart lawyer, the lawyer will advise his client to buy $100,000 worth of long-term U.S. Government bonds. Why? Because the U.S. Treasury will redeem its bonds at par (face) value in payment of estate taxes, no matter what his client paid for them. If his client, for example, buys Government bonds for $80,000 and his estate turns them in at $100,000 a few weeks later, the decedent reduces his estate tax bill by 20 percent.

The Treasury loses $50 million a year as a result of this little known generosity.

TITLE XII: LIMITING HOBBY FARMERS' USE OF FARM LOSSES TO OFFSET OTHER INCOME—SAVING $400 MILLION

The "hobby farm" loophole allows wealthy individuals with a yen for the bucolic to escape both city life and a large amount of taxes by becoming gentlemen farmers. These part-time rustics get most of their income from sources other than farming, but by maintaining a farm they can take advantage of special farm accounting rules—which were developed to ease bookkeeping chores for ordinary, full-time farmers—and show "tax losses" which are not true economic losses. These tax losses are then used to offset nonfarm income, generally resulting in a large tax savings overall.

Not only is this loophole a large drain on the Treasury—around $400 million a year—it also gives the hobby farmer an unfair competitive advantage over the genuine farmer. The ordinary farmer must compete in the market place with these wealthy hobby farmers, to whom a profit in the ordinary sense is not necessary. In addition, the Treasury has said, the attractive farm tax benefits available to the wealthy have caused them to bid up the price of farm land beyond that which would prevail in a normal farm economy.

This Title deals with the hobby farm problem by limiting the amount of nonfarm income that can be offset by farm losses in any one year. For those with non-farm income up to $15,000, farm losses can offset this non-farm income in full. However, for each dollar of non-farm income in excess of $15,000, the amount of non-farm income that can be offset is reduced by a dollar. Thus, someone with a non-farm income of $20,000 could only offset $10,000 of it with farm losses, while someone with non-farm income of $30,000 or more could offset none of it with farm losses.

In addition, there are carryover and carryback provisions that allow farm losses to be offset against farm income—but no other income—for the prior 3 years and the subsequent 5 years.

TITLE XIII: ELIMINATING ACCELERATED DEPRECIATION ON SPECULATIVE REAL ESTATE—SAVINGS $150 MILLION

This Title would repeal section 1250 of the Internal Revenue Code, which permits accelerated depreciation on speculative real estate investments.

By taking advantage of this accelerated depreciation provision, a real estate speculator can deduct more than the normal amount of depreciation in the early years of a building's life in return for lower-than-normal deductions in the later years. However, if he sells the building at the proper time he can avoid those lower deductions in the later years. The new purchaser can in turn begin again with higher-than-average deductions, skimming the cream of accelerated depreciation before he too sells the property. The advantage of this for the speculator is that these higher-than-normal deductions can be used to offset ordinary income, reducing his tax bill.

But this is not the only tax advantage that flows from accelerated depreciation. If the speculator sells the property at a profit, his entire profit is taxed at the low capital gains rate—including the "book profit" resulting from accelerated depreciation. This extra book profit comes about because accelerated depreciation has reduced the nominal value of the property below what it would be if normal straight-line depreciation had been used. In most non-real estate transactions this extra book profit—the difference between book value—and real value—is taxed as ordinary income. Not so for real estate (except in certain limited circumstances). There this fictional gain is taxed at the reduced capital gains rates.

Repealing the accelerated depreciation provision would save the Treasury $150 million annually.

TITLE XIV: REPEALING THE 7 PERCENT INVESTMENT TAX CREDIT—SAVINGS $3 BILLION

The 7 percent investment tax credit, enacted in 1962, permits business firms to subtract from their tax bills 7 percent of the value of eligible new equipment installed during the year. It was intended to stimulate the economy by providing a subsidy to private investment.

However, our economy has been overstimulated and we are now in a period of serious inflation, fed in part by the investment tax credit. The credit concentrates inflationary spending power on precisely that portion of the economy that is already most overheated—the capital goods sector. And, having stimulated inflation in the capital goods sector in the first place, it creates a second round of inflation by causing business to hasten to invest before inflation drives up capital goods prices even further.

Nor is this all. In order to damp down the inflation caused in considerable part by the investment tax credit, the country's monetary authorities are currently engaged in a policy of restricting money and credit and raising interest rates.

The purpose of the tight money policy is to slow inflation, mainly in the capital goods sector. Unfortunately, tight money and high interest rates fall upon the just and unjust alike. The business firm that overinvests in capital equipment may have to pay high interests rates, but it is bountifully subsidized by the government through the investment tax credit, and is thus largely insulated from the effects of interest rate increases. Meanwhile, the three segments of the economy that suffer most from tight money and high interest—the housing industry, state and local government, and small business have no investment tax credit to rescue them from the effects of tight money and high interest rates.

This Title would repeal the investment tax credit for all property installed after its enactment, except that property which was ordered under binding contract before enactment would continue to qualify. Doing this would bring in an extra $3 billion in revenues annually.

STATEMENT OF HON. BOB DOLE, U.S. SENATOR FROM THE STATE OF KANSAS

Mr. Chairman, I welcome your invitation to submit recommendations for income tax reform.

I agree with President Nixon's statement in his tax message to Congress on April 28, 1969, that reform of our Federal income tax system is long overdue—that too many Americans bear too much of the tax burden for too many who pay less than their fair share.

Among the inequities in our present tax structure, those listed below are, in my opinion, in need of attention:

1. Deduction against non-farm income of farm losses rising from unrealistic accounting methods—so-called "tax loss farming."
2. Increase the amount of the individual personal exemption from the current $600 per person to $1200.
3. Elimination of the scheduled termination of certain exemptions now accorded bank deposits owned by foreigners.
4. Remove tax exemption of certain non-profit organizations and make unrelated business income of churches subject to income tax.
5. Leave undisturbed the 27½ percent depletion allowance for oil and mineral exploration. This provision is essential to the continued search for oil and gas reserves in the continental United States.
6. To provide for the valuation of a decedent's interest in a closely held business for estate tax purposes as proposed by my bill S. 2200 pending before your committee.
7. To provide for sharing with the state and local governments, a portion of the tax revenues received by the United States as proposed by S. 1634 of which I am a co-sponsor.

A Statement of Position on the Tax Reform Act of 1969 (H.R. 13270) by the Following 70 Pennsylvania Colleges and Universities Submitted to the Committee by Hon. Richard S. Schweiker, a U.S. Senator From the State of Pennsylvania

Albright College, Reading
Beaver College, Glenside
Bryn Mawr College, Bryn Mawr
Bucknell University, Lewisburg
Cabrini College, Radnor
Carnegie-Mellon University, Pittsburgh
Cedarcrest College, Allentown
Chatham College, Pittsburgh
Chestnut Hill College, Chestnut Hill
College Misericordia, Dallas
Dickinson College, Carlisle
Drexel Institute of Technology, Philadelphia
Eastern Baptist College, St. Davids
Franklin and Marshall College, Lancaster
Gettysburg College, Gettysburg
Gwynedd Mercy College, Gwynedd Valley
Haverford College, Haverford
Immaculata College, Immaculata
Juniata College, Huntingdon
Keystone Junior College, La Plume
King's College, Wilkes-Barre
Lafayette College, Easton
La Salle College, Philadelphia
Lebanon Valley College, Annville
Lehigh University, Bethlehem
Lincoln University, Chester
Marywood College, Scranton
Moravian College, Bethlehem
Muhlenberg College, Allentown
Pennsylvania Military College, Chester
Philadelphia College of Pharmacy and Science, Philadelphia
Philadelphia College of Textile and Science, Philadelphia
Rosemont College, Rosemont
Saint Joseph's College, Philadelphia
Susquehanna University, Selinsgrove
Swarthmore College, Swarthmore
University of Pennsylvania, Philadelphia
University of Scranton, Scranton
Ursinus College, Collegeville
Villanova University, Villanova
Washington and Jefferson College, Washington
Westminster College, New Wilmington
Wilkes College, Wilkes-Barre

Twenty-seven additional independent colleges and universities are listed in Appendix C annexed hereto.

Believing that tax reform need not and should not be achieved at the expense of the long-range national interest, we join the American Council on Education and its 1538 institutional members in opposing certain provisions of H.R. 13270 that would adversely affect higher education by weakening some of the most effective incentives to its voluntary financial support.

Higher education in the United States has produced the men and women who have put Americans on the moon, banished many killing diseases, developed our economy, and made our system of government work. It holds our ultimate hope of rising to such critical challenges as the social and environmental ills of our cities. Clearly, funds contributed to colleges and universities go to the heart of our national welfare.

Today, the resources of our institutions are severely strained by the burgeoning demands on our services in the face of inflation and cutbacks in Federal aid.

We need more money, not less. Any discouragement of personal philanthropy from our accustomed benefactors would, it is submitted, increase rather than lessen the burden on the Federal government for the support of our institutions and indeed for our survival.

A gift to an educational institution has these characteristics that we believe pertinent to any consideration of its tax treatment:

It is a wholly discretionary expenditure.

It is an act of constructive citizenship, facilitated by favorable tax policy, but motivated by a concern for human good.

It is essentially an unselfish act; whatever the tax consequences, it reduces the donor's net worth.

With these insights into the nature of educational philanthropy and its importance to the vitality of our institutions, we have examined H.R. 13270 and assessed its implications in the broad context of the stated purposes of the Bill.

We concur in the purposes and general thrust of the Bill. We also concur in the principle that no individual should be able to "profit," that is, increase his net worth, by reason of donations to our institutions. The enactment of some of the provisions supported below, it should be pointed out, will clo meaningful avenues of past support for our institutions.

ACCEPTABLE PROVISIONS OF H.R. 13270

(1) Repeal of the Clay Brown transaction (pps. 25–26).[1]

The taxation of "unrelated debt financed income" of a charity where it acquires a business or investment property is justified. However, as written, it is possible that by reason of the definition of "obligation" in the statute, a promise to pay a life income or annuity in return for a gift of property will give rise to taxation. The life income contract and annuity agreement as used by our institutions is wholly distinct from the Clay Brown situation and the statute must be clarified if this unintended and unjustified side effect is to be avoided.

(2) Extension of the unrelated business income tax to activities which are not within the "function" of educational institutions and do constitute unfair competition to private enterprises (pps. 26–28).

(3) The increase in the annual limitation of deductibility of contributions to colleges and universities from 30% to 50% (pps. 31–32).

(4) Repeal of the unlimited deduction (pps. 32–33).

(5) Taking gain or income into account for tax purposes in the case of appreciated gifts to our institutions involving short term capital gain or ordinary income had the donated property been sold (pps. 33–35).

(6) Repeal of the Two Year Charitable Trust Rule (pps. 35–363).

(7) Allocation of basis in the case of a bargain sale of appreciated property to our institutions (pps. 33–35).

(8) Repeal of deduction for the charitable income trust with non-charitable remainders (pps. 38–39).

(9) Increase in the standard deduction (pps. 100–101).

(10) *Most important*, the continued deductibility at fair market value of the vital gifts to our institutions of long term appreciated securities and real estate.

OBJECTIONABLE PROVISIONS OF H.R. 13270

We feel impelled to oppose with the deepest conviction the following provisions, the enactment of which we believe would critically impair the voluntary support and financial viability of our institutions:

(1) Inclusion of the long term appreciation in donated securities and real estate in tax preference income for purposes of limited tax preference and allocation of deductions (pps. 47–50).

Gifts from individuals are the greatest single source of voluntary support for our colleges and universities; the largest of these gifts are commonly made in the form of appreciated property. In a sampling of Pennsylvania colleges and universities, a majority reported that from 30% to 70% of their total gift income from individual donors during 1968–69 was received in this form. (See Appendix A annexed hereto). Over the past three years, an average of 40.6% of outright gifts received by 18 of our institutions from individuals amounting to $43,415,000 consisted of securities.

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[1] (References are to August 18, 1969 *Summary of H.R. 13270* prepared by the Staffs of Joint Committee on Internal Revenue Taxation and Committee on Finance.)

The Ways and Means Committee deliberately chose to continue the deductibility of long term appreciated gifts at fair market value; the Bill's inclusion of the appreciation in tax preference income and in allocation of deductions is inconsistent with the principle which the Committee studied and upheld. Adoption of this provision would be severely damaging to our institutions; it would discourage precisely the very large gifts that make or break our programs of voluntary support. The deductibility of such gifts of appreciated property produces a benefit to society wholly distinctive from the other stated tax preference items. The unfortunate consequences of this provision would, in our judgment, discourage such vitally needed philanthropy at great cost to our future welfare and for relatively little revenue to the federal government.

(2) Inclusion of gifts of "a future interest in property" among those appreciated gifts that would be disqualified for deduction on the basis of fair market value (p. 34).

The adverse effect of this provision would appear unintended. The stated reasons for denying deduction for such gifts are (a) difficulty in evaluation and (b) over-valued claims for deduction. Although abuses infrequently arise in the valuation of gifts of tangible personal property, they do not occur in gifts of future interest. For colleges and universities, the provision would virtually eliminate gifts subject to life income. These gifts are usually made by donors of limited means who wish to contribute substantially to their college or university, but who must safeugard their personal lifetime security by retaining the income from their gifts. Upon the death of the income beneficiaries, the gift passes irrevocably to the institution.

The value of the tax deduction on such a gift is exactly ascertainable by mathematical computation; under existing law, it is determined by reference to U.S. Treasury issued actuarial tables.

The experience of representative Pennsylvania colleges and universities during 1968–69 (See Appendix B attached hereto) shows that gifts subject to life income are preponderantly in the form of securities. Such gifts would be markedly discouraged, if not altogether precluded, by the loss of fair market value deductibility.

(3) The assorted effective dates of various provisions of H.R. 13270 and the prospective application of new rules to past established contracts or trusts between donors and our institutions are not only confusing, but are inequitable. Such arrangements entered into with *bona fide* reliance on existing statutes or regulations should not, we submit, be upset.

Other provisions of H.R. 13270 to which we respectfully call attention are:

(1) Charitable Remainder Trust (pps. 37–38).

Tied in with gifts of "future interest," previously discussed, these provisions designed to prevent a life tenant from benefiting at the expense of the remainder interest passing to our institutions, fail to distinguish between situations where control of the assets is in the hands of the educational institutions and where it is not. Where an educational institution is Trustee, the possibility of abuse is eliminated, for, realistically, no reputable college or university would countenance tax mischief on the part of a donor. Similarly, trust law concepts of every state impose fiduciary responsibilities upon Trustees, which make improper administration punishable by surcharge. The Bill provisions would eliminate deduction for the traditional life income gift, namely, a reservation of a life estate in real property with the property passing outright at the death of the life tenants to a college or university. Again, in such a situation, deduction abuse is not possible and the basis for this restriction is without merit.

(2) Charitable contributions of estates and trusts (pps. 36–37).

The one-year "set-aside" limitation is insufficient where circumstances beyond the control of a Trustee or an Executor (e.g., tax audits, litigation, appraisals) prevent a distribtuion to a charity within that period.

(3) Gifts of tangible property (pps. 33–36).

Other than a gift of one's own work by an artist, author, or other creative person, gifts of tangible property are now capable of fair evaluation by Treasury procedures, which prevent an excessive deduction. The fair market value deduction has encouraged gifts of unique manuscripts and great works of art to our institutions that might otherwise not be made available to students, scholars and the public.

(4) Gifts of use of property (p. 37).

This provision requires a clarification of definition. As written, a donor might be denied a charitable deduction for a gift of 50 acres of a 100-acre tract of land,

or a remainder interest subject to a life estate. As intended, the provision was to deny a deduction for the fair rental value where a gift of use of property was made—a principle we do not oppose.

(5) Filing information returns (pps. 18–19).

While none of our institutions objects to disclosure to the Treasury of its income and expenses, or its donors or highly compensated employees, the extraordinary proposal to expose this latter information by name and address to the public record could have serious adverse consequences in the day-to-day operations of our institutions. The rationale for their rule with respect to "private foundations," namely policing their exempt status, is inapplicable, we submit, to educational institutions such as ours. Our purpose is in evidence on our campuses at all times.

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In addition, we question the logic of taxing foundations at a revenue-producing rate. Foundations are an important source of support for higher education and a stimulant to innovative solutions to society's problems. To supervise foundations and require them to bear the cost of supervision is eminently fair; to impose a tax upon them ostensibly to raise revenue would be a denial of the function for which this type of organization was permitted by Congress.

Regulation of foundation expenditures through penalty must not be an excuse for control; if this happens, their distinctive contribution to society will be largely lost, and contemporary problems, often requiring legislative cures, will ultimately lose the benefit of the research which Foundations have supported with increasing effectiveness.

CONCLUSION

Tax reform, once enacted, will influence national priorities for years to come. We believe the Congress would agree that the development of our capabilities in higher education must have a basic place among these priorities.

Speaking for 70 colleges and universities in the Commonwealth of Pennsylvania that are educating aproximately 128,600 students each year and whose expenditures for that purpose aggregated over $348,000,000 in 1968, we urge that while tax reform is needed and timely, remedial legislation must not impede the fulfillment of national expectations vested in our country's colleges and universities. If we are to continue to provide knowledge, education, and understanding as wellsprings of our nation's strength, critical incentives to private support require the endorsement of our nation's leaders.

APPENDIX A

GIFTS OF SECURITIES OR REAL ESTATE TO REPRESENTATIVE PENNSYLVANIA COLLEGES AND UNIVERSITIES FROM INDIVIDUAL DONORS IN FISCAL YEAR ENDING JUNE 30, 1969

Institution	Value of gifts of securities or real estate from individuals	Percentages of such gifts to total gifts from individuals
Haverford	$1,214,000	70
Pennsylvania	6,909,000	61
Juniata	243,000	53
Lehigh	2,022,000	52
Chatham	5,000,000	50
Carnegie Mellon	6,573,000	48
Lafayette	674,000	44
Bryn Mawr	1,536,000	44
Pennsylvania Military College	561,000	40
Moravian	244,000	34
Rosemont	271,000	34
Washington & Jefferson	418,000	33
Drexel	327,000	32
Gettysburg	352,000	27
St. Joseph's	350,000	26
Bucknell	441,000	24
Lebanon Valley	58,000	23
Westminster	280,000	22
Villanova	89,000	15

APPENDIX B

ILLUSTRATIVE GIFTS SUBJECT TO RESERVATION OF LIFE INCOME MADE IN THE FORM OF SECURITIES

Institutions	Total value of gifts subject to life income	Percentage of such gifts made in securities
Philadelphia College of Pharmacy & Science	$150,000	100
Drexel	300,000	100
Lehigh	1,480,000	95
Carnegie Mellon	621,000	91
Pennsylvania	2,597,000	87
Bryn Mawr	750,000	85
Gettysburg	293,000	60
Bucknell	623,000	41

APPENDIX C.—ADDITIONAL ENDORSING INSTITUTIONS OF PENNSYLVANIA COMMISSION FOR INDEPENDENT COLLEGES AND UNIVERSITIES

Allegheny College, Meadville.
Alliance College, Cambridge Springs.
Carlow College, Pittsburgh.
Delaware Valley College of Science & Agriculture, Doylestown.
Dropsie College, Philadelphia.
Duquesne University, Pittsburgh.
Elizabethtown College, Elizabethtown.
Gannon College, Erie.
Geneva College, Beaver Falls.
Grove City College, Grove City.
Holy Family College, Philadelphia.
Lycoming College, Williamsport.
Mercyhurst College, Erie.
Messiah College, Grantham.
Moore College of Art, Philadelphia.
Mt. Aloysius Junior College, Cresson.
Philadelphia College of Art, Philadelphia.
St. Charles Borromeo Seminary, Philadelphia.
St. Francis College, Loretto.
St. Vincent College, Latrobe.
Seton Hill College, Greensburg.
Thiel College, Greenville.
Valley Forge Military Junior College, Wayne.
Villa Maria College, Erie.
Waynesburg College, Waynesburg.
Wilson College, Chambersburg.
York College of Pennsylvania, York.

STATEMENT OF HON. BOB PRICE, A U.S. REPRESENTATIVE FROM THE STATE OF TEXAS

Mr. Chairman, I greatly appreciate being afforded the opportunity to testify before the Senate Finance Committee on the subject of tax reform. I would like to confine my remarks today to several areas of the Tax Reform Act of 1969, which I think need rewriting by this committee.

OIL DEPLETION

I submit that the oil depletion allowance must be retained at its full 27½ percent, because maintaining a healthy and active oil and gas industry is vital to the continued well being of the nation.

Our economy is heavily dependent on the production of oil and gas. Together, they provide nearly three-fourths of all the energy consumed in the United States. The Department of the Interior has aptly summarized the national dependence on oil and gas as follows:

"The importance of petroleum to the national life of the United States at this particular moment in history is abundantly in evidence. It supplies nearly three-fourths of all energy consumed. Virtually all movement of goods and people depend upon it. The Armed Forces would be immobilized without it. Countless industrial processes employ it exclusively, and nine-tenths of all space-heating is provided by it. And quite apart from its use as a fuel, petroleum forms the base for 88 percent of all organic chemicals manufactured in the United States."

Petroleum is truly the life blood of the Nation.

Throughout our history, the petroleum industry has met our national consumer and defense needs for oil and gas. I need not remind the Committee of the major crises our nation has met by virtue of the fact we had a healthy and active petroleum industry. The list is long, and our memories poignant.

At the core of the vitality of our oil and gas industry is the depletion allowance. More than any other single factor, the oil depletion allowance has provided the means by which oil producers could keep abreast of ever-growing consumer and national defense demands.

The reason why the depletion allowance is of such critical import to the petroleum industry lies in the very nature of the business. Extracting oil and gas from the land is a risky proposition in terms of financial success. Only one out of nine drillings produce some oil, while merely one well in forty five is even profitable. Moreover recent industry experience shows that, on the average, only about one out of 50 exploratory wells will find oil and gas in significant quantities; that is, the equivalent of at least one million barrels of oil. These risks are just as real today as they were 10, 20, or 50 years ago. In spite of all our scientific progress and technological advancements, there is still only one way to establish the presence of oil and gas in the ground; and that, is to drill a hole.

Searching for oil and gas is an expensive business. Capital for the search is provided by a mix of federal and private funds. Industry-wide averages show that for every dollar the industry recovers through depletion, it must spend another four dollars from other sources to capitalize the hunt for and development of new reserves.

If the reduction in the oil depletion allowance made by the House is allowed to stand, several undesirable effects will follow. The incentive for the oil producer to assume the risks associated with the oil business will be reduced especially for the small independent producers who produce a significant percentage of our oil and gas. With reduced incentive, fewer oil operators will take the risk of drilling wells. With the lower level of federal recovery money flowing in, fewer investors will finance oil ventures. The inevitable result will be that our production of oil and gas will decline, with the decline stemming from the independent producers segment of the industry which would either be forced out of business by the decline in revenue, or absorbed by the major oil companies.

The decline in the production of oil and gas will have a two-fold effect on our economy: the price of gasoline and petroleum products will be increased to the ultimate consumer, and our oil reserves will be lowered to such a point that the United States will be forced to rely more on foreign oil. As we all are well aware, the political situation in the oil-rich Middle East is too uncertain and too volatile for the United States to rely on the area as a prime source of supply.

We all remember the crises we faced only a few years ago when our supply of foreign oil was cut off by the Mideast War.

A reduction in the depletion allowance will also overburden the petroleum industry; which is, contrary to popular opinion, carrying its fair share of the federal tax burden. In fact, the petroleum industry bears an overall direct tax burden exceeding that borne by other industries, even though its federal income tax bill is reduced by the depletion allowance. The reason for this is that the lower income taxes are offset by the heavier burden of other direct taxes such as severance and property taxes. As a result, in 1966 the total taxes paid by the petroleum industry, exclusive of motor fuel and excise taxes, were equivalent to 6.0 percent of revenues. This is contrasted with the fact that mining and manufacturing corporations paid direct taxes equal to 5.8 percent of revenues in the same year, and all business corporations paid taxes equal to 4.8 percent of revenues.

The income structure of the petroleum industry reveals a similar disparity. Last year, 99 petroleum producing and refining companies earned 12.9 percent return on net assets compared with an average return of 13.1 percent for all manufacturing companies. This does not represent an unusual year; the rate of return on net assets for the petroleum industry has been lower than the average for all manufacturing companies in eight of the last ten years.

In conclusion, I re-emphasize the importance to the consumer, the petroleum industry, and the nation, that the 27½ percent depletion allowance has. It *should not* and *must not* be reduced.

CAPITAL GAINS

As passed by the House of Representatives, the provisions of the Tax Reform Act of 1969 dealing with the treatment of capital gains effects substantial changes in the present law. I feel that these changes, on the whole, will weaken our economic structure under the guise of reforming it, and their operation could cause irreparable damage to the nation's capacity for economic growth in coming years.

It is fundamental that an adequate level of investment must be maintained as a necessary precondition to continued national prosperity. What is not settled, however, is what the proper level of investment should be under varying economic conditions, and what combination of federal restraints should be utilized to insure that the proper level of investment is reached and maintained.

In recent testimony before this committee, Secretary of the Treasury David M. Kennedy made some pointed observations about the capital gains provisions of the Tax Reform Act of 1969. Secretary Kennedy noted that the Act is "weighted in favor of consumption, to the potential detriment of the nation's productive investment." He concluded that the House-passed version could impede economic growth in the years ahead by curtailing the incentive to make productive investments.

I fully agree with Secretary Kennedy's assessment of the impact to the national economy that would be caused by the new capital gains tax structure. In my view, the negative effects of the changes would manifest themselves in three ways.

First, the incentive for the businessman to take commercial risks would be reduced, and the supply of essential investment funds would be seriously curtailed. Since the early twenties, Congress has acknowledged through its taxation policy that there are distinct differences between ordinary income and income realized on true capital assets. The Congress has based its policy on the belief that it is in the national economic interest to encourage people to invest in productive enterprises. Capital must be encouraged to flow into new commercial ventures if society is to benefit from new technological trends and discoveries. This is part of the genius and the guiding force of our capitalist system.

It is axiomatic that the willingness of an individual to assume commercial risks depends to a considerable extent upon the prospect he sees for a suitable return on his investment. Obviously, then, if higher tax rates were levied on the gains an individual derived from his investments, the incentive of the individual to even get involved in a risk enterprise would be reduced. Consequently, if the tax treatment of capital gains is altered so that capital gains received less favorable treatment as is contemplated in the House-passed Tax Reform Bill, then the flow of investment capital to new ventures will be reduced. This would not be in the interest of the consumer, the businessman, or the nation.

Second, if the changes in the treatment of capital gains become effective, the investment in modern plant and equipment would decline. This is not a desirable consequence from a view of long term, national economic growth. As I mentioned earlier, the Administration has expressed the view that the tax reform bill involves too great an allocation of tax benefits to consumption and not enough tax benefits to investment in productive equipment and capacity.

It is well settled there is a clear need for an adequate level of investment to promote long-run economic prosperity. At present, the Federal government has available an adequate array of fiscal and monetary tools by which it can attempt to influence and control the level of aggregate private investment. It does not need more investment controls, especially of the type contained in the House-passed tax reform bill.

Third, any increases in the taxation of capital gains would adversely affect both the national level of investment and the allocation of investment funds. Economists generally agree that in order to achieve the optimum allocation of our economic resources, the mobility of investment capital should be encouraged. Accordingly, if investment funds are to be allocated among various commercial ventures with maximum value, it is essential for investors to have access to and be able to transact business in a liquid and orderly market. For this reason, tax measures which hamper investment liquidity and impair capital mobility are clearly undesirable. Moreover, in our free enterprise system, individuals should not be deterred from making desirable shifts in the composition of their asset holdings as their needs and expectations change.

In looking at capital gains in perspective, it is clear that in coming years, new capital and new investments must be generated if our economy is to meet the demands placed upon it by our growing population and our expanding technology. In the face of these demands, the traditional structure of incentives which has proven itself through the years should not be casually or hastily dismantled.

STATE AND LOCAL BOND INTEREST

The revised tax treatment of state and local bonds contained in H.R. 13270 is a matter of intense concern to our state and local officials throughout the country. I share this concern.

As we all are aware, the public pressure on state and local governments to furnish more and better services and facilities is enormous. I think this pressure is not only reasonable but its intensification is foreseeable on the basis of forecasted increases in our population, its needs, and its expectations.

Our citizens want their state and local governments to build more and better schools, hospitals, highways, water and sewer facilities, to provide all the other services that community oriented governments are peculiarly qualified to provide. This trend should be encouraged. Our political structure should be ordered so that problems government can resolve are attacked at their source with local personnel, rather than from afar by faceless and nameless bureaucrats for whom the people who have the problems are merely statistics, and the communities where the problems lie are only points on a map.

In providing expanded services, state and local governments receive federal grants-in-aid. These grants represent national policy decisions made in Washington, D.C. that the federal government must help state and local governments meet their obligations to their citizenry. President Nixon has recognized the needs of state and local governments in this regard and has proposed a dynamic and expanded federal revenue sharing plan for the states, as well as other measures to streamline and decentralize federal operations.

To date, total federal grants-in-aid to the states total approximately $25 billion. Grants for capital purpose will total about $6.5 billion for the 1970 fiscal year. The federal grants must be matched by recipient state and local governments; if there is capital expenditures involved, bond financing is used in most instances, because there is simply a lack of funds to do otherwise.

Governments raise money by various means. Taxation is the largest single revenue producer, but borrowing is also of great significance. In 1968, state and local governments issued more than $16 billion in debt instruments. Such a sum is evidence of the basic principle that the power to borrow is as essential to good government as is the power to tax.

If the Congress takes action to impair state and local capacity to borrow money, these governments will find their ability to raise capital funds, including those required to match federal grants greatly curtailed. This will mean that the costs for all public construction will be increased to the state or local government. As a result, the state or local tax burden of the people will be increased, and the construction of much needed public facilities could be slowed down or even halted. Eventually, of course, the facilities would be constructed. They would have to be paid for, however, out of increased sales and property taxes and utility fees. These taxes and fees, regressive though they may be, will have to be relied on even more heavily than at present in order to supply the necessary capital funds to state and local governments.

From a functional viewpoint, the effect of the tax reform bill is to tax the interest on state and local bonds in gradual stages. Within this context, the much discussed local choice to issue either tax exempt bonds or taxable bonds with an interest subsidy is an illusory choice. The illusion is created by the requirement that the Secretary of the Treasury fix the interest subsidy for fully taxable bonds each quarter on the basis of the difference between the interest yields on such full taxable bonds and the yield on "tax exempt" bonds as determined by the bond market at that time. It is thus apparent that this difference would gradually decline and the cost of borrowing to state and local governments even under the federal subsidy option would substantially increase.

From a philosophical viewpoint, I believe that the immunity of state and local governments in the exercise of their governmental functions from federal taxation is necessary for the preservation of our constitutionally delineated dual sovereignty system of government. Within this context, it is no more right for the federal government to interfere with or impede the states in the performance of their governmental functions than it is for a state to interfere with or impede the federal government in the attainment of its governmental aims.

An even more fundamental objection I have to the proposed tax treatment is that if the federal government undertakes to encroach upon the tax exemption of state and local securities, it inevitably has the power to control state and local financing. As we have learned from history, without self-control of its own financing, no government can maintain itself as an independent and autonomous body.

FARM LOSSES

While the House passed tax reform bill makes substantial changes in the tax treatment of farming operations, I will confine my remarks to a discussion of only three of the areas; tax-loss farming, lobby losses and the holding period for livestock. In addition, I would like to comment on what I think is an inequity in the Federal inheritance Tax structure which was not dealt with in H.R. 13270, an inequity which should be eliminated in any tax reform legislation.

H.R. 13270 attempts to correct a situation in which some high-income taxpayers who are not primarily engaged in farming have used farm losses to obtain a deduction in their high-bracketed nonfarm income. The means employed in the bill is to treat a gain on the sale of farm property as ordinary income rather than capital gains, to the extent of the taxpayer's previous farm losses.

Under H.R. 13270, the taxpayer would have to maintain an excess deductions account to record his farm losses. In the case of individuals, farm losses would be added to the excess deductions account only if the taxpayer had income from nonfarm sources of more than $50,000 for the year, and only to the extent that farm loss for the year exceeded $25,000.

In my judgment, the excess deductions account does not strike at the heart of the "tax-loss" farming loophole. It only postpones the issue and strikes at all farmers, big and small, and whether a farmer is bona fide or not is of no concern to the tax laws. I do not believe that the farmer who happens to lose money should be identified with, bear the blame, or share the guilt of those individuals who are "tax gimmick farmers." It is against those individuals, and not against the legimate farmer that punitive action should be taken. We have laws on the books which, if enforced, would put the "tax dodger" out of business. Section 165 of the Internal Revenue Code prohibits the deduction of any losses from a farm which is not being operated for profit. If laws such as this were rigorously enforced, as they should be, the Congress would not have to be considering ways to reduce the few remaining inventives that farmers enjoy today.

A corollary to this is the proposal contained in H.R. 12370 that limit the right of a farmer to deduct farm losses against non-farm income. This provision, if enacted, will seriously damage and curtail the operation of the genuine farmer of long standing in a community.

In today's highly competitive low profit farm economy, the farmer is increasingly turning to non farm enterprises in an effort to supplement his income. In so doing, the farmer is merely following the recommendation of the Farmers Home Administration, which, through its predecessor agency, began urging the farmer to diversify his farm operations when the agency first opened its doors in 1933.

The limited success that the farmer has enjoyed through diversification is reflected in recent statistics compiled by the Economic Research Service of the U.S.D.A. These statistics indicated that non farm income has become an increasingly significant factor in the life of American farm families. In 1967, the farm community netted $13 billion from farming operations and $10.7 billion from non farm sources. On the average, each farm operator family netted $4,526 from farming, and $4,452 from non farm activities. In this connection, it is interesting to note that non farm income per farm family more than doubled between 1960 and 1967.

I find certain inconsistency in proposals to vary and restrict the income accounting method traditionally utilized by the American farmer. By virtue of the so-called reform proposals, if the farmer proved to be more successful at farming than he was at his other commercial ventures, he could continue to deduct his business losses from his farming losses in computing taxable income. I believe that justice and fairness demands that the offset principle work equally in either direction.

Under H.R. 13270, a new hobby loss provision would disallow the deduction of all legitimate expenses from any business activity carried on "without reasonable expectation of profit." This contrasts to the present procedure whereby the "intent" of the taxpayer to make a profit is the controlling factor.

Under the new provision, the Internal Revenue Service would be permitted to decide whether or not the taxpayer's intent was reasonable.

Not only would this be a dramatic departure traditional in the evidentiary approach to federal taxation, it would also provide the IRS with too much authority to administratively adjudicate tax claims in this area.

I think the real danger in this lies in the fact that the determination of whether or not an particular operation constitutes hobby loss farming should not

be left to the determination of a group of individuals whose career success depends in large measure upon the number of tax claims processed, and the quantity of recoveries obtained.

Yet another provision in the farm loss section of the Act which is of great concern to me is the provision dealing with the holding period for livestock. If this provision becomes law, livestock breeders will be discriminated against. I say discriminated against because in our present tax structure there will be no other item of personal property which will receive similar tax treatment. Moreover, I do not believe that the reasons advanced by the proponents of this so called "reform" are sufficient to alter present law, a law which is of vital importance to livestock producers in Texas and across the country.

An area which I wanted to mention which was not included in the tax reform bill passed by the House is federal estate taxation. I fail to understand how the most revolutionary tax reform legislation since the inception of the Federal income tax law can ignore and fail to deal with the problem of Federal Estate Tax; especially as it affects the family-owned farming operation or a closely-held business.

I have introduced legislation in this session of Congress to rectify this problem. I had hoped that the House Ways and Means Committee would include it in its reform proposals but it did not. I would have made an amendment to H.R. 13270 on the Floor of the House and included my federal estate tax proposal had not the bill been debated under a rule of procedure prohibiting Floor amendments that was laid down for this particular occasion by the House Rules Committee.

My bill would permit the value of an estate for inheritance tax purposes to be set, at the option of the estate executor, either on the basis of the deceased's costs, or on the basis of the profit of the enterprise as revealed by the decedent's income tax returns. In action, my proposal would spare families who have farming, ranching, and small business operations from forced liquidation in order to pay high estate taxes resulting from unrealistic asset valuations.

The present inheritance tax laws were enacted in the emotion-laden depression years when men were selling apples in the streets, and bankers were jumping to their death out of Wall Street windows. During this tragic period in our national history, a few wealthy individuals flaunted inheritances with worldwide publicity. As a result, Congress enacted strict inheritance taxes to prevent similar episodes from reoccurring.

Unfortunately, the operation of the inheritance tax law has created many problems which are probably more middle-class in nature than they are the burden of the very wealthy. The wealthy have learned to use foundations and other tax loopholes to escape the full weight of the tax laws, leaving the tax burden to unfairly fall on the family farm and the closely-held business.

I believe that this is a situation that has existed too long without correction. This committee has an opportunity to affect substantial reform in this area; I hope it will do so.

Mr. Chairman, the areas of oil and gas, capital gains, state and local bonds, and farm losses generally encompass the major disagreements I have to the Tax Reform Act of 1969, as presently written.

I made my disagreements known to my colleagues in the House, and during the Floor debate on the bill, I joined 76 other Members who voted for a motion which wolud have sent H.R. 13270 back to the House Ways and Means Committee for further consideration. Unfortunately, we did not prevail.

On final passage, I voted for H.R. 13270 for the fundamental reason that the Act grants substantial tax relief to low and middle-income families, the very individuals who are presently most unfairly burdened by our tax structure. My feeling was that on the issue of tax reform, it was the role of the House of Representatives to devise a comprehensive tax reform legislative package, which the Senate could then rework and refine. It is in this spirit that I have submitted this testimony for your consideration; I hope it aids the Committee in its deliberations.

Statement Submitted by Arthur M. Arnold, Director of Taxation and Governmental Affairs, Empire State Chamber of Commerce

The Empire State Chamber is a federation of 180 local chambers of commerce and statewide associations with an underlying membership of 80,000 business firms. Our interest in federal tax reform stems from our representation of those 80,000 firms and their employees whose federal tax payments represent a major part of New York State's contribution to federal tax revenues. With New

York State leading as the major contributor to national governmental costs, its residents and businesses are most sensitive to changes in the structure of the taxes they pay.

Viewed broadly, the Internal Revenue Code suffers from two major deficiencies. It is excessively complex both in substance and application, and it distributes the tax burden unevenly and inequitably.

In recent years a third negative characteristic has been added—instability. This quality derives principally from successive enactments of reduced income tax rates, temporary surtax and temporary surtax extension on one hand, and of investment credit and its suspension and restoration (and currently proposed repeal) on the other.

Thus tax reform appears to be needed and, if there were no other factors to be considered, a tax reform bill which would provide greater simplicity, more even distribution of burden and greater stability would be justified. Despite its apparent acknowledgement of those needs, H.R. 13270 fails to achieve even that standard. Moreover, other factors, where applicable, negate the propriety of individual proposals embraced in the bill.

Consideration of a few of the elements of H.R. 13270 will demonstrate the bill's shortcomings and factors that were overlooked or disregarded when it was drafted.

STANDARD DEDUCTION AND MINIMUM STANDARD DEDUCTION

At a substantial revenue cost the bill would increase the rate and ceiling of the standard deduction and the minimum and maximum limits of the minimum standard deduction.

Both of these proposals appear to lose sight of the fact that the standard deduction basically is no more than a *de minimis* rule that provides administrative advantages for both taxpayers and tax administrators. The institution of the minimum standard deduction was an unwarranted departure from the *de minimis* approach, notwihtstanding the social motives underlying its enactment. It is objectionable on the ground that it uses the income tax law as a welfare device. Expanding the minimum standard deduction is subject to the same criticism.

Increasing the standard deduction would be both too much and too little: too much because it would grant some taxpayers substantially more in deductions than they would be entitled to by itemizing, and too little because the ceiling of adjusted gross income of $13,333 bars taxpayers earning incomes in excess of that amount the privilege of making a simplified computation except at the cost of increased tax liabilities.

In actuality these proposals are aimed at a serious defect in the structure of the individual income tax, a defect that should be cured. The method proposed, however, is wrong and does not merit enactment. It should be noted particularly that the minimum standard deduction, while having the effect of removing numerous taxpayers from the rolls, would benefit most of them very little, yet in the aggregate would occasion a substantial revenue loss. It seems clear that a device that would save one taxpayer $5 and another much more would not contribute to establishing a fairer distribution of the tax burden.

The same argument may be used with respect to the increase of the standard deduction which would grant (1) no benefit to the taxpayer with $13,333 of income and more than $2,000 of itemized deductions; (2) little benefit to one with slightly less than $2,000 of deductions but substantial benefits to those whose allowable deductions do not exceed 10% of their adjusted gross incomes.

A proper solution of this problem would be reestablishment of the original principle described as follows in *Your Federal Income Tax*, Treasury Dept., Bureau of Internal Revenue, 1951, 1952 and 1953 eds., p. 2: "The treatment of personal exemptions has been simplified. Originating as an allowance to leave untaxed a part of each taxpayer's income 'to rear and support his family according to the American standard and to educate his children,' the personal exemption has varied according to the Government's need for revenue."

If the federal government is prepared to suffer a revenue loss to increase equity and fairness of individual taxes, it should do so by increasing the deduction allowable for personal and dependency exemptions to a level that has a closer relationship to the minimum standard-of-living level. Although $600 per exemption was widely regarded as inadequate in 1951, let us assume that it was reasonably proportional to living costs at that time. That figure needs a substantial boost to absorb the rise in living costs recorded since then. Raising the amount deductible for each exemption would benefit taxpayers qualified to use

the minimum standard deduction and those who use the standard deduction. It also would benefit all other taxpayers and serve as a move away from the continuing distortion of the ability-to-pay principle which is manifest in the two proposals under consideration.

The common use, both publicly and privately, of a means test to determine eligibility for a service or the charge to be assessed for that service, when coupled with the progressive income tax rate structure and other so-called ability-to-pay devices, appears to represent a reversal of the principle described in the internal revenue publication.

If there is any sincerity about reform, amendments should be aimed at granting fair treatment to middle-income taxpayers, using the broadest definition of that term, who now and for years have paid tax at the most rapidly progressive rates while disqualified from the benefits provided by their tax contributions to federal, state and local governments.

INCOME SURTAX AND RATE REDUCTION

H.R. 13270 embraces provisions that would extend the income surtax at 5% for six months of 1970 and reduce the rates of the individual income tax in two steps effective in 1971 and 1972. Reason suggests that rate reduction be provided at the same ratio to the basic tax that the existing surtax bears to that basic tax without special treatment of certain levels of taxable income or certain classes of taxpayer. If there is to be any departure from that philosophy it should take the form of reducing the rapid progressivity of rates in the middle income brackets. Relief for middle income taxpayers is long overdue. If the pending bill is enacted with any change in rates, whatever preferences are provided should be concentrated in the middle income area in a manner that would embrace benefit to upper bracket taxpayers as well. In this regard it is sufficient to note that if individual income tax rates were reasonable in amount from the bottom to the top, there would be no impetus for establishing a maximum tax.

Deferral of rate reduction to 1971 and 1972 is viewed with suspicion. The recent history of federal taxation includes instances of immediately applied temporary rate increases and their extension, and deferral of enacted tax rate reduction and tax repeal. What assurance does the American taxpayer have that any deferred tax rate reduction provided in a bill that becomes law would be in force on the originally scheduled effective date?

ALLOCATION OF DEDUCTIONS

The proposal calling for reduction of specified itemized deductions in proportion to the ratio of specified *tax preferences less $10,000* to *adjusted gross income plus tax preferences minus $10,000* represents a broad brush treatment of an aggregate of tax refinements that have developed over a period of many years. It is doubtful that this proposal would survive penetrating scrutiny in the light of the reasoning that led to the tax preferences which it embraces. We prefer, however, to base our comments on this proposal on its patient complexity and its potential.

It is easy to visualize the difficulties involved in the computation that would be called for by the proposal. This is borne out by the text of the bill and by the Ways and Means Committee's report Even the brief description contained in this statement which was intended to be simplified bears out the inevitable complications that would be produced.

Potentially this proposal, which would establish a new and detrimental principle of taxation, could be adjusted at a later date to reduce the $10.000 limitation or eliminate it. The broad imposition of this tax treatment would then constitute a return-making burden to a multitude of taxpayers without significant change in their individual tax liabilities.

Desirable characteristics of a good tax law among other things include its being understandable and easy to administer. This proposal would make a giant stride way from those characteristics.

NET LONG TERM CAPITAL LOSS DEDUCTION

The bill proposes that only 50% of the net long term capital loss deduction be allowable. The proposal embraces an inherent inequity which may be demonstrated by the following example.

In one year a taxpayer sustains a long term capital loss of $10,000 and in the succeeding year realizes a short term gain of $10,000. Under existing law he would be entitled to a capital loss deduction of $1,000 in the year of loss and would carry over $9,000 to the succeeding year to reuce his short term gain to $1,000 which would be includable in his gross income.

Under the proposed amendment, he would still be entitled to deduct $1,000 in the loss year. But in the year of gain his carryover would be only $8,000 and he would have to include $2,000 of capital gain in gross income. Thus he would be subjected to a tax on $1,000 net as a result of two transactions that wash out.

And, assuming no other intervening capital transactions, the amount of phantom income that would be taxable would be greater with each additional year that separated his long term loss from his short term gain.

The House Committee report indicates that this proposal is aimed at taxpayers who "manage their investments to realize their gains and losses in different years." What of the taxpayer who in his entire lifetime sustained only a single long term loss and never realized any gains, short or long term? His loss for tax purposes would be limited to 50% even though the producing transaction took place only one day too late to be treated as a short term loss.

CAPITAL GAINS ALTERNATIVE RATES

The bill would eliminate the provision for an alternative capital gains rate for individuals and increase the alternative rate for corporations to 30%. The House Ways and Means Committee's report on H.R. 13270 sought to justify the increase for corporations on the ground that the elimination of the alternative tax on individuals required "that a comparable adjustment should be made to the corporate alternative tax." This conclusion does not necessarily follow because individuals and corporations frequently have received differing tax treatment under the code. Moreover, if the proposal in respect to individuals were revised along the lines of the Administration's recommendations, the Committee's conclusion would have even less merit.

The proposed rate increase for corporations also overlooks the double taxation of corporate income; capital appreciation, subject to a higher rate at the corporate level, would be taxed again at individual rates when distributed as dividends.

The essence of these proposals would be to increase taxes on capital appreciation rather than true income. In effect, these changes would further reduce reinvestible funds in the private sector of the economy and contribute to a curtailment in the production of goods and commodities as well as to a decline in the creation of new jobs. These results should be avoided by retaining existing individual and corporate capital gains alternative tax rates without change.

PERCENTAGE DEPLETION

The bill would reduce the percentage depletion allowance for oil and gas wells from 27½% to 20% and the percentages provided for most other materials.

Intended to encourage exploration for and development of petroleum and mineral resources, depletion allowances have proved effective. Under the incentive they provide, available supplies of those natural resources have expanded beyond amounts that otherwise would have been available, have constituted an important asset for national defense and have contributed to holding down product costs to consumers.

With the level of after tax profits in the extractive industries substantially similar to those of manufacturing companies, there appears to be no basis for claiming that percentage depletion grants them an unfair advantage. Present allowances should be maintained in order to continue resulting national benefits.

EMPLOYEE MOVING EXPENSES

The bill would liberalize the deduction of moving expenses incurred in connection with an employee's change of residence occasioned by a change in his place of employment by adding househunting, temporary living and certain home sale, purchase and/or lease expenses as deductible items. The deduction allowable for these categories would be limited to $2,500 with househunting and temporary living expenditures limited to $1,000 of the $2,500. The bill also would revise other aspects of the deduction.

Under existing law an employee who transfers to a new duty station and residence suffers an economic loss even when his employer reimburses him for every dollar of his moving expenses because he must pay tax on reimbursements of non-deductible expenditures.

Broadening the deduction to include the specified categories of expenses would lessen the employee's loss. For this reason, the amendment deserves favorable consideration. However, the dollar limitations specified should be deleted because the proposed new qualifying expenditures in actuality more often than not greatly exceed those limits. Retention of the proposed limits would serve to provide a tax variable that in most instances would be beyond the employee-taxpayer's power to control.

Anyone who has experienced a household move—particularly under the pressure of a change of employment duty station—knows there are many costs involved which are not deductible under existing law and would not be deductible under the proposal. Apparently the amendment is not intended to provide a *carte blanche* deduction of all move-related expenditures. Under these circumstances it would be reasonable to permit the deduction of allowable expenditures without limitation.

The proposal to limit the moving expense deduction to transfers of 50 miles or more would be unfair to individuals moving within a metropolitan area. It would mean than an individual transferred for the convenience of his employer a distance of less than 50 miles would face a choice between a material increase in his commuting or a material increase in his tax liability. The existing 20 mile rule is a fair limitation and should be retained.

INVESTMENT CREDIT REPEAL

Taxes are a material consideration in the planning of a budget whether it be for personal, household or business purposes. Accordingly, it is reasonable for a taxpayer to expect that he may rely on the stability of the taxes to which he is subject. As noted before, the on again, off again investment credit has provided an instability factor for business. Rather than ending this influence, termination of the investment credit would again interrupt expansion and other plans of business.

When proposed, the credit was opposed by many businessmen who viewed it as a device that would be turned on and off to influence the level of industrial investment in productive facilites. The fears of business have been realized; when the credit was last restored, it was hoped that it would remain as a continuing factor in the progressive development and expansion of business. Repeal would break faith with that hope. It would leave countless unfulfilled plans that were encouraged by the credit and its effects would fall unevenly on those businesses that benefited from the credit and those that were too late.

Recent changes in tax rates and the enactment-suspension-restoration of investment credit have proved that tax revisions can influence the economy. They have not proved, however, that taxation should be used to influence the economy. It is suggested that every reversal of this kind reduces the elasticity of the economy and that time will prove that the use of taxes as an economic factor is harmful in the long run. The time to put an end to tax tinkering with the economy is now—by abandoning the proposal to repeal the investment credit.

CONCLUSION

Our views on selected issues involved in H.R. 13270 are not intended nor should they be interpreted as an indication of approval or disapproval of any other matters embraced in the bill. Nevertheless, it is appropriate to comment on the bill as a unit.

The measure bears evidence of inadequate consideration and evaluation of the impact on taxpayers, on the national economy and on state governments. It is composed of provisions imposing greater taxes on some and distributing benefits to others. We are not satisfied that either group of provisions is aimed in the right direction. We note, for example, the observation that has been made that the bill as presently constituted weighs heavily against and discourages investment.

We intend no criticism of the diligent labors of the House Ways and Means Committee in producing a "reform" bill under the pressures that were generated by the income surtax extension legislation which was passed just prior to recess. We urge, however, that careful and deliberate consideration of each proposal

is needed. We urge that tax reform should be obtained through curative development rather than through major surgery and we suggest that a segment of our statement for the House Ways and Means Committee hearings on tax reform (P. 980 of the record) provides guidelines within which that development should take place:

"One of the definitions of the word 'loophole' in Webster's Seventh New Collegiate Dictionary reads, 'a means of escape; esp: an ambiguity or omission in the text through which the intent of a statute, contract or obligation may be evaded.'

"As applied to the Internal Revenue Code, that definition points up the impropriety of indiscriminate labeling of beneficial tax treatments as 'loopholes.' The tax treatments now being so characterized did not come into being through inadvertence or ambiguity or omission in the text of the law. Instead, they were intended to effectuate national policy, to provide equity, to encourage or discourage certain action or for some other desirable purpose.

"It is our view that the labeling of any tax provision as a loophole is a popular emotional device and constitutes no argument in favor of change. Moreover, a change is indefensible unless the circumstances and considerations that gave rise to the special tax treatment in the first instance have changed and the special provision to be amended is not so strongly established and basic to the tax law that its reversal would constitute a breach of faith and an unfair imposition on taxpayers affected. Clearly it would be the height of inequality to change a provision providing a special tax treatment where taxpayers have taken action in reliance thereon and are unable to reverse their action."

Statement of the American Retail Federation, Submitted By Eugene Adams Keeney, President

This statement is submitted on behalf of the American Retail Federation. The American Retail Federation is a national organization which, through its 50 state and 28 national retail trade association affiliates, represents more than 800,000 retail establishments of all types across the country.

The responsibility for the awesome task of tax reform draws from the Federation admiration and deep respect for those who serve on this Committee. The Senate and Congress are to be congratulated for their efforts in reforming this vital aspect of American life.

The Federation is concerned with all aspects of tax reform. However, the American Retail Federation would like to present to the Committee the following specific comments.

PRIVATE FOUNDATIONS

Section 101 of the bill pertains to taxation of investment income of private foundations. The Federation supports the view that the proposed 7½% tax on foundations' investment income be lowered to a 2% "supervisory" tax. The 7½% tax would fall heavily upon those private foundations which are providing public service—supporting educational and charitable projects. A 2% tax would provide a more extensive and vigorous enforcement of the tax laws without diminishing or undermining the useful and necessary place which private charitable foundations have within our society.

MOVING EXPENSES

Section 231 concerns employment-related moving expense. The Federation supports the House of Representatives proposed liberalization of this deduction. The inclusion of (1) travel, meals, and lodging expenses for pre-move house-hunting trips (2) expenses for meals and lodging in the general location for a period up to 30 days after obtaining employment; and (3) various reasonable expenses related thereto—up to a total sum of not more than $2,500 for the moving expense deduction—is a realistic and equitable treatment of this problem.

DEFERRED COMPENSATION

In Section 331, the Federation is opposed to the House-proposed changes in the tax treatment of deferred compensation.

The discontinuance of deferred compensation plans would result in a revenue loss to the Treasury. This would be the case because current compensation would

be taxed at no more than 50% rate and the average would be less than the deduction the corporation would get at the 48% rate. Furthermore, pension plans would be improved to offset loss of deferred compensation plans with the net result that employer contributions to pension trusts would be increased (a revenue loss), but the employee is not taxed until he receives the pension.

The tax burden would fall unduly on the survivors. In many instances, the employee dies before receiving the deferred compensation. When the money is needed most, the new law would require the survivors to pay tax on deferred compensation at the high rates applicable to the breadwinner's most productive years.

The deferred compensation plan should be categorized as a "tax gimmick." No income escapes tax and no capital gain is involved. Payments are ordinary income in the year of receipt. Timing and amount of corporation's deductions coincide with individual's realization of income. Furthermore, any tax saving merely results from leveling of income.

Deferred compensation plans serve many useful and noteworthy purposes. Deferred compensation enables corporations to attract and retain capable people. Deferred compensation can be equated with or expressed in terms of shares of the corporation's stock, giving the employee an incentive to improve the corporation's profitability. It insures a flexible means of giving employees an appropriate level of income after retirement.

The proposed House changes relating to deferred compensation are unduly complex. For example, it is proposed that in each year a payment was received, the tax liabilities for all years in the period over which the deferred compensation was earned would have to be separately recomputed.

LUMP SUM BENEFIT DISTRIBUTIONS

For the same reasons as set forth above, the Federation believes that taxing lump sum distribution as ordinary income will further weaken employee incentive programs.

The present law properly taxes as a capital gain the amounts received in one taxable year which are attributable to many taxable years. Any change will be detrimental to the interests of the employees who have the expectation of capital gains treatment of the lump sum at date of retirement.

REAL ESTATE DEPRECIATION

H.R. 13270 would provide for restrictions on the use of accelerated methods of depreciation. The bill would limit accelerated depreciation on new real estate construction to 150% declining balance depreciation. The bill would deny accelerated depreciation to real estate purchased from prior owners. These provisions, the Federation respectfully submits, are unduly repressive. Any misuse of the existing accelerated depreciation are more than adequately remedied by the proposed recapture provisions in the House bill. The bill would amend the present recapture provisions of the Code to deny long-term capital gain treatment on the sale of real estate to the extent of all depreciation claimed in excess of straight line, eliminating the ten-year phase-out of the recapture provisions under present law.

INVESTMENT TAX CREDIT REPEAL

As a matter of basic principle, the American R-tail Federation supports a tax adjustment for business, both incorporated and unincorporated, based on investment in depreciable assets.

The Federal favors the retention of the liberalized investment tax credit. However, with deference to the Administration and the House of Representatives' opposition to the retention of the 7% investment credit, the Federation respectfully submits that in limited areas the credit be retained. The small businessman serves an important segment of our national business fabric. The 7% investment credit, in many cases, is vital to the existence and growth of small business. The credit in these circumstances should be retained.

MULTIPLE SURTAX EXEMPTION

Many of the smaller chain store units, particularly in the agricultural mid-West, the South and the Southeast serve communities from 1,200 to 12,000 people.

These are primarily service institutions and in order to preserve their regional

images and functions they engage in activities with profitable units, marginal units and loss units.

The average income of many of these chains is shockingly low per unit when measured by the popular conception "chain store", which calls to mind and vision, supermarkets and marble hall mercantile establishments.

A survey of such chains will disclose that the average net income per store will range from $1,500 to $25,000 with an average income well below the $10,000 figure. Taxes are after all merely a cost of doing business. When they relate to overall operations to the extent that such cost of doing business is increased, business must eliminate its costly or non-profitable divisions.

If business must retrench, it does so at the cost of service to the community leaving non-revenue producers and less effective methods of distribution to supply the vacuum.

The Treasury loss is apparent. First, there is the loss from the unit removed; second, the higher cost of doing business in the contracted enterprise, and a resultant net profit shrinkage; and finally, the loss to Treasury in distribution of profits to shareholders and owners.

Competition of the small chain is at the grassroots level, where revenue production is at a minimum and where Treasury loss from the first instances is not even likely to be recouped. Low level taxpayers and entities cannot fill the gap. One of the most overlooked areas of Treasury loss is the significant loss of revenues derived from the earning power of managers, assistant managers, and employees of units which will unquestionably be curtailed. The members of the Committee doubtless recognize from counterparts in their own communities the contributions made in revenue and community value.

In a survey of eight chains, which had a total employee role of approximately 11,000 employees, stores which had profits lower than $5,000 constituted employable units for fully one-half of this total.

The unfortunate situation in which we find ourselves is a misconception of the role of the chain store, which frequently serves as a warehouse clearing source or the equivalent of a retail organization.

The industries as a whole have significantly low net profit figures at all smaller chain levels.

The Federation supports a reasonable phase-out of the exemption in lieu of complete retention, preferably over a ten-year period after a three-year moratorium. In this way, the effect would not be so catastrophic on small marginal profit businesses.

OTHER CONSIDERATIONS

Section 119 of the Internal Revenue Code exempts from an employee's gross income those meals which, as a convenience to the employer, are served to the employee during working hours.

Many retail establishments have luncheon counter facilities in their stores. The luncheon counter employees are served a meal if their particular shift works through the common accepted meal hours. There is no option to take the meal or its cash equivalent. The meal is given as a convenience to the employer to keep the employees at the sites of their employment. The uneven flow of luncheon business makes any standardized meal hour extremely difficult; thereby, necessitating the serving of employee meals so that the employee will not be out of reach for sudden peak periods of business.

The Federation submits to the Committee a tax problem that has created difficulties to many segments of the retail industry, as well as taxpayers which operate restaurants and hotel and motels with restaurant facilities. However, the term "wages" is defined in both the Federal Insurance Contributions Act and the Federal Unemployment Tax Act as "all remuneration for employment, including the cash value of all remuneration paid in any medium other than cash." The cardinal question, therefore, under both Acts, is not whether the employee consumed a meal free of charge but, rather, whether the meal was offered by the employer and accepted by the employee as a part of the remuneration for services rendered. Section 31.3121(a)-1(f) of the Employment Tax regulations provides, in part, as follows:

"Ordinarily, facilities or privileges (such as entertainment, medical services, or so-called 'courtesy' discounts on purchases) furnished or offered by an employer to his employees generally, are not considered as remuneration for employment if such facilities or privileges are of relatively small value and are offered or furnished by the employer merely as a means of promoting the health, good will, contentment, or efficiency of his employees. The term 'facilities or

privileges,' however, does not ordinarily include the value of meals or lodging furnished, for example, to restaurant or hotel employees, or to seamen or to other employees aboard vessels, since generally these items constitute an appreciable part of the total remuneration of such employees."

The Federation submits that the Federal Unemployment Tax Act, Section 3306(b), Internal Revenue Code 1954, and the Federal Insurance Contribution Act, Section 3121 (2), Internal Revenue Code of 1954, be amended to clarify and correct the present conflicting rulings and regulations pertaining to the question of whether or not meals and lodging furnished to an employee for the convenience of the employer constitute remuneration for services rendered by the employee.

The amendments should establish a statutory test similar to Section 119 of the Internal Revenue Code of 1954, which sets up such a statutory test to determine whether such meals and lodging are income under the income tax law.

CONCLUSION

The monumental efforts that this Committee and its counterpart in the House of Representatives have undertaken will, aside from all else, carve an indelible place in American history. The importance of an equitable tax reform system is paramount in the minds of all Americans.

In conclusion, the Federation respectfully submits that the Committee, in giving full consideration to the Federation's comments, will enhance the principle for which tax reform was undertaken—an equitable tax system.

COMMUNICATIONS WORKERS OF AMERICA,
Washington, D.C., July 9, 1969.

HON. RUSSELL B. LONG,
U.S. Senate, Washington, D.C.

MY DEAR SENATOR LONG: Because tax policy—and equity thereof—will be the prime issue facing the 91st Congress, I am enclosing materials to outline the position of the Communications Workers of America and of organized labor in general.

We are calling on the Senate to look after the interests of the average citizen who actually pays his taxes. We regret that the House of Representatives last week failed to recognize its duty clearly enough.

The citizens of this Nation have been told that extension of the surtax is the "responsible" course, so that the Federal Government will not be plunged into chaos. We must reject that thinking, since the surtax has been a major factor in the skyrocketing increases in living costs, mortgage interest rates, and inflation in general. We see nothing "responsible" about extending taxes which we know are unfair to begin with. The responsible course is rejection of such expedients.

This Union firmly believes the Federal Government must have every last dollar to meet commitments; our argument is that the burden of taxation is improperly, and must be more evenly, distributed.

The Communications Workers of America trusts that the Senate will recognize the interests of the general public and act accordingly.

Sincerely yours,

JOSEPH A. BEIRNE,
President.

THE SURTAX

President Nixon, on April 19, 1969, asked the Congress to extend the so-called temporary surtax beyond its June 30 termination date. His proposal would raise the effective surtax rate on 1969 wages and salaries of individuals to 10 percent—up from last year's 7.5 percent rate.

He proposes, however, that the surtax rate on corporations, despite their unprecedented, after-tax profits, be the same as last year's rate. High income individuals would, of course, continue to avoid their share of the surtax since so much of their income is tax exempt.

American workers pay their regular taxes and the surtax, payday after payday, through the payroll withholding program.

They are willing to pay their fair share.

But they are tired of having to pay the share of others whose incomes are greater and whose taxes are lower.

We welcome President Nixon's recommendation for repeal of the 7 percent tax credit for business investment, a special tax privilege, which is fueling the fires of the major source of inflationary demand in the economy. But this one proposal does not satisfy the long overdue and critically urgent need for tax justice.

Furthermore the April 22, 1969, tax reform proposals offered by the Administration, even if adopted immediately, would not succeed in moving the tax structure very far toward tax justice. The President's proposals fail to directly attack the major loopholes which unconscionably reduce the tax burdens on the wealthy, such as capital gains, depletion allowances and state and local bond interest. And, equally important, though the President's tax proposals would effectively remove from the tax rolls those whose incomes are below government poverty standards, no relief is recommended for those of moderate and middle incomes, who bear the brunt of the tax burden.

We in the AFL-CIO will not support any extension of the surtax, until it is combined with immediate substantial and equitable reform of the federal income tax structure.

Full reform of the tax structure would provide revenue to eliminate the poor from the federal income tax rolls and provide much-needed tax relief to those with low- and moderate-incomes. And the urgently needed expansion of federal programs to meet America's urban crises would be fully funded.

The AFL-CIO's prescription for complete tax justice in America has been stated many times. In sum, achievement of tax justice depends upon taking the following steps:

Income from capital must be taxed the same as income from work. State and local bond interest must not be tax exempt. The provisions in the law which allow imaginary costs to be deducted from the taxable income of wealthy real estate operators, hobby farmers, and oil, gas and other mineral operations must be eliminated.

The Congress must close these and other loopholes and gimmicks which have rigged the federal tax structure against those whose income comes from the work they do.

There is no rational reason for lengthy delays. The time to bring the American standard of fair play into the tax structure is now.

The American people want tax justice and we will continue to fight for that goal.

RESOLUTION 31A-69-7 TAX REFORM

The United States Congress has been asked to extend the 10% surtax on individual and corporate incomes. When it was proposed in 1967, the surtax was advertised as the best means of controlling inflation, the rise in cost of living, mortgage interest rates, and Federal budgetary deficits.

After months of debate and parliamentary chicanery, the surtax was passed. Those who doubted the wisdom of the surtax in 1967 and 1968 now can point to these results:

Each wage-earner now pays an extra 10% in Federal taxes, with the money withheld from his personal budget already strained by the rampant inflation.

Many persons and corporations, who have been escaping taxation on large blocks of income, are benefited because the surtax cannot be levied on tax-exempt income.

Mortgage interest rates, cost of living, and inflation in general are reaching new high levels.

Many vital Federal programs, in the fields of education, health, housing, and community development, are being sharply curtailed because of budget priorities; the budget squeeze is a direct result of the failure of the Administration and the Congress to examine and amend the Internal Revenue Code so as to provide sufficient Federal revenues on the basis of equality of sacrifice and ability to pay.

Not content with record earnings, the major banks have been agitating for and receiving increases in the "prime" interest rate.

Existence of the surtax has allowed the Congress to postpone fulfilling its duty to correct the inequities in the tax structure. The Communications Workers of America and the AFL-CIO in 1967 strongly urged that the long-neglected job of tax reform be started. Had the Administration and Congress acted two

years ago, the job could have been done, and the Federal revenue system would not be in the present near-chaotic state.

Currently the Congress is studying "tax reform" legislation. The studies have been undertaken solely because of public pressure, a loud outcry from the average citizens who actually pay their taxes because they have no other choice. The wealthy and the corporations have been able to have tax laws so drafted as to protect their special interests. The list of "loopholes," or tax leakages, is lengthy and well known. While these "loopholes" are all legal, they are improper in that they benefit those who least need this kind of aid.

The opposition to fair taxation has begun to come to the surface. The Chamber of Commerce of the United States, long the unashamed champion of entrenched avarice, has asked the Congress to extend the 10% surtax and to forget about tax reform.

The Communications Workers of America wants the surtax to be allowed to expire June 30, in order that each member and all other wage-earners may have an immediate pay raise without having to go to the bargaining table. This Union is convinced that the sole means of forcing the Administration and Congress to become serious about equity of taxation is to reject the surtax, which is a thinly disguised expedient to help the rich. Therefore, be it

RESOLVED: That this 31st Annual Convention of the Communications Workers of America goes on record as opposing any further extension of the surtax, and petitions the Administration and Congress to produce more than "show window" tax legislation and to provide for equity and fairness in income taxation. We urge each member of the Communications Workers of America, all other members of organized labor, and those whose taxes are withheld from their paychecks, to intensify the already tremendous pressure on the Congress to enact a truly equitable tax law.

Communications Workers of America, AFL–CIO Executive Board Statement March 1969

TAX REFORM AND EXTENSION OF SURTAX

The Communications Workers of America in 1967 gave its full support to the 10% surtax on individual and corporate incomes, with that support conditioned on several factors.

However, the Communications Workers notes that the Administration and the Congress have not taken steps in those two years toward meeting the conditions set for CWA support.

Therefore, the CWA is opposed to the extension of the surtax in 1969.

The conditions for CWA support in 1967 were:

1. "That ability to pay must be the criterion and equality of sacrifice the watchword."
2. "That the Administration and the Congress face up at long last to those fundamental reforms needed to close the loopholes in our present tax structure."
3. That the corporate tax structure be examined, in light of the 7% investment tax credit and the accelerated depreciation guidelines.
4. That "the broad prospects of the Great Society must not be made the price for fulfilling those commitments (in Vietnam and elsewhere abroad)."

The surtax imposed in 1968 is not truly based on ability to pay. The Communications Workers of America offered an alternative which would have given true progressivity to the surtax.

There is no question that the tax laws are unfair, as written and administered. In February 1969, Mr. John D. Rockefeller III told the House Ways and Means Committee that he regularly has no Federal income tax liability whatever. However, he added that he gives voluntarily 5 to 10% of his adjusted gross income away.

Mr. Rockefeller has no legal tax liability, thanks to the treatment of rich people by the tax laws. However, a low-income workingclass person must pay at least 14% of his adjusted gross income.

The CWA's position is that the Federal Government must have all needed revenues to finance its programs, foreign and domestic. The sole factor in the CWA opposition to extension of the surtax is where the revenue is collected.

We are aware that the House Committee on Ways and Means is currently holding hearings on "tax reform." However, these hearings are not likely to produce equity in the tax laws. The Committee should forthrightly confront the areas in which the greatest abuses exist—depletion allowances on oil, gas

and other minerals, the 7% investment tax credit, accelerated depreciation of speculative real estate, foreign tax credits, and other areas of revenue leakage.

The Congress may adopt some kind of "tax reform" in 1969 or 1970. The American taxpayer will be the key to whether it is token reform or real revision for equity. Already, the lobbyists for special interest groups are peddling the nonsense that the tax concessions to the wealthy are in the national interest, that opposition is tantamount to treason.

April 15 is nearly upon us. The ordinary citizen, whose taxes are withheld from his paycheck, will only face penalties if he refuses to pay his balance due or to file his return. The wealthy person or company can dispute his tax bill for awhile, invest the money he should have paid the U.S. Treasury, eventually pay 10% or a little more as a quiet settlement or get a special tax law passed by the Congress to cover the individual situation.

Tax policy is always made behind closed doors of the House Ways and Means and Senate Finance Committees. The ordinary citizen is represented there poorly or not at all. The tremendous power and influence of the oil industry have thus far been able to protect its special privileges from the spotlight of public hearings. We all would enjoy hearing the true reason that there never are public hearings on reduction of depletion allowances. The alleged reasons do not hold up under examination.

The CWA contends that the only method for achieving equity in the tax structure is to oppose the extension of the surtax. Since the Administration needs revenue, it will be forced to support tax equity for its own sake and for needed revenue. The CWA rejects as nonsense the contention that tax reform will not produce much revenue. Too many billions of dollars of income escape taxation for that argument to be credible.

The Communications Workers of America calls on its members, all of organized labor, consumer groups, and the American people to tell Congress that they have had their fill of subsidizing the rich.

The term "tax reform" can mean many things, including protection of the many current tax giveaways in present law.

The CWA program of tax revision for revenue and equity—true reform—would include the following areas:

1. An increase in the standard deduction above the present 10% of adjusted gross income, or $1,000 (whichever is less).
2. An increase in the present $600 personal exemption for dependents.
3. Elimination of special tax treatment for capital gains, by which 50% of otherwise taxable income may not be levied. This income should be taxed at ordinary rates.
4. Reduction of the maximum allowance for charitable contributions, a special gimmick that allows the very wealthy to practice "funny bookkeeping" on their tax returns.
5. Reduce all mineral depletion allowances, so that oil, gas and other extractive industries will recover only their costs of development of the properties.
6. Require payment of a minimum tax of 14% on all income from $15,000 to $50,000 a year, and 20% above $50,000, regardless of source.
7. Eliminate tax benefits derived from organizing multiple corporations from a single firm.
8. Limit hobby farmers' use of farm losses to offset other income.
9. Eliminate accelerated depreciation on speculative real estate.
10. Repeal 7% investment credit for business.
11. Eliminate the tax-exempt status of all State and municipal bonds, including those for public facilities financing, industrial development and arbitrage.

COMMUNICATIONS WORKERS OF AMERICA,
Washington, D.C., April 24, 1969.

The PRESIDENT,
The White House,
Washington, D.C.

MY DEAR MR. PRESIDENT: We fully agree with the statement in your April 21 Tax Message to the Congress that "Our goal is to take important first steps in tax reform legislation during this session of the Congress."

It is most encouraging that your Administration shares our recognition of many of the problems facing our Nation's economy, including the inflationary effect of the 7% investment tax credit, the tax burden imposed on those least

able to pay, and the billions of dollars of non-taxable income accruing to high-income citizens.

While we agree with the import of your message, we find ourselves still in opposition to extension of the surtax—at any rate—on individual and corporate incomes. We hold to our position that the surtax should expire June 30, 1969, and that all necessary Federal revenues be derived from an entirely recast Tax Code whose first emphasis is on equity.

We recognize that your proposals represent only the first steps toward tax equity, and we know that the Treasury Department is diligently at work on the remainder of your tax program to complete the reform task, which we all agree is long overdue. The time for action is now, in 1969.

We pledge to you our full support in enactment of a Tax Code meeting these tests:

1. Production of all needed revenues;
2. Preservation of the tax base without erosion from tax credits and other forms of Federal expenditures escaping the normal processes of tax collection, appropriation, and oversight of spending;
3. Equity, i.e., ability to pay and equality of sacrifice.

Respectfully,

JOSEPH A. BEIRNE,
President.

COMMUNICATIONS WORKERS OF AMERICA,
Washington, D.C., March 27, 1969.

The PRESIDENT,
The White House,
Washington, D.C.

MY DEAR MR. PRESIDENT: I write this letter to apprise you of a statement on tax policy adopted today by the Executive Board of the Communications Workers of America. Our union, which gave strong but qualified support to the 10% surtax two years ago, cannot now continue that support any longer.

The members of the CWA Executive Board have asked me to convey to you their concern over the issue of unfair tax policies and I enclose a copy of the CWA statement setting forth our specific complaints.

Equally important, my colleagues and I agree that no general economic issue of recent years has so deeply aroused CWA members as the question of the element of fairness in our tax policy. Our reading of the sentiment of CWA members indicates that a tax rebellion may soon be the product of gathering discontent over the lack of equity in the tax laws.

Stated most simply: The tax system is drastically out of balance. Working people, as a result, must endure an unfair tax burden, and they resent it. The American people need a fair tax system—not some day, but now.

Mr. President, so long as wealthy persons and big corporations enjoy a variety of tax loopholes, the average working man and woman feels bitter that he is called upon to over-subsidize the government of the United States . . . particularly in a period of sharply rising costs of living. It is obvious that this out-of-balance tax payment structure cannot long continue to function.

Two years ago we in CWA based our support of the 10% surtax on a four-point stipulation that new elements of fairness must be introduced into the tax schedule: (1) the principle of "ability to pay" and "equality of sacrifice"; (2) the closing of loopholes that permit the wealthy to escape their fair share of the tax burden; (3) a re-examination of the corporate tax structure, which now offers 7% investment credits and many forms of fast depreciation to business firms and stockholders; and (4) no sacrifice of domestic programs to help our citizens in order to make possible the continuation of our necessary overseas commitments.

During the year of the surtax, the rich have continued to enjoy tax favors—while the pressure of inflated prices and even heavier taxes has rested on the shoulders of wage earners. This lack of balance erodes the morale of working people, it breeds suspicion and distrust, and it threatens the future continuity of domestic and international programs essential to the well-being of America and the entire free world.

There are sources of revenue—billions of dollars of revenue—to support the programs we need. A fair tax policy would make them available . . . not after years of study, but now in 1969. The loopholes can be closed; the depletion allowances can be stopped, as they should have been a long time ago; the busi-

ness investment credit of 7% can be repealed; the accelerated depreciation can be slowed down to a normal rate; the special-privilege foreign tax credits can be halted.

In other words, the time is ripe for ending special privilege in the tax structure.

Millions of working Americans look to you, Mr. President, for leadership in their search for relief from an unfair, out-of-balance tax structure. We ask you to provide that leadership, in order to halt the frightening trend of bitterness, despair and distrust among the average citizens of this great nation.

Respectfully yours,

JOSEPH A. BEIRNE,
President.

COMMUNICATIONS WORKERS OF AMERICA,
Washington, D.C., July 9, 1969.

Hon. RUSSELL B. LONG,
Chairman, Senate Committee on Finance,
U.S. Senate, Washington, D.C.

MY DEAR SENATOR LONG: Although the House of Representatives acted last week to extend the "temporary" surtax on incomes and the "temporary" excise taxes on automobiles and communication services, this Union calls upon your Committee to take the necessary steps to adjust the tax structure for equity and revenues.

The narrow five-vote margin on passage of the bill, H.R. 12290, carried a very clear message to the United States Congress: the wage earners who have no choice but to have their taxes withheld at the source are inflamed at the gross inequities of the Internal Revenue Code. Their interests were not adequately represented in the vote to extend their burden, while allowing the defects in the Code to continue in effect until some more appropriate "mañana."

Even the "reform" provision of H.R. 12290, the "repeal" of the Investment Tax Credit, contains enough exemptions to let one question whether this is a repeal.

On June 16, 1969, this Union, in Convention assembled, adopted a Resolution calling on the Congress "to enact a truly equitable tax law." A copy of the Resolution is enclosed.

I am also enclosing copies of my letters of March 27 and April 24 to the President, the CWA Executive Board Statement of March 1969, and the AFL-CIO Executive Council Statement of May 14, 1969, all dealing with the issue of equitable taxation.

Mr. Chairman, the members of this Union are well aware of the sizeable blocks of income now legally escaping taxation. A general breakdown of the public's confidence in the United States' tax system can be the only result of another patching-up of the present method of raising the needed revenues for the Federal Government.

It is our position that the needed revenues can and will be raised from a tax system designed for equity as well as revenue yield; in other words, a system based on ability to pay and equality of sacrifice.

Two years ago, this Union gave conditional support to the surtax. However, one of the four conditions for CWA support was met. Two years ago, the long-overdue work of tax reform could have begun, and the job could have been completed by this time.

The proposed 1969 extension of the surtax was rushed to the House floor without adequate discussion in Committee. On June 24, 1969, before the Committee on Rules during his remarks in favor of extending the surtax, Rep. John W. Byrnes was questioned about anticipated deficits and debt ceiling increases. Mr. Byrnes admitted that even with the surtax, the administrative budget would have deficits of $8.4 billion in Fiscal 1969 and $5.4 billion in Fiscal 1970. Mr. Byrnes added that the Administration would seek a debt ceiling increase by next March or April. Yet the alleged reason for extending the surtax has been "to keep the Government out of the money market." The facts show otherwise. As we both are aware, debt ceiling increases and deficits force the Government into the money market.

We of organized labor view tax policy as the prime issue facing the 91st Congress. A thoroughgoing revision of the Revenue Code can go a long way toward restoring the public's confidence in the Congress; such a revision can and must produce the needed revenues without resort to expedients and palliatives of which the surtax is a prime example.

I hope you and your Committee will consider the wishes of the 450,000 men and women represented by this Union when the time comes to decide on specifics. The major specifics we want to see emerging from the Committee on Finance will be rejection of the surtax and equitable, revenue-producing new provisions of the Internal Revenue Code.

Sincerely yours,

JOSEPH A. BEIRNE, *President.*

STATEMENT OF THE ILLINOIS STATE CHAMBER OF COMMERCE, SUBMITTED BY LESTER W. BRANN, JR., EXECUTIVE VICE PRESIDENT

This statement is presented on behalf of the Illinois State Chamber of Commerce, a statewide organization with a membership of more than 19,600 businessmen in 478 communities in every part of the State of Illinois. The members are engaged in virtually every type of business and range from the self-employed to those associated with some of the nation's largest corporations.

The recommendations set forth in this statement were developed by the Chamber's Federal Taxation Committee of sixty members after preliminary study and recommendations from its Subcommittee on Technical Tax Developments.

The Illinois State Chamber of Commerce has had a history of supporting fiscal responsibility, a balanced federal budget, reductions in federal spending, and reform of the federal tax structure.

For many years, the most basic reform we have advocated has been a reduction in federal income tax rates to reduce their stifling effect on business.

Secretary of the Treasury David M. Kenndey has pointed out that increasing the tax liability of corporations and high income individuals and decreasing tax liability of most individual taxpayers, the bill in its present form has the effect of encouraging consumption while discouraging investment and the creation of new production facilities.

The general effect of increase in some tax liabilities and decreases in others is further reinforced by various specific provisions with particular bias against the creation of production facilities, such as, repeal of investment credit, provisions relating to depreciation of real estate, changes in capital gain treatment, and taxation of natural resources.

We feel more attention should be given to this legislation's overall effect on economic stability and on long-term growth of the economy.

The legislation's apparent intention is to make the tax burden on individuals more closely approximate the stated progressive rate schedule of the Internal Revenue Code through the reduction of special treatment of some taxpayers.

To the extent the overall effect of the bill represents a shift from individual payments to corporate payments, the original purpose is defeated since corporate payments will be considered primarily as an additional cost of doing business which will be reflected in the price of the corporate product or service.

Thus, corporate taxes act somewhat as a sales tax—regressive in nature—tending to obscure the ultimate burden of the tax on individuals particularly those in the lower income brackets.

We suggest careful consideration be given to the recommendations of the Administration for the reduction of corporate tax rates and for a lesser reduction of individual tax rates. Also there seems to be strong arguments for reducing the overall revenue loss to prevent and control inflation and to provide adequate revenue for the financing of necessary government services.

We also suggest a careful review of the multiplicity of effective dates for various provisions of the bill.

Although we recognize the need to limit actions by taxpayers after a change is suggested and before its effective date, the large number of differing dates adds unnecessary complexity and confusion to an already complex measure.

In the following pages, we will react to eight specific provisions in H.R. 13270. This does not mean the Illinois State Chamber of Commerce either supports or opposes other sections of the bill. Our selection of these items is merely intended to indicate our feeling that observations on these subjects may be of help to the committee in its deliberations. Our selection was severely limited by the time available and the knowledge that other groups would provide more detailed information and express their views most forcefully on some sections of the proposed act.

Specific recommendations cover the following topics:

Section 231: Moving Expenses.
Section 704: Amortization of Pollution Control Facilities.
Section 515: Capital Gains on Lump Sum Distributions from Qualified Pension, Profit Sharing, Stock Bonus or Annuity Plans.
Section 451 and 452: Depreciation Allowed Regulated Industries.
Sections 411 thru 414: Corporate Mergers.
Section 421: Stock Dividends.
Section 431 and 432: Foreign Tax Credit.
Section 541: Subchapter S Corporations.

MOVING EXPENSES—SECTION 231

The willingness of responsible employees to move from one location to another—and labor mobility in general—is of benefit to the economy as a whole as well as to individual employers.

It also should be recognized that most employee transfers are primarily for the convenience of the employer.

Public policy should favor relocation with a minimum burden for the employee involved.

We feel it is desirable to recognize "indirect" expenses of pre-moving house hunting trips, temporary living expenses and costs of sale and purchase of a residence. We also welcome the proposed exceptions to the 39-week rule. However, the dollar limitations on deductible amounts, increase of the 20-mile test to 50 miles, and requirement that all reimbursed moving expenses be included in adjusted gross income and subject to withholding appear unduly restrictive.

Employees most likely to be relocated are those in middle management or with extensive technical skills who are apt to have families, to receive above average compensation and to have higher than usual housing expenses. Costs of moves vary tremendously. A relocation to a foreign country or from one coast to another may either make house hunting trips extremely costly or impossible and may greatly increase the period during which temporary living expenses are incurred. A 7% commission on the sale of a $30,000 to $50,000 home could well exhaust the $2,500 limitation; while in other cases involving moves over a relatively short distance, the reasonable cost of house hunting trips and temporary living expenses might be much less. We would suggest that "reasonable" expenses be allowed and following the precedent of travel and entertainment expense, detailed accounting to the employer should be a satisfactory justification.

In metropolitan areas, such as the one surrounding the City of Chicago, a relocation of less than 50 miles in a job site may require the relocation of a family. A change in job location from the north to the south edges of the Chicago metropolitan area might well be less than 50 miles and yet effectively require relocation. We, thus, oppose increase of the 20-mile test to 50 miles.

Even if additional items of "indirect" expenses are recognized, there are apt to be a number of other moving expenses which cannot be recognized but which may constitute a substantial economic burden to the employee being transferred. Inclusion of all reimbursement in adjusted gross income and to require withholding on that amount not only causes additional paper work, but delays the availability of funds to a transferred employee at a time when this may constitute a substantial financial burden. Thus, we strongly urge these items not be included in adjusted gross income to the extent that they are not subject to taxation and reimbursement which will not result in additional taxable income not be subject to withholding.

AMORTIZATION OF POLLUTION CONTROL FACILITIES—SECTION 704

Pollution control facilities do not generally produce income and are not of an economic benefit. In effect, any pollution control expenditure is an expense from which no returns can be anticipated. Provision to amortize these facilities over 60 months recognizes this relationship to some degree, but this is such an important area that we feel expenditures for pollution control facilities should be further encouraged by being treated as an expense in the year made. Control of pollution is one of our most pressing national problems and failure to act promptly and effectively will not only increase ultimate costs, but will lead to permanent or temporary loss of use of our natural resources. In this context, the current loss of revenue is minor. As the only benefit received by the taxpayer would be the immediate recognition of the true nature of the expenditure, there should be no opportunity for substantial abuse under this provision.

CAPITAL GAINS ON LUMP SUM DISTRIBUTIONS FROM QUALIFIED PENSION, PROFIT SHARING, STOCK BONUS OR ANNUITY PLANS—SECTION 515

The proposed treatment of these lump sum payments seems to consider them as a species of deferred compensation with particular application to highly compensated individuals.

We feel the most important thing to remember about this provision is it applies solely to *qualified* plans which must be non-discriminatory. A survey of Illinois State Chamber members indicates that a great many employees of quite moderate means elect to receive lump sum payments. The proposed provisions require quite involved calculations and add greater complexity to the Internal Revenue Code. Because of the non-discrimination requirements, lump sum payments from qualified plans are not readily available as a device to allow deferral of income by highly compensated individuals and we suggest other provisions, which tend to restrict the benefit of capital gains treatment, would accomplish, to a large degree, the intent of this provision.

We, therefore, suggest this provision, which is widely applicable to retired persons of moderate means, not be changed.

DEPRECIATION ALLOWED REGULATED INDUSTRIES—SECTION 451 AND 452

In previous tetstimony, the Illinois State Chamber of Commerce indicated its opposition to the action of some federal and state regulatory agencies in defeating the purpose of the Internal Revenue Code in allowing accelerated depreciation. These agencies have, in some cases, required a "flow through" of accelerated depreciation or have calculated the rate base as if utilities taking straight line depreciation had taken accelerated depreciation and there had been a "flow through." These sections effectively freeze the present status.

This will have the dual benefit of preventing substantial, potential revenue loss and permitting regulated industries to continue to follow the existing accounting and rate making treatment without a threat of a requirement to adopt flow through accounting. We support this freeze, but we feel the legislation should go farther and require a reversal of past regulatory action which denies regulated industries the right to exercise business judgment in selecting their method of depreciation, or accounting for depreciation, on a deferred tax accounting basis.

CORPORATE MERGERS—SECTIONS 411 THRU 414

We would certainly agree the Internal Revenue Code should not give any special or unwarranted inducements to corporate mergers and we instead suggest the aim of our tax laws should be to be neutral in merger situations. We approve the purpose and general content of these sections and we certainly agree care should be taken to not over-react in approaching a relatively new subject. At the same time, it appears many of the provisions suggested are sufficiently narrow so they may not have the desired results. We suggest developments in this area should continue to receive careful study with the idea that more general restrictions may be required to achieve effective neutrality.

DISALLOWANCE OF INTEREST DEDUCTIONS IN CERTAIN CASES

It is certainly true the classifications of various corporate obligations as either debt or equity is a difficult and uncertain matter. However, the application in the conjunctive form of the subordination, convertibility, and debt-equity or interest coverage tests may not be sufficient to correct the basic problems. For example, an obligation which is not subordinate or which does not meet the debt-equity or interest coverage test may still present the very problems sought to be rectified.

Problems involved in the limitation on the installment sales provision and with original issue discount are more clear cut and are met more specifically by the suggested changes.

We also agree the provisions concerning re-purchase premiums or convertible indebtedness require clarification and the provisions of the bill in this regard seem realistic.

LIMITATION ON INSTALLMENT SALES

Although these provisions occur under the designation "Corporate Mergers" they seem, by their terms, to have broader application. We suggest the language

be modified to make it clear that these provisions are applicable only to corporate mergers.

STOCK DIVIDENDS—SECTION 421

The bill proposes to continue the current provision that a stock dividend is taxable if payable—at the election of the shareholder—in property instead of stock, but additional provisions are proposed concerning disproportionate distributions, convertible preferred stock, treatment of some redemptions as distributions and the tax treatment of dividends on preferred stock.

It is our feeling the additional complexities introduced by this suggested change and their interference with normal corporate operation and structure far outweigh any possible future revenue loss and, for this reason, the changes should not be enacted.

FOREIGN TAX CREDIT—SECTIONS 431 AND 432

Provision is made to recapture any tax benefit gained as a result of a loss in a foreign operation. In the early years of operation in any foreign country, a business can reasonably expect losses. Nothing should be done to discourage or to make less advantageous, the institution of new foreign operations. In addition, the complex provisions added to these sections make the already complex foreign tax provisions that much more difficult to apply. Only a minor amount of additional revenue is anticipated from this source and there is no indication such a provision is necessary to avoid losing large amounts of revenue in the future or that the present law creates any "loopholes" which will lead to undesirable results. We, therefore, suggest the provision on recapture tax benefits due to foreign losses be eliminated.

SUBCHAPTER S CORPORATIONS—SECTION 541

At the present time, Subchapter S corporations, although electing to be taxed as partnerships, get the same treatment of pension contributions as other corporations. The amendment proposes that non-taxable contributions to pension and profit sharing plans be subject to the limitations provided self-employed individuals under H.R. 10, as modified. It is our feeling the provisions of H.R. 10 are inadequate and they should not be extended to other groups. The employees of the Subchapter S corporation should be treated as the employees of any other corporation and if any other modifications are to be made in this area, provisions of H.R. 10 should be modified so self-employed persons more nearly get the same treatment as corporate employees.

STATEMENT OF JOHN M. BARKER, VICE PRESIDENT–TAXES, GENERAL MILLS, INC.

I would like to discuss several matters directly contained in the Tax Reform Bill of 1969—H.R. 13270, and others which are closely related to certain provisions of the Bill.

I oppose the repeal of the investment credit and the extension of the surtax at 5% until June 30, 1970 on corporations. I believe corporation tax rate should be reduced rather than increased which is the effect of the Bill as written.

I do not believe that the definition of private foundations contained in the Bill is fair and, in my opinion, if it is left unchanged, corporate giving to worthy causes will be reduced. In a similar vein, I recommend that the proposed charitable contributions amendments be revised so that donations of scrap to such worthy organizations as the Volunteers of America, the Salvation Army, and Goodwill Industries, can be continued.

There are other provisions in the Code closely associated with amendments proposed in H.R. 13270 which should be corrected as part of any tax reform measure—that is, if reform is designed for and expected to be equitable to corporations. Some of these are covered herein.

SEC. 413(b) IRC 1232(b)(2); 413(c) IRC 6049(a); 413(d) IRD 6049(c)

These sections relate to original issue discount—its taxation and deduction and requirements for information returns.

It should be clarified that these sections include convertible indebtedness whether or not the conversion feature is in a separate and/or detachable document or is included in the terms of a single document. If it is intended that a

single security with a conversion feature (not capable of being detached) does not include original issue discount, then economic facts of life are being ignored evidently for administrative convenience.

SEC. 431(a) IRC 904(a)

This section reduces the foreign tax credit for U.S. taxpayers who choose the per country limitations for losses incurred in the country by the taxpayer in prior taxable years. I do not agree that this section should be enacted. It seems to me it should be incumbent on the U.S. Treasury Department to negotiate as part of the tax treaties in each country that the foreign country allow loss carryovers for U.S. permanent establishments within the countries. The foreign country is receiving an economic benefit of the business activity carried on in the country at a loss. Enactment of this provision will discourage promotion of export trade by U.S. taxpayers and can directly affect the U.S. trade balance. The provision discriminates against companies which are trying to get established in foreign countries as against those that are already there.

The provision discriminates as between companies, depending upon each of their circumstances. The company that has extensive foreign source royalty and interest income subject generally to either no foreign tax or a low rate of withholding tax, can choose the over-all limitation for tax credit purposes and use all the available foreign taxes as credits and still incur substantial losses in countries other than those from which the income was received.

For instance, assume foreign income of $1,000 on which the effective foreign rate is 10%. To use the $100 credit attributable to the foreign income, the net income from all foreign sources (assuming a 50% U.S. rate) will only have to be $200. The taxpayer in this position can absorb losses of $800 without penalty.

On the other hand, if the $1,000 income is dividend income which is distributed from income after a 40% foreign tax, the taxpayer must choose the per country limitation and his $800 loss is a potential U.S. tax liability for the future. It does not appear equitable that the happenstance of types of foreign income should determine liability under this proposed section. Moreover, the method of operating also determines whether or not this provision is to be applicable.

If, for instance, a U.S. person opens a sales office and maintains a stock of merchandise in a foreign country, he has a permanent establishment under the terms of the U.S. tax treaties. If the branch operates at a loss, this section will apply. On the other hand, if the U.S. person uses independent agents or confines his activities so as not to qualify as maintaining a permanent establishment in the foreign country, this section will not apply whether the loss is as great or greater than it would be with the permanent establishment. With today's world-wide competition, U.S. sellers of U.S. manufactured goods need encouragement and help from their government and not economic hindrances such as this section imposes.

This is particularly important considering that key competitors of the United States in international markets have enacted tax *incentives* to promote their world-wide trade. Japan has special accelerated depreciation provisions in the case of export sales. West Germany recently enacted legislation which permits a deduction for losses generated by a permanent establishment in those countries with which it has concluded a tax treaty. Significantly, losses thus incurred are not added back to German taxable income in later years when the permanent establishment becomes profitable unless the foreign country allows loss carryovers.

The section as written is either defective or not clear in the following respects:

(1) a loss in a country or possession and offset thereafter by income therein on which the taxpayer does not receive the benefit of a foreign tax credit or on which no foreign tax is imposed (because the foreign country allows a loss carryover), should not require reduction in the allowable credit in future years, nor inclusion of the loss in income of the operation is discontinued. As now written this does not appear to be permissible.

(2) If taxpayers electing the world-wide election for foreign tax credits who are in the fortunate position of receiving income at an average foreign tax rate below the U.S. rate so they can incur these types of losses are permitted to be exempt from this section, then taxpayers who elect the per country limitation should be allowed losses to the extent that foreign source income from countries or possessions outside the loss country or possession are subjected to U.S. taxes. For instance, if a taxpayer receives a dividend from Country A which has an

effective tax rate such that the equivalent of $1,000 of the dividend is subjected to the full U.S. tax, then that taxpayer should be permitted a loss of $1,000 in any other foreign country or possession.

(3) The section should be clarified as to the taxation of gains and losses on disposition of property associated with the foreign operation if it is discontinued.

Subsequently herein I discuss capital losses of corporations. Non-allowance of capital losses on investments in foreign corporations affects and is related to this problem.

IRC SECTIONS 367 AND 954

Closely related to the matter of foreign tax credit and income from foreign sources is a particularly vexing and troublesome problem relating to Subpart F income as defined in Sec. 954(a)(1) (Personal Holding Company type income) and as determined under Sec. 954(c)(1). The Secretary has ruled that any transactions which would be classified as reorganizations or tax free transfers under the sections of the Code as listed in Sec. 367, must be cleared in advance by the Secretary to qualify for non-recognition of gain. If such clearance is not received, then Subpart F income exists for the U.S. taxpayer. The Secretary has taken an extremely technical approach in his rulings and regardless of the tax and corporation laws of the foreign countries, he has insisted on completely technical compliance with the applicable provisions of the U.S. tax law. I doubt that under the present law he has any choice to do otherwise. Because of the necessity to get advance rulings under Sec. 367, U.S. taxpayers are delayed in carrying out these types of transactions; foreign partners cannot understand the problem and General Mills was involved in at least one instance where the procedure and technicalities have cost it and the U.S. $40,000 in foreign exchange.

If there are no possible abuses, and I can't visualize any, I believe there should be no potential tax liability hanging over U.S. taxpayers' heads and there should be no requirement that the Secretary rule in advance on the transactions if the substance of the transactions results in the equivalent of the reorganization sections of the U.S. laws and the ownership of the U.S. person in the enterprise after all the transactions is substantially unchanged from his ownership before the transactions. To this end I would amend Sec. 954(c) by adding a new sub-paragraph number (5) at the end.

CERTAIN REORGANIZATIONS INVOLVING FOREIGN CORPORATION

"(5) For purposes of paragraph (1), foreign personal holding company income does not include . . .

"Gains (or losses) in transactions similar to those which would be applicable under Sections 332, 351, 354, 355, 356 and 361 if the foreign corporation or corporations are involved in transactions which produce substantially similar results, whether or not the form of the transaction technically conforms to the said sections and whether or not the Secretary or his delegate has ruled under Sec. 367 before such exchange or exchanges that they were not in pursuance of a plan having one of its principal purposes the avoidance of Federal income taxes, and provided further, that ownership by the person who is a U.S. shareholder in the foreign corporation or corporations after the transactions is not materially different than it was before the transactions. For the purpose of this paragraph, continuation of one or more of the foreign corporations as an inactive non-operating entity will be disregarded."

Provision should be made some way in the Code to give a taxpayer a right of appeal to the courts if he does not agree with a determination made by the Secretary under Sec. 367. The taxpayer is often required to agree to include certain items in income before a favorable ruling will be issued. He either must agree or forego the ruling. If he foregoes the ruling, he has no standing in the courts.

If Section 367 was amended so as not to require approval before the transfer the purpose of giving the taxpayer his day in court would be accomplished. The taxpayer would then have a choice of seeking or not seeking an advance ruling. If it would be determined by the Secretary after the transaction that the principal purpose of the exchange was the avoidance of Federal income tax, the usual appeal procedures would apply to any assessment which might be made.

SEC. 461(a) IRC 1201(a)

I do not agree that the rate of capital gain tax on corporations should be increased from 25% to 30%. In fact, taxing capital gains to corporations and

limiting deductions of capital losses to capital gains over a carryover period is grossly unfair.

Since enactment of Sections 1245 and 1250 corporations are denied a substantial source of capital gains against which they could apply capital losses. I suggest the following principles be incorporated into tax policy respect to capital losses:

(1) Losses from sales of stock in domestic corporations by corporations be allowed as ordinary losses (and netted against gains on sales of property used in the trade or business to determine if there is a net capital gain).

(2) Losses on other capital assets (including losses on sales of stock in foreign corporations) be permitted on deductions each year and the tax benefit be limited to the corporation long term capital gain tax rate. Permit carrybacks and carryovers of capital losses the same as net operating losses (if a net operating loss exists or income is not sufficient to absorb the capital loss in the year of the capital loss) limited to the long term capital gain rate.

SEC. 521 IRC 1250

This section further restricts corporations to recover tax on costs of buildings in a reasonable time by denying present accelerated depreciation methods. This is in the face of continuing rising costs of construction and inflation of our currency. I do not agree that use of the sum-of-the-year's-digits, and the 200 per cent declining balance methods of depreciation on industrial and commercial buildings should be withdrawn.

Closely related to this is the taxation of recaptured depreciation in transaction to which Sections 337 or 334(b)(2) apply. Existence of these provisions creates a disparity in the method of taxing transactions. The seller wants to sell shares of stock and pay only a capital gain tax and buyers want to buy the depreciable assets and avoid the tax under Section 1245. Unfortunately, some uniformed sellers have been caught with tax liabilities they did not expect when they sold assets.

It is difficult to understand any reasoning which will support imposition of this tax as it is now applied except perhaps as an additional source of revenue. Historically, Section 337 was intended to exempt corporations from tax during a liquidating period. The section could be amended to require payment of corporation tax on regularly conducted commercial transactions during the liquidation period. Section 334(b)(2), historically, is a basis section. In neither event should a tax apply on recaptured depreciation.

Canada taxes recaptured depreciation, but it does not levy any capital gain tax. Neither does it require that depreciation be deducted each year to the extent of the amount allowable or lose the deduction. The U.S. taxes capital gains and requires depreciation to be taken for the amount allowable but not less than the amount allowed. Canada, therefore, cannot be looked to as support for the policy.

If the reasoning is that the selling corporation received a tax benefit from the deduction equivalent to the tax which is to be assessed, this may or may not be the case. There is no assurance that the seller received any tax deduction because of loss situations and the benefit may or may not have been equivalent to the rates of tax assessed on the recaptured depreciation.

To reason that the benefit goes to the buyer assumes future income from the property and that tax rates must go even higher to account for the time value of the money to be paid out.

Perhaps it is the objective to match deductions given to business with income accruing to the person who is on the other side of the transaction. If this is the case, then goodwill should be deductible to the buyer. This, unfortunately, is not permissible although I do believe goodwill should be deductible to business over a five year minimum and 10 years maximum time period. This is, in my opinion, the strongest argument against a tax on recaptured depreciation when Sections 337 or 334(b)(2) apply.

I suggest that Section 1245 be amended to remove transactions to which Sections 337 or 334(b)(2) apply or, alternatively, allow purchased goodwill to be amortized.

I would like to conclude by pointing out that, with the Federal income and temporary surtax, state income taxes, and foreign taxes, that owners of corporations are the minority partners in the profits. Without the temporary surtax the owners are no more than equal partners with the tax collectors. Since many of the states define taxable income in substantially the same way as you in the Congress define it for Federal income tax purposes, it is extremely important

that all economic losses and expenses be deductible to corporations. A partnership cannot long endure in which the majority partner takes his share of all the profits and leaves the losses to the other partners, i.e., the stockholders. Formation of capital and creation of jobs will suffer if this situation continues in any respect for any material period of time.

Thank you for this opportunity to express my views.

WHIRLPOOL CORP.,
Benton Harbor, Mich., October 8, 1969.

Hon. RUSSELL B. LONG,
Chairman, Senate Finance Committee,
Washington, D.C.

DEAR SENATOR LONG: Whirlpool Corp. submits for the record the following statement on the Tax Reform Act of 1969 (H.R. 13270).

General tax reform legislation must undergo careful and deliberate scrutiny by the public and Federal Government prior to enactment.

Hasty tax reform action would create more complications and problems, not solve them. We recommend a more calculated pace and extensive study of the U.S. tax system prior to final action on H.R. 13270.

Three sections of H.R. 13270 are of specific concern to Whirlpool Corporation: Real Estate Depreciation; Total Distributions from Qualified Plans, and; Moving Expenses.

1. We oppose Title V. Subtitle C, Section 521 to the extent it denies accelerated depreciation to facilities used by businesses. This provision is apparently intended to challenge the use of Real Estate Depreciation as a tax shelter. This is not the intent of business use of real estate. If Section 521 is enacted, real estate investments by businesses as well as others will be discouraged because the return on investment will not be as favorable. Projects where the profit return from expansion is relatively low, may not be undertaken at all.

It is recommended that the problem of using depreciation as a tax shelter be solved by the recapture provisions in the bill which, on sale of real estate, would eliminate capital gain treatment to the extent of the excess of accelerated over straight line depreciation. Any changes in depreciation should be part of a larger study involving all aspects of depreciation revisions aimed toward realistic measures competitive with other countries and consistent with the growth objectives of our economy.

2. We oppose Title V, Subtitle B, Section 515, which limits capital gains on lump-sum distributions from qualified stock bonus, pension, or profit sharing plans. This limitation on capital gains treatment would:

Handicap a worthwhile incentive for our 3100 exempt-salaried employees;

Result in a diminishing value of our compensation-benefit package placing us at a disadvantage in our search-for-talent competition, against companies that do not offer profit-sharing plans;

Upset the orderly and practical retirement plans of many employees;

Discourage employees from investing in such plans to the detriment of the employees as well as the national interest as it indirectly aids in the creation of jobs and economic strength;

Result in a different tax treatment on the distribution of employer securities than if the employee had purchased the securities himself, although the employee's participation in the plan is virtually the same as if the employee had directly purchased the securities.

3. We support Title II, Subtitle D, Section 231, Moving Expenses, because it offers a fair and equitable deduction of moving expenses. We also strongly recommend removal of any dollar liimtation on the deductible amount.

Mobility of the work force is a valuable asset to our nation's economy, as people will more readily move to where opportunities exist if they are not confronted with the financial losses incurred during such moves. We urge that no dallar limitation be placed on deductible amounts as this could not only discourage certain moves, but also any formal dollar limit would cause an intolerable administrative-paperwork problem for employer and employee.

Sincerely,

JOHN E. CURLEY,
Director of Taxes.

[From the Elizabeth, N.J., Daily Journal, Mar. 26, 1966]

INVENTOR TRIES NEW APPROACH: HIT AIRLINES IN TAX POCKET

(By James McCombe, Journal Staff Writer)

If perseverance breeds success, William J. Erwin should realize one of his major goals in life.

That would be to strike a big blow for better aircraft safety.

Erwin of 2040 Bleecker St., South Plainfield, invented a take-off monitoring device in which he has tried to interest airlines and federal agencies for five years.

He couldn't find a market for his invention or for another idea designed to increase take-off safety.

But Erwin, a millwright and former Air Force technical sergeant, doesn't discourage easily.

The failure he encountered in selling a safety device led him to his present objective and strengthened his resolve to keep up the fight.

FEAR, OTHER REASONS

He is convinced that most politicians and governmental agencies connected with aviation are either afraid or for other reasons, are reluctant to take the initiative in demanding better safeguards for commercial flying. One of the problems, he discovered, is pinpointing the responsibility.

But he is determined to continue a one-man crusade until someone in authority is moved to do something about it.

At the moment, Erwin is entertaining the hope that he may have knocked on the right door.

He has taken his case to the Internal Revenue Service.

The inventor said he has submitted an application and voucher for reward money paid for original information leading to detection of a violation of the internal revenue laws.

ACCUSATORY FINGER

Erwin said his application points the finger of suspicion at major airlines, insurance companies and an air safety organization.

He has been assigned a claim number and has been advised by an official in the Internal Revenue Service that "appropriate attention is being given the information."

As proof of his efforts to get action, the South Plainfield resident can produce a bulky accumulation of letters attesting to his correspondence.

The collection includes documents and news clippings. It continues to grow while he wages an endless battle to accomplish his aim.

Erwin says he believes "there is an 'acceptable' death rate in commercial flying operations which can be lowered. But I don't think anybody is going to do anything about it until it hurts his pocketbook."

BASIS OF CLAIM

He said the claim he filed with the Internal Revenue Service is based on his contention that damage to aircraft cannot be deducted by airlines in their tax returns if due to willful negligence.

Erwin's reason for hoping his efforts will bear fruit soon is that "the Internal Revenue Service is big enough to fight the airlines, the insurance companies, the Civil Aeronautics Board and the Federal Aviation Agency, all of which share responsibility for aircraft accidents."

He also includes the Flight Safety Foundation, Inc. of New York City among organizations he says are responsible.

Erwin insists he no longer is interested in selling his take-off monitoring device.

"What is important is reducing the loss of lives from air accidents," he asserted.

CITES SAFETY STUDY

It is Erwin's contention that many of his opinions and observations about the hazards prevalent in commercial flying operations are supported in a booklet based on a flight forum sponsored two years ago by the Connecticut General Life Insurance Company. The topic was "Air Safety: A Study of Ethics, Economics and Attitudes."

The core paper for the forum was written by Jerome Lederer managing director of Flight Safety Foundation Inc. Lederer has gained world recognition for his work in the field of air safety research.

He wrote that the major type of transport accident is that which occurs during the approach to a landing or the landing itself. This type accounts for about 40 percent of the fatalities and about 30 per cent of fatal accidents.

The next largest category is take-off accidents, which account for about 20 per cent of the total.

LACK OF LANDING AIDS

Lederer wrote, "the absence of the most modern type of landing aids, or the malfunction of aids coupled possibly with errors in judgment, is the principal reason for approach and landing accidents."

He also stated, "Part 601 of the Federal Aviation Act of 1958, in calling for the highest degree of safety in airline operation, fails to define whether industry or the FAA is responsible for achieving this.

"The operating environment is, of course, provided by government. Industry is responsible for producing aircraft, techniques, and management to operate safely in this environment.

"And the ultimate responsibility for safety is borne by the individual pilot, mechanic, traffic controller, or other airman, working as part of the system, except, of course, in cases of Acts of God or sabotage."

Lederer noted that the Federal Aviation Act calls for the highest possible degree of safety only in air carrier operations. Elsewhere in aviation, only minimum standards are required by federal law.

MUST CUT ACCIDENT RATE

He pointed out the accident rate must be improved to reduce the number of fatalities that will increase with the expansion of air traffic.

Lederer contends the government alone cannot do this. He says "industry must share the load and should take the initiative."

Lederer also wrote: "The government can supply the environment; the ground rules, the checking and much of the research and investigation. But industry as a whole—not just some companies, but all—should show more positive leadership in safety matters.

"Specifically, industry should weed out incompetence. It should decline to operate into marginally unsafe areas until they are made safe. It should adopt more techniques and devices of proven value, such as an adequately lighted chartholder so the pilot need not balance the chart on his knee, in bad light, while making an instrument approach."

Erwin points out that documentation of this type serves to substantiate what he has been saying about the negligence he claims exists in commercial aviation.

CITES NEWARK RUNWAYS

Erwin, for instance, has been quoted as saying the runways at Newark Airport are too short for the type of airplanes that operate out of that facility.

As a further indication that his efforts may be ready to pay off with a more aggressive attack on the problem of safety, Erwin disclosed one of the latest replies to his stream of correspondence.

The letter, dated March 9, this year, came from Henry M. deButts, administrative assistant to the chairman of the Civil Aeronautics Board.

Based on materials and a covering letter which related to his charges of safety shortcomings, Erwin was informed that the CAB plans to conduct an "independent investigation."

STATEMENT BY RICHARD FOREGGER, M.D., MILWAUKEE, WIS.

SUMMARY

The income tax on single persons is now unduly heavy relative to that on married couples. Single persons are entitled to tax relief. Methods of achieving this are discussed.

I have read H.R. 13270, the tax reform bill of 1969. Mr. Wilbur Mills was also kind enough to send me copies of the hearings before the House Ways and Means on the subject of tax reform held in February, March and April of 1969 which I have also read in great part.

H.R. 13270—NO TRUE REFORM

First, I note that the bill H.R. 13270 as passed by the House on August 7, 1969 does not represent a true reform. The proposed tax law makes amendments and revisions here and there. The complexity of the tax law is still retained. A true reform would institute an entirely new, simplified system, as proposed by various persons. Indeed, Chairman Mills indicated that he was in favor of "simplicity, equality and neutrality" as important elements of a new tax system, in contrast to "patchwork revisions of the old fabric."[1]

One such simple reform would eliminate all personal deductions, double dependent exemptions, and lay down a flat tax of 20% on all income to raise as much money as government now raises.[2] The simplest of all proposals made to the committee was a single flat-rate tax of 12¾% to yield the required revenue. By doubling the personal exemption to $1200 a single flat-rate of 14⅔% would provide the necessary revenue.[3] This would eliminate the issues concerning joint returns and income splitting. Much of the elaborate effort now allocated to arranging for tax shelters would become too expensive and taxpayers would forgo it. Computational chores and record keeping would be decreased. Such a simple flat-rate tax would go a substantial way toward achieving equity and neutrality in the income tax system and a truly egalitarian society.

THE MARRIAGE LOOPHOLE

I am particularly concerned with tax inequities based on marital status. The Constitution makes no mention of marriage yet the old tables of taxation based on marital status are still retained.

Although Dan Throop Smith, Professor of Finance, Harvard University, agrees that single persons taxation is inequitable, he states it is probably justifiable because on political grounds the married group is in the majority and any inequity which does exist should be in favor of the family status which perpetuates society.[4]

The distinguished economist Harold Groves also agrees that the entire class of single taxpayers is entitled to relative tax relief. Nevertheless, he does not want this to be at the expense of married persons for he adds,

"Other things being equal, we would at least prefer a system that does not associate higher taxes with marriage."

Groves says that family budget studies show that it costs a married couple less than twice what it does to maintain a single person at the same standard of living—probably about 1.4 times as much. Budget evidence also indicates that the cost of maintaining children is substantially less than that of maintaining adults and that family unit costs decreases as more children are added to the family due to economics of scale.

Of suggested reforms, he favors a dual rate schedule including the manipulation of bracket widths. They could be designed to close the gap in relative tax burdens as between single persons and married couples either in whole or in part.[5]

Joseph Pechman, writing for the Brookings Institution in the book *Federal Tax Policy*, 1966, states that the practical effect of income splitting is to produce large differences in the tax burdens of single persons and married couples, differences which depend on the *rate of graduation* and not on the level of rates. Such differences are hard to rationalize on any theoretical grounds. Moreover, it is difficult to justify treating single persons with families more harshly than married persons in similar circumstances. It has been assumed that single persons should be taxed more heavily than married couples because they do not bear the costs and responsibilities of raising children. But income splitting for husband and wife clearly does not differentiate among taxpayers in this respect since the benefit is the same whether or not there are children.

Richard Goode also writing for the Brookings Institution states that the, ". . . relationship between the taxes of single people and married people

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[1] *Tax Reform, 1969. Hearings Before the Committee on Ways and Means,* 91st Congress, 1st Session, part 12, p. 4569.
[2] *Ibid.*, part 5, p. 1994.
[3] *Ibid.*, part 12, p. 4249.
[4] Dan Throop Smith, *Federal Tax Reform*. McGraw-Hill, New York, 1961, pp. 45–6.
[5] Harold Groves, *Federal Tax Treatment of the Family*. Brookings Institution Report, 1963.

should be re-examined because the present situation seems to be an incidental result of the 1948 legislation rather than a reflection of consensus. . . . My opinion is that the income tax on single people is now unduly heavy relative to that on married people."

He proposes that the same rate schedule should be applied to taxable income of single persons and married persons who file joint returns and that husbands and wives who choose to file separate returns should be required to use a rate schedule with brackets half as wide as those in the schedule for joint returns. This arrangement would reduce the tax of single persons relative to married people.[6]

The treasury department is losing $14 billion per year because of favorable taxation of married persons.[7] I submit that married couples require government service to the same extent as single persons and these services are just as available to married persons as they are to single persons. It would indeed be unpopular to tax married persons at a higher level than at present because there is a larger proposition of married persons than single persons subject to taxation. Yet when one group, even though in the majority, receives more favorable tax treatment than another group, it is inequitable. The marriage loophole should be eliminated, as popular as it may be. The government is not properly in the business of either promoting or discouraging the institution of marriage through the Internal Revenue Service. The government does, however, have an interest in the welfare of children in order to continue the species. Nothing herein should be construed to mean that the exemption for children should not be continued.

TAXATION OF SINGLE PERSONS

According to the Treasury Department, there are 25 million single person taxpayers in the United States.[8] Under H.R. 13270 single persons will be taxed at a higher rate than married couples at every income level, even though government services are the same for both categories. Further, I note that persons under the age of 35 are to be taxed at a still higher rate. No explanation has as yet been given in the various press releases of the Committee on Ways and Means as to why single persons are taxed more than married couples. Taxpayers should know clearly and in advance what the law prescribes and why.

When Edwin Cohen, Assistant Secretary of the Treasury for Tax Policy, appeared before the Committee on Ways and Means on April 23, 1969 he was asked by Representative Ullman,

"What about the problem of single persons? There is a rather widespread feeling that there is not equitable treatment for single persons now."

Mr. Cohen's answer was,

"This is again a problem. We have had, as I am sure you have, Congressman, a good many letters from single individuals pointing out the difficulties that are involved. . . . We have not been able to come to a conclusion on that point and, because of the budgetary considerations will not be able to propose such a measure until we are able to develop sufficient items that will produce additional revenue to permit an adjustment of that kind."[9]

On the following day Mr. Cohen was again asked, this time by Congressman Vanik, to discuss the plight of the single person.

Again Mr. Cohen had no immediate answer, but repeated that,

"We have had numerous inquiries about that and have the item high on our list of matters for consideration."[10]

Mr. Vanik insisted that a careful study of the problem of the single person taxpayer be made and requested a full response in the record.

It would seem that the Treasury Department had no intention of considering the problem of the single person taxpayer, despite the fact that there had been "numerous inquiries" on the matter.

A complete exposition of the problem of the single person taxpayer was presented to the Committee on Ways and Means by Miss Dorothy Shinder, President, Single Persons Tax Reform.[11]

No less an authority than Henry W. Bloch, President, H. R. Block Inc., stated that,

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[6] Richard Goode, *The Individual Income Tax.* Brookings Institution Report, 1964, p. 245.
[7] *Tax Reform, 1969*, part 15, p. 5625.
[8] U.S. Treasury Department and Internal Revenue Service, *Statistics of Income—1966 Individual Income Tax Returns*, p. 1.
[9] *Tax Reform, 1969*, part 15, p. 5551.
[10] Ibid., part 15, p. 5624.
[11] Ibid., part 5, pp. 1976–96.

"Our current tax laws admittedly discriminate against the single person. I, for one, happen to feel it's being overdone." [12]

To tax all unmarried persons at the same rate as married persons would cost the government $1.8 billion. In contrast, the government is losing $14 billion per year because of favorable taxation of married couples, as previously mentioned.

The Lorenz curve [13] and the Gini index [14] have long been used as a statistical measure of inequality of income distribution. Dr. Okner of the University of Michigan in a sample of 103,336 income tax returns finds that if single persons and married couples were to be taxed at the same rate by removing the income splitting privilege, this would shift the new after tax Lorenz curve closer to the line of equality and reduce the Gini index from the present after tax value of 419.20 to a new value of 412.18. This represents a 1.67 per cent reduction in the after tax area of inequality. No single factor applied to the tax rate produces such a large area of inequality as measured by the Gini index as that of the split income.[15]

RECOMMENDATION

Based on the foregoing factors and in order to achieve a more egalitarian society in conformity with the Constitution, it is recommended that single persons be afforded complete equality with married persons in the matter of income taxation. This could be best achieved by a single flat-rate tax of 12 to 14%. Exemptions and/or a standard deduction.

The single flat-rate tax herein proposed will provide revenue proportionate to the scale of an individual's economic activity. It has long been recognized that persons of larger income pay a proportionately greater share of taxes to maintain the government. Indeed it is in their own self interest to do so. They have more to lose than individuals of lesser income and the government therefore renders them a greater service for protection of property and the right of free enterprise, and they should be willing to pay more for these services.

ALUMINUM CO. OF AMERICA,
Pittsburgh, Pa., October 6, 1969.

Re H.R. 13270, Tax Reform Act of 1969.

HON. RUSSELL B. LONG,
Chairman, Senate Committee on Finance,
Old Senate Office Building, Washington, D.C.

SIR: We appreciate this opportunity to express our views with respect to H.R. 13270, the Tax Reform Act of 1969, which is currently before your Committee for consideration.

At the outset, may we say we believe that adjustment of our tax laws is required from time-to-time to avoid abuses developing around certain sections of the Code, and changes of rates as revenue requirements change. We cannot support, however, the substantial corporate tax increases contained in H.R. 13270 now before your Committee of $4.9 billion. The Secretary of the Treasury has recommended these increases be reduced to $3.5 billion, which is still too much of an increase in the tax burden.

Our concept of tax return includes, wherever possible, tax simplication. We do not see simplification in H.R. 13270, but, rather, increasing complexities for individuals and business alike. In several areas, H.R. 13270 seems to be drafted as a punitive measure aimed at certain segments of the economy.

We are attaching specific comments on various sections of the Bill, and we urge your careful consideration of these suggestions for changes to H.R. 13270 to reflect more equity in our tax Code. We do not comment on personal tax rates, but urge that the job producing segment (i.e. business) not be asked to carry an increased burden overall in taxes. Therefore, any revenue produced by changes to code sections affecting corporations should be used for coporate rate reduction which is so badly needed.

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[12] Ibid., part 12, p. 4262.

[13] M. O. Lorenz, "Methods of Measuring the Concentration of Wealth," *Publications of the American Statistical Association*, Vol. 9, New Series, 1905.

[14] Corrado Gini, "On the Measure of Concentration with Especial Reference to Income and Wealth," Cowles Commission, 1936.

[15] Benjamin A. Okner, *Income Distribution and Federal Income Tax*. Michigan Governmental Studies, Institute of Public Administration, University of Michigan, 1966.

We request that this letter and its attachment be made a part of the official record of your Committee Hearings.

Respectfully,

E. A. VAUGHN,
Vice President and Controller.

GENERAL COMMENT

HR 13270, as proposed, provides for a wide range of effective dates for the various sections, stretching from April 18, 1969 for investment credit repeal, to taxable years beginning after 1975 when the multiple surtax provision becomes fully effective. Between these two dates, there are a host of effective dates, each of which may at one time have had some significance. However, with ultimate passage of the Bill not before December of this year, no provision should be made effective before the taxable year beginning after the date the Bill is enacted into law.

SEC. 231—MOVING EXPENSE (CODE SECTION 217)

This section expands the allowance for deductible moving expenses to include expenses incurred in selling and purchasing a residence, and up to $1,000 for house-hunting trips and thirty days of interim living costs, subject to a $2,500 limitation for all three categories of expense. We believe this proposal is a step in the right direction. However, we do not see the need for such rigid dollar limitations and would suggest either that (1) all such expenses be allowed to the extent they are ordinary and necessary without dollar limitation; (2) there be a single dollar limitation.

Sec. 231(b) provides for a new section of the Internal Revenue Code—Sec. 82—which requires that any reimbursement, either directly or indirectly, of moving expenses is to be included in gross income of the employee as compensation for services. The accompanying House Report (page 77) states in paragraph (ii)—

"Thus, moving expense reimbursements or payments to or on behalf of an employee by his employer are *wages* subject to the *withholding provision* of Sec. 3401(a) and the reporting provisions of Sec. 6041(a)."

Sec. 3401(a)(15) provides that reimbursed moving expenses are exempt from withholding where it is reasonable to believe that a deduction will be allowable under Sec. 217. *However*, Sec. 6041(a) still requires that any reimbursements be reported as income on the employee's W-2 Forms. Many states use the W-2 wages for tax purposes; therefore, we recommend that your Committee provide an exclusion for reporting under Sec. 6041(a) similar to that in Sec. 3401(a)(15) since there should be no reporting to the extent withholding is not required. This provision would provide tax form simplification for employees.

SEC. 331—NON-QUALIFIED DEFERRED COMPENSATION (CODE SECTION 1354)

The doctrine of constructive receipt has been interwoven throughout our tax structure since its inception. On this basis, cash basis taxpayers have not been taxed until an item of income is received. The rate applied is that in effect at the time the income is, thus, reduced to their "possession and enjoyment." It seems incongruous that for a negligible amount of revenue this long-standing principle is to be violated, yet, theoretically, observed. This section provides increased complications and requires complex calculations over many years.

More specifically, this section of the Bill adds Sec. 1354 of the Internal Revenue Code. In Sec. 1354(b)—the definition of "year in which earned", it states:

"A deferred compensation payment shall be deemed to have been earned ratably over (1) the employee's entire period of service with the employer, (—————) or (2) a portion of such period, if under regulations prescribed by the Secretary or his delegate, such payment is attributable to such portion."

We believe that (1) in the quoted portion is the definitive intent of the Congress in this matter and can see no reason whatsoever for abdicating to the Secreary of the Treasury the ability to legislate via regulations. If the Ways and Means Committee had some specific thoughts for limiting the definition, it should have indicated that fact with implementation hereof via regulations rather than leaving the matter open to the imagination of the writer of the regulations. It is our suggestion that (2) in the quoted portion above the deleted, and the definition be solely the employee's entire period of service with the employer.

In the definition of "earned income", Sec. 1348(b), as added to the Code by Bill Sec. 802 (Fifty Percent Maximum Rate on Earned Income), it states that such term does not include and deferred compensation payment. In light of the discussion above, with respect to the "year in which earned," as applied to deferred compensation payments, this treatment under the 50% rule is contradictory. If an item, which, obviously, is income, is deemed to be earned in a given year for one purpose, it should be so considered for all purposes. This provision alone would kill the use of deferred compensation agreements, and there would be an immediate deduction by the employer of wages earned in the year. The penalty in the present law is that the employer does not get a deduction until the employee has taxable income—no one escapes tax.

We seriously question the need for any changes on the deferred compensation provision.

SEC. 432—SEPARATE LIMITATION ON FOREIGN TAX CREDIT WITH RESPECT TO FOREIGN MINERAL INCOME (CODE SECTION 904)

This section proposes to amend Sec. 904 of the Code by providing a separate country limitation for foreign mineral income where the foreign country:

1. Receives a payment of a bonus or royalty, *or*
2. Holds substantial mineral rights with respect to mineral property, *or*
3. Imposes any income, war profits, or excess profits taxes on such income at an effective rate higher than on other income.

The avowed purpose of this amendment is to cure the situation of the taxpayer claiming a foreign tax credit for a high effective tax rate, which is in reality part royalty and part tax. We cannot disagree with this as a matter of principle.

It takes only one of the three above listed criteria to bring taxpayers under this proposed amendment. Alcoa has mining operations in three foreign countries wherein we pay royalties, *and* the foreign government holds substantial rights to the properties (we have concession agreements), *but* we have a tax rate that is equal to or lower than the rate on other income. The proposed amendment should not apply to a taxpayer unless all three conditions are present.

SEC. 461—ALTERNATIVE CAPITAL GAIN RATE FOR CORPORATIONS (CODE SECTION 1201(a))

We oppose any increase in the tax rate on capital gains. However, we have no objection to the proposal to lengthen the holding period for meeting the requirements for capital gains treatment.

SEC. 501—NATURAL RESOURCES (CODE SECTION 6[illegible] AND 636)

To make changes, such as this proposed section, which have little or no revenue effect to the United States Treasury, and do increase the operating costs of the United States taxpayers, seems to us to be a detrimental move. The consensus of opinion, including that of the Treasury Department, is that the reduction in the percentage depletion rates applicable to foreign deposits being mined by United States companies will not produce revenue for Treasury.

In our own case, we will have substantial additional costs per year resulting from a reduction in the rate applicable to foreign bauxite from 15% to 11%. All of these increased costs will go to foreign governments.

It is important to note that about 80% of the bauxite requirements of the United States aluminum industry comes from foreign countries, primarily those within the Western Hemisphere. Other than in Arkansas, the United States does not have bauxite reserves in commercial quantities.

We believe that these facts warrant not imposing any additional cost burdens on United States corporate taxpayers by changing the foreign depletion allowances.

SEC. 521—DEPRECIATION OF REAL ESTATE (CODE SECTION 167)

This provision, according to the Ways and Means Committee's Report, was primarily aimed at real estate tax shelter situations by limiting to 150% declining balance depreciation for Sec. 1250 property constructed after July 24, 1969. In addition, there is full recapture, at ordinary tax rates, of the depreciation in excess of straight line depreciation, if gain is realized on a subsequent sale.

Sec. 1250 property includes industrial buildings, wherein the opportunity for the machinations attributed to real estate operations per se is not available, and we, therefore, recommend your consideration of eliminating such buildings from the applications of this provision.

Aside from the above comment, we feel that the new recapture proposal is sufficient penalty, without taking away the right to use one of the accelerated depreciation methods, for all depreciable real estate used in the active conduct of a trade or business.

SEC. 703—INVESTMENT CREDIT REPEAL (CODE SECTION 38)

We opposed Sec. 703 repealing the investment credit. Since much has been written and said on this subject, we shall make only a brief comment. When the investment credit was passed in 1962, statements were made that this was in lieu of a reduction in the corporate tax rate, and that it was a step in the reform of our antiquated depreciation allowances. With investment credit repeal and the negative depreciation reform under Sec. 521, above, there has been an effective tax rate increase on corporations, and nothing effectively accomplished toward updating our depreciation policies.

If repeal of the Inevstment Credit is demanded for political reasons, then, as a step in the right direction, we suggest that the depreciable lives in Rev. Proc. 62-21 be made a matter of right by legislation and by removing the reserve ratio test retroactively.

We endorse Secretary Kennedy's recommended 2-point reduction in the corporate rate but suggest that this be extended to cover the full $4.9 billion corporte tax increase contained in HR 13270.

NEW YORK, N.Y.,
August 23, 1969.

COMMITTEE ON FINANCE,
Senate of the United States,
Washington, D.C.

GENTLEMEN: As you review the provisions of Tax Reform Act of 1969 affecting foundations and tax exempt organizations, the following points may well warrant your attention.

1. The quality of results of foundations over the years will depend heavily upon the people serving as trustees. Some features of the bill would impose penalties on a trustee or subject a conscientious person to serious qualms about the risks of damage, inadvertant. For broad, basic, deeply fundamental improvement in the good work foundations do, not penalties and restrictions and restraints are needed so much as better men and women. Serving on a board can take quite a lot of time. Can you not at least minimize possible penalties on boards and somehow help create conditions to attract more of the best effort of good people?

2. Complying with the new law will cost time and money, reducing what is available for good accomplishment. Please try to make meeting the requirements easier. Those you believe essential can probably be adopted to reduce the red tape's tightness.

3. Restrictions on activities to influence legislation, etc., can sadly hamper work of good to society. Government agencies pressing for changes in law would become relatively more powerful with mimeograph machines and easy access to news media. The role of Government at all levels is now so *pervasive* that alternative sources of ideas, argument, debate, reply, challenge, response—all these things can be very useful. Often no individuel or business organization is in a position to know, to spend the time and effort needed for best action. The bill's restricting provisions seems to me too tight, especially cumulative effect. Certainly too much power by far could exist in the hands of administrators to prevent criticism, debate, etc., by merely implied threat. For a democracy to write into law on aid to voter registration may seem a bit odd.

4. Requirements of payout in full may be defensible although some accumulation can lay stronger bases for better achievements in some cases. Two provisions of the bill seem to me in any case defective:

(a) the 5 percent is clearly too high, even in today's markets. No fixed statutory figure or formula can fail to work unintended hardship and perhaps a lot of it. Conditions are too varied and change too much. A figure lower now by

one-fifth (4%) would be too high in my judgment. Give leeway, elbow-room if you decide to retain any rigidity; (b) the practical problems of foundation budgeting, management, change of peace, etc., need more than a year. The goals you seek can be served adequately by allowing at least two budget periods (of 12 months) after the year.

5. The 7½ percent tax will directly curtail good work. If we are to develop in the many ways our society can to enrich and improve itself, then more foundation activity, not less, seems to me desirable. Thus, tax would have its incedence, not on "rich, tax-exempt foundations" but on the people they serve. If some evidence of direct burden of tax is desired you can require estimates of how much a foundation's stocks were taxed under the corporate income tax before the money reached the foundation and how much its real estate was taxed. (Columbia University's real estate was taxed around $9 million in 1968/9).

6. Programs of direct foundation grants to individuals can economize on costs of administration, red tape, overhead, compliance, and so on. And the flexibility and adaptability have lots of merit. I hate to see more rigidity and red-tape in society and especially where freedom means so much in aiding people and projects. Not routine and formality deserves aid so much as matching person, money, and unique opportunity.

7. Try on your own to insert some encouraging, creative, forward-looking provisions to help foundations. The need to prevent abuse ought not to distract attention from the mass of positive, wonderful work. Try to build on the good, not risk reducing it (as the bill inevitably would) to curb the scalawags, except as new aids are provided. The abuses ought not to spread their evil effects by leading indirectly to restraints on the many who have been functioning well (not perfectly, but nothing in society can safely be expected to be perfect) and could do better.

I am a member of the Board of Lincoln Foundation, cooperate with Barnhart Foundation Fellowship Program, and have at times received at least indirect foundation help for research.

Respectfully yours,

C. Lowell Harriss,
Professor of Economics,
Columbia University.

Committee on Finance,
U.S. Senate,
Washington, D.C.

Gentlemen: Your telegram just reached me. I understand the problems you face in trying to accommodate all who want to be heard. Unfortunately, my absence from the country in attending the conference of the International Institute of Public Finance makes it utterly impossible for me to prepare and have in your hands by Sept. 10 (50 copies of) a statement covering the points I would like to make. A brief listing and terse indication can hardly suffice.

1. The bill contains much that will serve the country well. But because the changes are so numerous and of such pervasive influence—and because modification in later years will be difficult—time for thorough examination now, to "start right," will be vastly rewarding. Haste will lead to avoidable errors.

2. The bill bears heavily on returns to capital. Every change bringing more revenue, as I recall, involves heavier taxation of (recipients of) income from capital. This bias deserves your careful consideration.

3. Most of the revenue increases come from heavier burdens on business firms. The processes of production will suffer. This important point, I believe, deserves explicit examination as part of your scrutiny of the bill.

4. The complex issues involved in the taxation of natural resources concern both individuals and corporations. The examples of individuals with large incomes who pay rather little or no tax have properly aroused concern. Changes to tax them more heavily may well be desirable. The large corporations, however, are owned by tens of thousands (or more) shareholders. Heavier taxes on these stockholders would impose burdens different in significance from those on individuals with large and largely tax exempt incomes from menoral properties. One probable results of the tax provisions of the bill will be higher prices for gasoline and other products. The hundreds of millions of added revenue will not come from a few rich people who now pay less tax than they should.

5. The financial needs of universities, hospitals, and other such institutions are great. The accomplishments in the public benefit are unique and vital. Therefore, the provisions of the bill which directly and indirectly discourage contribu-

tions will at best, I feel, be exceedingly costly methods of increasing Treasury receipts and reducing tax avoidance by some persons. True, some present provisions can certainly be criticized; but they have good as well as bad results. The good ones deserve your attention. I am biased, admittedly, but I feel that the good consequences exceed those which are unwelcome by a margin so large as to make restricting actions undesirable.

6. The use of tax law to control private foundations, as a matter of principle, and the specific provisions of the House Bill, ought to have exhaustive study. No issues of urgency press for action this year; and you would, in my view, be doing the country a good service to hold over decisions until you can examine the many implications (and alternative ways of achieving some of the objectives).

Again, acknowledging bias, I urge that any actions taken now be less restrictive than in the House Bill. Several could be modified to reduce the narrow confines of the bill without hampering the objectives sought (not all of which I believe are desirable). The provisions drastically restricting activities having some tie to legislation go much too far. Good as we know our society is, we want to make it better. Discussion, debate, challenge, response—all these are desirable, much as each of us will disagree with many things said. The specification of actions prohibited sets a dangerous precedent for "thought control."

8. The tax on foundations runs against the achievement of many and varied goals which, on balance, I submit (but cannot of course prove) would serve the public interest better than if the funds were merged into those of the Treasury.

9. The many restrictions designed to prevent abuse will hamper activities of many good foundations, diverting attention, adding to costs, and in ways not yet fully foreseeable reduce positive benefits. The benefits overall can hardly be great enough to justify such serious and confining restraints.

10. One focus in trying to get better results from foundations, I suggest, should be to provide incentives for better direction and management. How can more and better trustees be attracted and induced to give more of their best efforts?

Respectfully yours,

C. LOWELL HARRISS,
Professor of Economics.

Views are my own and not necessarily those of any organiaztion with which I am associated.

STATEMENT OF AMERICAN LIFE CONVENTION AND LIFE INSURANCE ASSOCIATION OF AMERICA, SUBMITTED BY WILLIAM B. HARMAN, JR., GENERAL COUNSEL, AMERICAN LIFE CONVENTION AND KENNETH L. KIMBLE, VICE PRESIDENT AND GENERAL COUNSEL, LIFE INSURANCE ASSOCIATION OF AMERICA

The American Life Convention and the Life Insurance Association of America are two associations with an aggregate membership of 355 United States and Canadian companies, accounting for about 92 percent of the total life insurance in force in the United States and holding approximately 99 percent of the assets attributable to insured qualified pension and profit-sharing plans.

This statement contains the associations' views on certain provisions in H.R. 13270, the "Tax Reform Act of 1969", which are of interest and concern to the life insurance business. The statement is divided into two parts: (1) Provisions Which Should Be Deleted From The House Bill; and (2) Provisions Which Should Be Amended Or Clarified.

SUMMARY

I. Provisions which should be deleted from the House bill

(1) *Voluntary employee beneficiary associations (section 121(b)(5) of the house bill).*—The existing 15-percent limitation on the amount of investment income that may be earned by a tax-exempt employees association would be repealed by section 121(b)(5). This change would allow these associations to operate essentially as insurance companies without being subject to Federal income tax and, thus, would be discriminatory.

(2) *Preferred compensation (section 331).*—The proposed change in the tax treatment of deferred compensation is contrary to historical—and valid—cash accounting principles. Moreover, the new tax computations are unduly complex and would require individuals to repeatedly recompute their taxes for many past years. Finally, the new provisions are unclear as to their intended coverage. Thus, this section should be deleted. In any event, a technical change is needed to make it inapplicable to retirement plans of educational institutions.

(3) *Total distributions from qualified plans (section 515).*—The proposed ordinary income tax treatment for a portion of a lump-sum pension distribution will be extremely complex to apply, both for the employer and the employee, and will, in some cases, require employees to overpay their tax and wait five years for their refund. Moreover, the new tax formula will lessen the flexibility of private pension plans. Thus, this section should be deleted or, at the very least, limited to large distributions of the type illustrated in the Ways and Means Committee Report.

(4) *Qualified pension plans of small business corporations (section 541).*—By extending the contribution limitation applicable to pension plans of the self-employed to cover contributions for shareholder employees of Subchapter S Corporations, the House Bill implicitly adopts the philosophy that the self-employed restrictions are a reasonable standard for all pension plans. To the contrary, the pension limitations on the self-employed are unduly restrictive and, if anything, should be substantially modified, instead of extended to corporate plans. Thus, section 541 should be deleted from the House Bill and any legislative action in this area should be directed towards liberalizing the self-employed rules.

II. Provisions which should be amended or clarified

(5) *Tax incentive for investment in residential mortgages, etc.*—The Treasury Department has proposed a special tax incentive to encourage investment by financial institutions in residential real estate mortgages and certain other loans made pursuant to national policy objectives. Any such incentive should be made available to life insurance companies so that they may participate in the investment market on an equal footing with other financial institutions.

(6) *Limitation on interest deduction attributable to investment indebtedness (section 221).*—Since this provision is generally applicable only to individuals and clearly would not apply to corporations acting alone, it should be amended to make clear that it does not apply to corporations acting through a joint venture or partnership.

(7) *Moving expenses (section 231).*—While the associations support the objective of liberalizing the deductible categories of employee moving expenses, we believe that the limitations in section 231 are too restrictive. As limited in the House Bill, the added deductions will not adequately cover the legitimate moving expenses of a great many employees, especially those who are required to move long distances.

(8) *Bonds and other evidences of indebtedness (section 413).*—Two clarifying amendments of this provision are desirable. *First,* life insurance companies should be excluded from the new provision requiring accrual of original issue discount since there is, and has been for many years, a specific provision in the law requiring such accrual for these companies, but permitting a somewhat different method of computation than is called for in section 413. *Second,* in valuing the various elements of an investment unit, the amended section 1232(b)(2) should be expanded to provide that fair market value is to be determined as of the time a firm commitment is made to issue the unit.

STATEMENT

I. Provisions which should be deleted from the House bill

(1) *Voluntary employee beneficiary associations*

Under present law, an employee association which provides for the payment of "life, sick, accident, or other benefits" to employees or their dependents may qualify for a Federal income tax exemption so long as at least 85 percent of its income each year is derived from employer and employee contributions, as contrasted to investment income. While such an association may provide benefits similar to those provided by life insurance companies, the limit on the amount of investment income it may earn provides at least some safeguard against such an association operating, at a tax advantage, in direct competition with life insurance companies. However, section 121(b)(5) of the House Bill would remove the 15 percent limitation on investment income so that there would be no limit on the reserves that such an association could accumulate (and invest) in order to provide insurance benefits. Without this limitation, such an association could operate essentially in the same manner as a life insurance company, but with a valuable tax shelter.

We believe that the enactment of such a tax shelter would provide an important, but unwarranted, incentive in the direction of self-insuring as against purchasing insurance from a life insurance company which is subject to the Federal income tax. We can see no good reason for this policy. Thus, the associations oppose the removal of the 15-percent investment income limitation with respect to funds accumulated by a tax-exempt employee association for the purpose of providing insurance benefits. If the funds in the association may be used for either insurance or noninsurance benefits and cannot be separated on this basis, the 15-percent limitation should apply to the entire fund. If the employee association desires to operate without the limit as to its noninsurance benefits, it should be able to furnish these benefits through a separate association.

(2) *Deferred compensation*

The associations are opposed to the provisions in section 331 of the House Bill which would change the tax treatment of deferred compensation arrangements. Under existing law, employers and employees (or independent contractors) may enter into deferred compensation arrangements under which a part of the employee's compensation is not payable until a future year. For those that report their income on a cash receipts basis, it logically follows that this compensation should not be taxable until received and the Internal Revenue Service has so ruled. Section 331 of the House Bill would, to a significant degree, ignore the cash basis accounting system, which has historically been an option under the tax laws, by requiring that the amount of tax due on deferred compensation payments (in excess of $10,000 in any year) be computed on the basis of the tax rates applicable to the employee in the year in which he is deemed to have earned the compensation rather than in the year in which he actually receives the compensation and, thus, has realized a taxable event.

Deferred compensation arrangements are, in many instances, an integral and necessary part of an employer's compensation structure. They serve valid business purposes apart from tax considerations. For example, a life insurance company may enter into an arrangement with a general agent which provides that renewal commissions with respect to policies renewed after he has ceased to be a general agent will be payable to him over a number of years, rather than a lump sum. This is to insure that he will not be faced with a sudden drop in his income, and is certainly not a tax-motivated arrangement. Yet, under the House Bill, the historical cash method of accounting would be ignored and the agent, in this situation, might be required to compute his tax on these commissions on the basis of his tax rates and income for a much earlier year. The associations object to this result as being completely inconsistent with generally accepted tax accounting concepts.

The deferred compensation provisions in the House Bill are also objectionable because of the complexity they would add to the tax laws and the additional burden they would place on the taxpayer. For example, in order to compute the tax due in the year a deferred compensation payment is received, the taxpayer will have to go back and recompute his tax for at least three prior years and, if he is to take full advantage of the options open to him, possibly for many, many more years.

In addition, the provisions in the House Bill are unclear in many respects and will cause considerable confusion. For example, is the compensation arrangement for life insurance agents described above a "deferred compensation" arrangement? It would seem clearly not since none of the amounts involved could have been paid to him as compensation during his working years. It was because of questions such as these, as well as disagreement with the underlying philosophy, that the Treasury Department recommended deleting the deferred compensation provisions from the House Bill. We are in complete agreement with the Treasury Department in this regard.

In the event that it is decided to retain the deferred compensation provisions in the bill, we urge that the agent's compensation plan described above be clearly excluded. Moreover, we urge that annuity plans of educational institutions and other exempt organizations which are purchased under the provisions of section 403(b) of the Internal Revenue Code be added to the list of compensation arrangements which are excluded from the new provisions. The House Bill presently excludes qualified pension plans as well as unfunded compensation plans which would otherwise meet the tax qualification rules. Annuities provided for employees under the provisions of section 403(b) serve essentially the same purpose as qualified pension plans and, generally, are afforded the same tax treatment. For example, the estate and gift tax exclusions in sections

2517 and 2039 are applicable to qualified plans and section 403(b) plans alike. Similarly, if the new deferred compensation tax rules are made inapplicable to qualified plans, they should likewise be made inapplicable to section 403(b) plans. The House Bill is deficient in this respect and we would suggest, thereof, that if the deferred compensation provisions are to be retained in the bill, the list of exceptions in the new section 1354(f) be expanded to include payments under annuities purchased under section 403(b).

(3) *Total distributions from qualified plans*

The associations are opposed to the provisions in section 515 of the House Bill concerning the tax treatment of lump-sum distributions from tax qualified pension and profit-sharing plans. Under present law such lump-sum distributions, if they meet specified conditions, qualify for taxation at the capital gains tax rates. This tax treatment is a simple method for mitigating the harsh tax effects which would otherwise occur by reason of a significant amount of income—accumulated over a number of years—being included in a single year for tax purposes.

The House Bill would replace this simple system of taxation with one that is very complicated and will produce inequitable results in some cases. Under the House Bill, that portion of a lump-sum distribution equal to the employer's contributions under the plan, plus forfeitures allocated to the employee, would be taxed under the ordinary tax rate schedule, subject to a very complex averaging procedure. Under the averaging mechanism, a tax would be computed and paid in the year the distribution is received, utilizing an averaging computation similar to that applicable to lump-sum pension distributions received by self-employed people. Then, at the end of five years, the taxpayer would recompute his tax for each of the past five years as though he received one-fifth of the distribution in each year. If the sum of the hypothetical increases in his taxes for these years is less than the tax he actually paid, he may claim a refund.

The House Bill rightly recognizes that in no event is ordinary income tax treatment appropriate for other than the deferred compensation (*i.e.*, employer contribution) element of a lump-sum distribution since the remaining portion is analogous to capital appreciation. However, separating out this compensation element for special treatment will be very difficult. For example, under a plan which does not provide for immediate vesting, the employer's contribution level may reflect his projection as to future forfeitures on account of employee-turnover. In such a situation, it will be difficult, and perhaps unrealistic to attempt to allocate each year's contribution among the employees. Certainly, this added complexity—which will affect employees at every income level—is not warranted in order to exact additional taxes out of a few highly-paid individuals, which is the apparent intent of the provision as explained in the House Committee Report. The Report speaks of individuals with incomes of over $50,000 and distributions of $500,000 or more. These are hardly the typical cases and yet, it is their existence which is used to justify added complexity for *all* cases.

The House Bill recognizes that the tax it imposes in the year the distribution is received may be too high by allowing the taxpayer to "look back" after five years and claim a refund if he was over-taxed. If such a complex and basically unfair relief measure is needed, we submit that the basic tax provision itself should not be adopted.

Finally, the new tax formula will lessen the attractiveness to some individuals of receiving their pension accumulation on one lump sum. To this extent, it will reduce the flexibility of the private pension system and, in so doing, slow down its growth especially for small employers. It certainly should not be assumed that a periodic pension is, in every case, superior to a lump-sum payment. For example, some individuals may wish to go into business for themselves during their retirement years, and this may be possible only if they have access to their pension accumulation as a source of capital.

For these reasons, the associations oppose section 515 of the House Bill. However, if it is decided to take some action in this area, we believe that the undue complexity can be partly avoided by limiting the new tax treatment to large distributions of the magnitude indicated in the House Committee Report. Moreover, we believe that it would be more accurate to provide an averaging provision which has the effect of spreading the income over the employee's life expectancy, rather than over only five years.

(4) *Qualified pension plans of small business corporations*

Section 541 of the House Bill would impose an annual limitation on the pension contributions that may be made under the ordinary pension tax rules by

a so-called "Subchapter S" Corporation for employees who own more than 5 percent of the stock in the corporation. Under this new limitation, which is very similar to the limitation now applicable to plans for self-employed persons, any contributions by the corporation during the year in excess of 10 percent of the employee's salary (or $2,500, if less) would be currently taxed to the employee.

The associations oppose this provision in the House Bill. The basic problem underlying this provision is the fact that there are significantly different tax rules applicable to pension plans depending on whether they are established to meet the retirement needs of corporate employees or of self-employed individuals. The philosophy of section 541 is that, since "Subchapter S" Corporations are taxed in certain respects (but certainly not all) in a manner similar to partnerships, it is consistent to apply the more strict partnership pension rules to these corporations. We certainly believe that the present disparity between the self-employed and corporate pension rules is illogical. On the other hand, we believe that the self-employed rules are unduly restrictive and certainly should not be extended on a piecemeal basis to various types of corporate organizations. Instead, we strongly recommend that Congress close the gap by revising the self-employed pension rules to bring them more in line with the rules historically applicable to corporations and, thus, make them more responsive to the retirement needs of the self-employed.

We note that the Treasury Department, in its testimony before the Senate Finance Committee, indicated that it is engaged in a comprehensive review of the entire deferred compensation area with the view to submitting recommendations to Congress. We agree with the Treasury Department that the piecemeal legislation in the House Bill concerning "Subchapter S" Corporations should be dropped in anticipation of this more comprehensive review.

II. *Provisions which should be amended or clarified*

(5) *Tax incentive for investment in residential mortgages, etc.*

In its testimony before the Senate Finance Committee, the Treasury Department proposed the enactment of a special tax incentive to "encourage investment by financial institutions in residential real estate mortgages" and certain other loans made pursuant to national policy objectives. However, in spelling out the details of this proposal, the Treasury spokesman indicated that the incentive would be limited to "banking institutions". (See statement of Edwin S. Cohen, Assistant Secretary of the Treasury for Tax Policy.)

The life insurance business invests in residential real estate loans. For example, as of June 30, 1969, life insurance companies held residential mortgages in one to four-family unit dwellings with a value of $28.8 billion. They held another $13.2 billion of mortgages involving multi-family unit property, for a grand total of $42 billion. If life insurance companies are to continue to partcipate in this aspect of the investment market on an equal footing with other financial institutions, they should be granted the same special tax incentives. Thus, if the Treasury Department's special five-percent deduction—or any provision like it—is adopted, it should be extended to life insurance companies as a deduction from "life insurance company taxable income".[1]

In this regard, we note that the Federal Home Loan Bank Board, in its testimony before the Senate Finance Committee, indicated that the need for residential housing is so great that "all lending institutions should be stimulated to participate". (See testimony of Preston Martin, Chairman, Federal Home Loan Bank Board, on Setpember 15, 1969.) Thus, the Board would seem in complete accord with our request that any special incentive in this area be extended to life insurance companies.

(6) *Limitation on interest deduction attributable to investment indebtedness*

Section 221 of the House Bill would limit the amount that may be deducted with respect to interest on funds which are borrowed to purchase or carry investment assets. The new limitaiton would generally apply "in the case of a taxpayer

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[1] As we understand the Treasury's proposal, a bank would receive the special deduction in addition to its deduction for interest paid to depositors. To achieve parity, a life insurance company should receive the deduction *after* the application of the proration formula which measures the company's share of the income after an exclusion is made for moneys set aside for policyholders. Specifically, the special deduction should be included in a new section 804(a)(2)(C) in arriving at taxable investment income (Phase I) and in a new section 809(d)(13) in arriving at gain from operations. With respect to Phase III, section 815(b)(2)(A) should be amended to include the amount of the special deduction in the shareholders surplus account.

other than a corporation" (section 163(d)(1)). The Ways and Means Committee Report indicates that the bill places a limitation "in the case of individuals (and other non-corporate taxpayers)". Thus, it appears clear that the new provision is intended to be limited to individuals. However, the new section 163(d)(4)(A) creates some confusion as to how the limitation would operate in the case of a partnership where the partners are corporations. This paragraph provides that the new limitation shall, in the case of a partnership, "apply with respect to the partnership and with respect to each partner." The question is whether this provision extends the limitation to corporate as well as individual partners or whether it should be read in conjunction with the opening provision and limited to individual partners. Since it is clear that the new limitation would not apply to a corporation acting alone, it would appear inconsistent to apply it to a partnership consisting of corporations or to the individual corporate partners. Therefore, we recommend that the House Bill be clarified to make clear that the new limitation on the interest deduction is not applicable to a partnership or its partners where the partners are corporations.

(7) *Moving expenses*

The associations support the objective of section 231 of the House Bill which is to expand the allowable deduction for employment-related moving expenses. One of the undeniable facts of our modern society is the necessity for a mobile work force. Employees are frequently required to move to new cities or towns where their particular skills are needed. The cost of such a move—which unquestionably is part of an employee's work-related expenses—is frequently heavy and the present tax provisions which allow a deduction or exclusion for only a portion of it are inadequate.

While we support the objective of the House Bill in this regard, we believe it falls short of being an adequate solution. While the dedudctible categories of moving expenses would be expanded to include the cost of house-hunting trips, temporary living expenses at the new job location, and the cost of selling and buying a residence, a deductible ceiling of $2,500 would be applied to these added expense categories. With this limitation, the amount allowable as a deduction will not, for many employees, cover the expenses they incur which fall within these new categories. (Of course, the bill is of no help with respect to the other expenses related to a move which are not within the enumerated categories.) For example, the sales commission on a $20,000-$30,000 home would use up a substantial portion of the $2,500 deduction allowance, leaving the employee with an inadequate deduction for other expenses of his move, even though they clearly fall within the category of deductible-type expenses. This would work a particular hardship on an employee who must make a long-distance move where just the transportation fares involved in a house-hunting trip would involve considerable cost. In this regard, the $2,500 limitation clearly goes far beyond merely cutting out lavish deductions. Moreover, it discriminates against employees making long-distance moves.

The bill also provides that no more than 30 days of temporary living expenses may be deductible and that the move must be at least 50 miles (as compared to the present limit of 20 miles). These, too, are unrealistic limitations which will cause the new deduction to fall far short of covering the expenses of many employees.

These are only examples of the various limitations in the House Bill which will prevent many employees from obtaining a tax reduction for a substantial part of their work-related moving expenses, even though the level of their expenses can hardly be considered lavish or unreasonable. In this regard, we believe the bill falls far short of providing adequate recognition in the tax laws for those moving expenses which are incurred in connection with job-related moves. They are business expenses and should be deductible as such, without the imposition of unrealistic limitations.

We recommend, therefore, that if limitations must be imposed, they should more realistically reflect the real cost of moving to a new job location and be aimed only at eliminating abuse of the deduction.

(8) *Bonds and other evidences of indebtedness*

(a) *Original issue discount.*—Under section 413 of the House Bill, if a bond or other evidence of indebtedness is issued at an original issue discount, the holder would be required to include this discount in his income for tax purposes on a ratable basis over the life of the bond. The issuer of the bond would be

reqiured to file annual information returns indicating the amount so includable in the holder's income.

For many years, life insurance companies, unlike most other taxpayers, have been required to accrue discount (and amortize premium) with respect to bonds and other evidences of indebtedness they hold. (See section 818(b)(1) of the Internal Revenue Code.) Under this provision, the amount includable in income with respect to discount may be determined "in accordance with the method regularly employed by such company, if such method is reasonable." Otherwise, the includable amount is to be determined in accordance with Treasury Department regulations, which have prescribed the "ratable" method.

The method regularly employed by a number of life insurance companies, and which has been accepted by the Internal Revenue Service as being reasonable, is the scientific (present value) method. Under this method, instead of spreading the discount evenly over the life of the indebtedness, a compounding factor is recognized. Thus, as compared to a ratable method, the method used by those life insurance companies produces an accrual which is smaller in the early years and higher in the later years. However, it is an accurate method of measuring the amount of discount earned each year. We can see no good reason for requiring life insurance companies to change their historical practices in this regard and, indeed, assume that the House bill did not so intend since it made no change in section 818. In order, however, to avoid any possible confusion, we request that section 413 of the House Bill be amended to make clear that section 818, and not the new provision, applies to life insurance companies with respect to the accrual of bond discount.

We would also note that the information returns filed under the new provisions of the House Bill will not accurately reflect the original issue discount actually taken into account by life insurance companies since the information returns will be filed according to the "ratable" method while the life insurance company's income will be computed under the scientific method. Perhaps a provision could be added which would not require returns to be filed with respect to life insurance companies.

(b) *Investment units.*—Section 413 of the House Bill amends section 1232 (b)(2) of the Internal Revenue Code to provide that, if a bond is issued together with an option or other security (such as a warrant), the issue price of the total package must be allocated between the bond and the warrant in the ratio of their respective fair market values. We recommend that this provision be expanded to provide that, for this purpose, the fair market value is to be determined at the time a firm commitment is made to issue the investment unit. Such a rule would provide certainty, especially in the case of private placements. Moreover, it would avoid the distortions that might otherwise arise on account of substantial fluctuations in value between the time of commitment and the time of disbursement.

AMERICAN LIFE CONVENTION,
LIFE INSURANCE ASSOCIATION OF AMERICA,
Washington, D.C., October 2, 1969.

Re H.R. 13270.

Hon. RUSSELL B LONG,
Chairman, Committee on Finance,
U.S. Senate, Washington, D.C.

DEAR SENATOR LONG: The American Life Convention and the Life Insurance Association of America are two associations with an aggregate membership of 355 United States and Canadian companies, accounting for about 92 percent of the total life insurance in force in the United States and holding approximately 91 percent of the total assets of legal reserve life insurance companies.

We wish to bring to your attention and to the attention of the Senate Finance Committee a serious problem that has arisen with respect to the tax treatment of certain special reserves held by life insurance companies under group insurance contracts. In brief, we believe the Congressional intent as to the tax treatment to be afforded these reserves was clearly indicated in the Senate Finance Committee report accompanying the Life Insurance Company Income Tax Act of 1959, and in the remarks made on the floor of the Senate by Senator Harry F. Byrd, then Chairman of the Finance Committee, and Senator Frank Carlson. Unfortunately, the Internal Revenue Service is not following this intent.

Life insurance companies maintain two types of so-called special reserves under group life and group accident and health insurance contracts. One type of these reserves is used to fund over an employee's working life the cost of providing him group term life or group health and accident insurance after retirement. The second type of reserve is used for premium stabilization purposes, that is to meet unusually large current claims which would otherwise require an increase in the premium payments of employers for the insurance coverage provided their employees. In some instances, the reserve is a combination of both types.

Amounts set aside in policyholder reserves have long been deductible in computing the income of life insurance companies subject to tax. Moreover, the interest added to such policyholder reserves has also been deductible by insurance companies in arriving at their tax base. These special reserves mentioned above are policyholder reserves and must be used to provide insurance coverage for retired employees of the policyholder or to stabilize his premiums under the policy. These special reserves are of the same nature as other reserves held for policyholders which are deductible in arriving at the taxable income base of a life insurance company. Thus, there is no basis for providing different tax treatment for these special group reserves.

At the time of the 1959 legislation, the Senate Finance Committee had called to its attention a special reserve that was established under the Federal Employees Group Life Insurance Act (FEGLI). The Finance Committee added a special provision dealing with the deductibility of interest on FEGLI reserves (Section 805(e)(4) of the Internal Revenue Code). At one point, a draft was prepared which would also have specifically provided for special reserves under plans other than FEGLI. The final version of Section 805(e)(4), however, was limited to FEGLI reserves because the earlier draft was considered cumbersome and, in any event, was thought to be unnecessary since even the FEGLI amendment was intended only to clarify the status of these reserves.

The fact that this was the Congressional intent is specifically indicated in the Finance Committee Report, in Senator Harry Byrd's explanation of the Senate Finance Committee amendments, and in Senator Frank Carlson's explanation, on behalf of Senator Byrd, of the Conference Committee's actions. The Report and both of these statements indicate that Section 805(e)(4) was adopted "to make it clear" that a deduction was available to insurance companies for interest credited to the special reserves. For example, the following description of this amendment appears on page 7546 of the Congressional Record for May 19, 1959:

"23. The committee agreed *to make it clear* under the bill that the interest paid deduction is to be available where a life insurance company is required to make payments or credits on special contingency reserves of a nonforfeitable character which it must hold as a liability under *some* group insurance policy (sic) such as that authorized under the Federal Employees Group Life Insurance Act of 1954." (Emphasis added.)

In the 1959 legislation, it was assumed by both the Senate Finance Committee and the life insurance companies that deductions were available for interest credited to all special reserves under section 805(e)(2) of the law.

Unfortunately, the Internal Revenue Service has taken the position that life insurance companies are not to be allowed a deduction for the interest added to these special reserves.[1] Although we believe this is a matter on which the Congressional intent is clear, the Service apparently believes it cannot effect this intent without further legislative changes.

In recognition of this clear Congressional intent, Mr. Wilbur D. Mills, Chairman, House Ways and Means Committee, introduced a bill, H.R. 8442, on March 6, 1969, which would clarify existing law with regard to these special reserves. (See Mr. Mills' press release dated March 6, 1969, copy attached.) This bill would revise Section 805 (e)(4) of present law so that it expressly covers not only interest credited to reserves under FEGLI contracts but also interest credited to any special reserves under contracts of group term life insurance or group health and accident insurance on retired lives (although such reserves also may be used for premium stabilization purposes). Comparable changes would also be made under the phase II tax, i.e., the tax on gains from operations other than

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[1] See, for example, *Occidental Life Insurance Company of California v. U.S.* (in the U.S. District Court, Central District of California), where an order was recently entered denying the taxpayer a deduction for these special reserves. It should be noted that, as of now, no findings of fact, conclusions of law, and judgment has been entered.

investment income. These amendments, since they are clarifying in nature, would be made applicable with respect to the effective date of the Life Insurance Company Income Tax Act of 1959, namely, taxable years beginning after December 31, 1957.

H.R. 8442 covers the reserves for retired lives and also retired lives reserves combined with stabilization reserves. This bill does not specifically cover reserves used solely for stabilization purposes. The legislative history indicating the Finance Committee's intent in 1959 draws no such distinction, and, logically, there is none. Accordingly, we have drafted an amendment to specifically cover stabilization reserves whether or not in combination with retired lives reserves.

We urge the Senate Finance Committee to add a provision to H.R. 13270 which would make clear, beyond any doubt, that these special reserves (both reserves for retired lives and stabilization reserves) and the interest added thereto, are items that life insurance companies may deduct under the 1959 Company Tax Act. Such a provision would clearly be in accordance with the intent of the Senate Finance Committee as expressed in the legislative history of the 1959 Company Tax Act.

There is attached a proposed amendment which would clarify the tax treatment of these special reserves (this proposed amendment is identical with H.R. 8442 except that all stabilization reserves are specifically included in the draft). We would be pleased to discuss this amendment with you or your staff.

Sincerely yours,

AMERICAN LIFE CONVENTION,
WILLIAM B. HARMAN, JR.,
General Counsel.
LIFE INSURANCE ASSOCIATION OF AMERICA,
KENNETH L. KIMBLE,
Vice President and General Counsel.

AMENDMENT—TO MAKE CLEAR THE TAX TREATMENT INTENDED FOR CERTAIN SPECIAL RESERVES UNDER GROUP CONTRACTS IN THE CASE OF LIFE INSURANCE COMPANIES

Sec. —. Life Insurance Companies

(a) Policy And Other Contract Liability Requirements—Paragraph (4) of Section 805(e) (relating to interest paid on certain special reserves) is amended to read as follows:

"(4) Interest on Certain Special Reserves.—Interest for the taxable year on special reserves under contracts of group term life insurance or group health and accident insurance which are established and maintained for insurance on retired lives or for premium stabilization, or a combination thereof."

(b) Rules for certain reserves.—Section 810(c) (relating to items taken into account as reserves) is amended by inserting after paragraph (5) thereof the following new paragraph:

"(6) Special reserves under contracts of group term life insurance or group health and accident insurance which are established and maintained for insurance on retired lives or for premium stabilization or a combination thereof."

(c) Effective date.—The amendments made by this section shall apply with respect to taxable years beginning after December 31, 1957.

CHAIRMAN MILLS INTRODUCES BILL TO CLARIFY CONGRESSIONAL INTENT WITH RESPECT TO TAX TREATMENT OF SPECIAL RESERVES UNDER GROUP CONTRACTS IN THE CASE OF LIFE INSURANCE COMPANIES

Chairman Wilbur D. Mills (D., Ark.) today introduced H.R. 8442, a bill to clarify Congressional intent with respect to the tax treatment intended for certain special reserves under group contracts in the case of life insurance companies.

Chairman Mills' explanatory statement follows:

SPECIAL RESERVES FOR RETIRED LIVES

I am today introducing a bill to amend the Internal Revenue Code to make clear the tax treatment intended for certain special reserves for retired lives

(and also for premium stabilization purposes) under group contracts in the case of life insurance companies.

This is a subject which has been discussed with the Internal Revenue Service over a period of several years. Although it is a matter on which I believe the congressional intent is clear, the Internal Revenue Service informs me that it does not feel that it can effect this intent without further legislative changes. It is for this reason that I am introducing a bill at this time although I believe that it should be possible to obtain the results specified in the bill without legislative change.

The special reserves I am referring to are used to fund, over an employee's working life, the cost of providing him group term life insurance or group health and accident insurance after retirement. In addition, some of these funds are also used to some extent for premium stabilization purposes, that is to meet usually large current claims which would otherwise require an increase in the premium payments of employers for the insurance during the working lives of the employees. In other words, in addition to making provision for group insurance for employees after their retirement the reserves also are used to even out or stabilize over a period of years the premium payments an employer must make for the current insurance.

Amounts set aside in policyholder reserves have long been deductible in computing the income of insurance companies subject to tax. This was true before 1959 when essentially the only income taxed to the life insurance companies was their investment income and since 1959 when not only investment income but also underwriting income has been taxed. The amounts deducted in this respect have included not only amounts added to what are called life insurance reserves but also, among other items, interest paid on indebtedness and amounts in the nature of interest on insurance or annuity contracts which do not involve, at the time of the accrual, life, health or accident contingencies. At the time this latter provision was added to the Code in 1942, the Congress in its committee reports indicated that this provision was to be interpreted broadly. It said that the provision includes amounts in the nature of interest such as so-called excess-interest dividends and guaranteed interest but did not restrict the provision to only these items. In 1959 when the tax treatment of life insurance companies was substantially revised and broadened, this provision was nevertheless carried over substantially unchanged from the prior law and again Congress indicated that it was to be interpreted broadly. It said, for example, that this category includes interest paid on supplementary contracts and policyholder dividends left to accumulate but did not limit it to merely these amounts. I think it is clear that Congress intended amounts credited to the special reserves I have referred to would be deductible under this provision. However, at the time of the 1959 legislation, the Senate had called to its attention a reserve of the type I have referred to established under the Federal Employees Group Life Insurance Act (FEGLI). The Senate decided to add a specific provision dealing with the deductibility of interest on FEGLI reserves to the Internal Revenue Code (section 805(e)(4)). At that time a draft was prepared which would also have specifically provided for special reserves under plans other than FEGLI. That draft read as follows:

"(4) Interest on certain special contingency reserves.—Interest on special contingency reserves—

"(A) established pursuant to section 8(d) of the Federal Employees' Group Life Insurance Act of 1954, and

"(B) for group life insurance contracts and group accident and health insurance contracts, if the use of such interest is limited in a manner similar to the limitations on the use of the interest on reserves described in subparagraph (A)."

The final version of section 805(e)(4), however, was limited to FEGLI reserves because the earlier draft was considered cumbersome and, in any event, was thought to be unnecessary since even the FEGLI amendment was intended only to clarify the status of these reserves. The fact that this was the congressional intent is specifically indicated in the Finance Committee report, in Senator Harry Byrd's explanation of the Senate Finance Committee amendments, and in Senator Frank Carlson's explanation, on behalf of Senator Byrd, of the conference committee's action. The report and both of these statements indicate that section 805(e)(4) was adopted "to make it clear" that a deduction was available to insurance companies for interest credited to the special reserves. In the 1959 legislation, it was assumed, as I indicated earlier, that deductions were

available for interest credited to the special reserves I have referred to under section 805(e)(2) of the law.

It was because the congressional intent seemed so clear to me in this regard that I concluded after I heard that the Revenue Service thought they could not hold that amounts credited to the special reserves would be deductible under section 805(e)(2) that I decided to introduce a bill making more specific what I believe is the intent of Congress in this regard. The bill I am introducing revises section 805(e)(4) of present law so that it covers not only interest credited to reserves under FEGLI contracts but also interest credited to any special reserves under contracts of group term life insurance or group health and accident insurance which are established and maintained for the provision of insurance on retired lives (although such reserves also may be used for premium stabilization purposes). Comparable changes are also made under the phase 2 tax, or the tax on gains from operations other than investment income. These amendments, since they are clarifying in nature, are made applicable with respect to the effective date of the Life Insurance Company Income Tax Act of 1959; namely, taxable years beginning after December 31, 1957. This bill does not deal with reserves which are maintained solely for premium stabilization purposes since it does not now appear that there is any neeed for clarification with respect to such reserves.

I should say that I believe that it is wholly proper, as long as amounts credited to life insurance reserves are deductible to the insurance companies for amounts credited to these special reserves also to be deductible to the insurance companies. The amounts held in these reserves are held for the benefit of specific groups of employees and are not generally available to the life insurance company to meet other obligations, which is essentially the reason why life insurance companies are permitted to deduct amounts credited to life insurance reserves.

The bill which I am introducing today does not deal with the deductibility of the premiums paid by the employers or with the treatment, in their case, of amounts credited by life insurance companies to these reserves. It is my understanding that the Internal Revenue Service intends to rule that the premiums in these cases may be deducted by the employers and that any amounts added to the reserves under these contracts are not taxable to the employer policyholder. I understand this position is consistent with that taken by the Service in rulings going at least as far back as 15 years.

In these cases employers are funding obligations incurred presently which will have to be met after employees retire. When section 401(h) was added to the Code in 1962, providing for the funding of accident and health benefits on retired lives in connection with qualified pension plans, it was indicated in the committee reports that this funding for accident and health benefits was permitted under the then existing law if a separate plan was involved, but not then under a qualified pension plan. This statement in the committee report on H.R. 10117 was based upon the Treasury Department report to the Senate Finance Committee (included in such report) that a deduction currently was available to employers under section 162 of the Code for amounts used to fund separate accident and health plans. Since this treatment was available in the case of accident and health plans, it would appear that it would also be available in the case of group term life insurance for retired lives.

[H.R. 8442, 91st Cong., first sess.]

A BILL To amend the Internal Revenue Code of 1954 to make clear the tax treatment intended for certain special reserves under group contracts in the case of life insurance companies

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That paragraph (4) of section 805(e) of the Internal Revenue Code of 1954 (relating to interest paid on certain special reserves) is amended to read as follows:

"(4) INTEREST ON CERTAIN SPECIAL RESERVES.—Interest for the taxable year on special reserves under contracts of group term life insurance or group health and accident insurance which are established and maintained for the provisions of insurance on retired lives (although such reserves also may be used for premium stabilization purposes)."

SEC. 2. Section 810(c) of such Code (relating to items taken into account as reserves) is amended by inserting after paragraph (5) thereof the following new paragraph:

"(6) Special reserves under contracts of group term life insurance or group health and accident insurance which are established and maintained for the provision of insurance on retired lives (although such reserves also may be used for premium stabilization purposes)."

SEC. 3. The amendments made by this Act shall apply with respect to taxable years beginning after December 31, 1957.

STOCKTON, CALIF., *September 23, 1969.*

Re tax reform bill H.R. 13270: Overlapping provisions in the bill are too cumbersome and complicated.

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

DEAR SENATORS: It has come to my attention that the Senate Finance Committee is at present considering the Tax Reform Bill H.R. 13270.

It becomes my obligation and duty as a professional tax consultant to call the attention of the Committee to certain overlapping provisions in the Bill which will cause the average businessman and his tax adviser to face the most incredibly complicated and cumbersome tax laws in U.S. history if the House version of the Bill becomes law.

Many of the major reform proposals would apply over a certain dollar amount of income or deductions, as the case may be. This would require two separate computations under both old and new law when the dollar amount is large enough to cause the reform provision to apply. Then, some of the reform provisions themselves provide an alternative computation which would require two more completely separate computations, and some of the new alternatve computations could be made as late as five or ten years after the taxable event. Then, there are also grandfather clauses that could require still another computation over and above the previous alternative and sub-alternative computations.

The overlapping provisions which will cause these incredibly complicated and cumbersome computations to apply relate to: (1) Deferred compensation; (2) Lump-sum distributions from a qualified employee benefit plan; (3) Limit on tax preferences; (4) Allocation of itemized deductions; (5) Interest on borrowings for investments; (6) Charitable contributions in appreciated property; (7) Cash basis farmers and investors in livestock; (8) Earned income 50% rate ceiling; and (9) Distributions from accumulation trusts.

Where the proposals overlap with each other and overlap with the current rules on income averaging and net operating loss carry-overs and carry-backs, the average businessman will be rudely shocked with the cumbersome complexities with which he will be faced. Huge sums of money and considerable time will have to be spent by accountants and lawyers preparing income tax returns of monumental proportions where a combination of the overlapping provisions apply.

The complicated calculations involved will become a veritable nightmare, and, despite the promise to the taxpayers by the government made many years ago to make the preparation of income tax returns a comparatively reasonable task, the resentment of the indigent taxpayers will be felt in the halls of Congress for many years to come. The burden which you gentlemen will bear because of this will be heavy.

May I recommend that you and your staff consider very carefully these most incredibly complicated and cumbersome technicalities in the proposals before you take action to release the Bill from Committee.

The undersigned for over twenty years was the Chairman of the Committee on Taxation of the San Joaquin Chapter of the California Society of Certified Public Accountants and a member of the State Society Committee on Taxation, as well as being a recognized expert in the field of income tax and estate tax.

Respectfully,

EMILE R. JARDINE, C.P.A.

CAN MANUFACTURERS INSTITUTE, INC.,
Washington, D.C., September 26, 1969.

Hon. RUSSELL B. LONG,
Chairman, Senate Finance Committee,
New Senate Office Building, Washington, D.C.

DEAR SENATOR LONG: The Tax Committee of Can Manufacturers Institute, Inc. respectfully submits, herewith, a copy of its letter of May 21, 1969 addressed to Mr. John M. Martin, Jr., Chief Counsel, Committee on Ways and Means.

In view of the decision of the Senate Finance Committee to report H.R. 7311 with an amendment to repeal the 7% Investment Tax Credit, we feel it is appropriate to reiterate the points discussed in the attached letter of May 21. We especially request your consideration of the paragraphs numbered 1. (a), (b) and (c) on pages 3 and 4 dealing with "Depreciation Reform". If H.R. 7311 is enacted with the amendment calling for repeal of Investment Credit, we strongly urge the amendment of H.R. 13270, the Tax Reform Bill of 1969, to incorporate meaningful depreciation reform along the lines suggested in the attached letter.

Sincerely,

WALDO B. LYDEN,
Chairman, Tax Committee.

CAN MANUFACTURERS INSTITUTE, INC.,
Washington, D.C., May 21, 1969.

Mr. JOHN MARTIN, Jr.,
Chief Counsel, Committee on Ways and Means, U.S. House of Representatives, Room 1102, Longworth House Office Building, Washington, D.C.

DEAR MR. MARTIN: The Tax Committee of the Can Manufacturers Institute, Inc., respectfully opposes the repeal of the 7% Investment Credit. The Committee feels that the proposed action is of such major importance that it should not be taken at this time and certainly not without careful consideration and public hearings at which industry and other taxpayer groups would be given an opportunity to express their views.

From the President's message of April 21, 1969 it appears that repeal is being recommended for the following reasons:

1. The increase in America's productive capacity in order to effectively compete with industry abroad is no longer a matter of high priority.

2. Repeal of the investment credit will provide the tax revenues necessary to allow reduction of the surtax on January 1, 1970, and repeal on June 30, 1970.

3. On a longer term basis, the revenues provided from repeal can be used to finance—

(a) Revenue sharing with state and local governments.

(b) Tax credits to encourage investments in poverty areas and training of the hard-core unemployed.

We believe the case for repeal is unsound for the following reasons:

1. Priority of economic growth

The Committee feels that continued growth in America's productive capacity in order to effectively compete with industry abroad should still be a matter of the highest priority.

The investment credit was enacted as a permanent part of the U.S. Internal Revenue Code to provide an incentive to encourage replacement and modernization of American industry in order that the U.S. could better keep pace with industrial growth in other countries, particularly Western Europe and Japan. Before repealing the credit, a thorough review should be made to determine whether or not attainment of this goal has been enhanced as a result of the investment credit. If it has been, then the credit should be continued and other means should be considered for financing the programs which, under the President's proposal, would be financed by repeal.

The Committee believes that the economic objectives which the investment credit was intended to promote are still matters of national concern in 1969 as they were in 1962. It is true that America's investment in new capital for industrial production has increased since 1962. But the investment by foreign countries with whom American business must compete has increased at an even faster rate. In addition, the U.S. rate of growth appears to have begun declining in the first quarter of 1969. It could well be that a repeal of the investment credit might occur at a time when it is most needed in order for America to keep pace with its foreign industrial competitors. Repeal of the investment credit also

would tend to worsen the U.S. trade balance and defeat efforts of the U.S. to correct its balance of payments position.

The 1966 suspension of the investment credit occurred at a time when capital expenditure began to decline. When this became evident, Congress acted quickly to restore the credit in order to prevent further erosion. We do not believe the situation is basically any different today. The credit has proved to be an effective tool for encouraging continued industrial expansion and should be continued as a permanent part of our tax law. If it is not, the ability of the U.S. to compete abroad will be severely restricted.

2. Reduction in surcharge

The termination of the temporary surtax is, of course, a desirable goal and should be accomplished at the earliest possible date. However, the Committee objects to a trade-off of a permanent provision, such as the investment credit for the acceleration or reduction of a temporary surcharge. Such a reduction or termination should be tied into control of expenditures and not to a shift in the tax burden.

3. Revenue sharing, poverty areas, and hard-core unemployment

This Committee agrees with President Nixon that these are high priority items. These are social problems which must be solved. However, we do not believe attainment of these goals will be enhanced by repeal of the investment credit. On the contrary, it is possible that they will be even more difficult to achieve if the incentive for American industry to grow and compete with foreign manufacturers is removed. Only as a last resort should these programs be financed at the expense of the loss of the investment credit.

We are in a long continued inflationary spiral, partially as a result of Government deficit financing policies. As a result, creation of new jobs through equipment investment is becoming more costly, relieved only by the 7% investment credit and accelerated depreciation policies. Poverty and unemployment cannot be relieved other than through sound industrial expansion to create productive jobs. It is in this area we believe the 7% investment credit has been of material assistance.

CONCLUSION

The investment credit was enacted as a permanent part of the U.S. Internal Revenue Code to provide an incentive to encourage industrial growth in order that the U.S. could better keep pace with the highly industrialized countries of Western Europe and Japan. If the possibility of achieving this goal has been enhanced as a result of this credit, it should be continued because we are far from solving the basic problem.

If after careful deliberations and public hearings Congress determines that repeal is inevitable, alternative measures should be taken to protect the position of the U.S. in international and domestic trade. Some alternatives which should be considered are:

1. Depreciation reform:

(*a*) The "Reserve Ratio Test" should be eliminated by Congressional action. This is an administrative provision included in Revenue Procedure 62-21 in order to limit the use of depreciation rates which the Treasury Department apparently feels may, in some cases, be higher than the "reasonable" rates allowed by Section 167 of The Internal Revenue Code. Higher depreciation rates can be a real boon to United States business in competing with industry of other countries having high arbitrary depreciation allowances. Therefore, Section 167 should be amended to permit the use of the depreciation rates set forth by the Commissioner of Internal Revenue without being limited by a "Reserve Ratio Test".

(*b*) Section 167 should be amended to permit the use of depreciation methods which provide a greater degree of acceleration. Suggestions have been made that the declining balance method described in Section 167(b)(2) be increased to an amount not exceeding three times the straight-line rate. Another possibility would be to allow amortization of a percentage of total cost over a short period, say 5 years, with the balance of cost subject to accelerated depreciation. This would be similar to amortization allowed under "Certificates of Necessity" in the 1940's and 1950's.

(*c*) Section 167 should be amended to allow depreciation under statutory rates for each class of assets. This could be similar to the Canadian system where taxpayers may claim the amount allowable or such lesser amount as they may

choose. Thus, taxpayers suffering operating losses would elect to claim no depreciation in any year.

2. Consider reduction in the rate of credit or suspension for a fixed period rather than permanent repeal.

3. Provide for more liberal transitional rules (such as a later cut-off date) in order that corporation spending programs authorized prior to repeal are not affected.

4. The law should permit the continuation of the credit in certain critical areas. For example, the control of air and water pollution is such an urgent matter that investment credit should be allowed for amounts spent by industry for this purpose. In fact, the rate probably should be increased above the present 7%. Similarly, the credit should be allowed for investments in poverty areas which will assist in fighting poverty and hard-core unemployment.

Respectfully submitted.

WALDO B. LYDEN,
Chairman, Tax Committee.

CAN MANUFACTURERS INSTITUTE, INC.,
Washington, D.C., September 29, 1969.

Hon. RUSSELL B. LONG,
Chairman, Senate Finance Committee,
New Senate Office Building,
Washington, D.C.

DEAR SENATOR LONG: The Tax Committee of Can Manufacturers Institute, Inc. wishes to express its views relating to certain sections of H.R. 13270, the Tax Reform Bill of 1969. This Committee heartily endorses the broad objective of tax reform and agrees in principle with many of the proposals in the Bill. However, there are many specific proposals which we feel should be modified in order to achieve greater tax equity and simplicity as well as desirable economic effects. Some of our comments relate to technical matters; others are concerned with the broader aspects of tax policy.

We are attaching 7 separate one-page summaries of this Committee's views with respect to the following sections of H.R. 13270:

1. Section 231—Moving expenses

(a) The separate $1,000 limit provided in Section 217(b)(3) on deductible expenses described in section 217(b)(1)(C) and (D) should be increased to $1,500 and not charged against allowances granted by Section 217(b)(1)(E).

(b) The period of time provided in Section 217(b)(1)(D) should be 60 days instead of 30 days.

(c) Section 217(c)(1)(A) and (B) should be modified to substitute "20 miles based on road miles" instead of "50 miles".

(d) Reimbursement of expenses deductible under Section 217 should be excluded from gross income subject to withholding.

2. Section 521—Depreciation of real estate

An exception should be provided for owner-used-and-occupied industrial and commercial buildings.

3. Section 221—Interest

Should be deleted or modified.

4. Section 331—Deferred compensation

Should be deleted or modified.

5. Section 515—Capital gains and losses, total distribution from qualified pension, etc., plans

Income not subject to the limitation in Section 402(a)(5) should include a minimum additional amount not to exceed $10,000 subject to capital gains treatment.

6. Section 704—Amortization of pollution control facilities

Provisions for certification should be relaxed or modified.

7. Section 201—Charitable contributions

A single effective date should be adopted for this Section and Section 83(b)(1) should be modified to make it clear that an organization making qualifying dis-

tributions under Section 170(e)(3)(B) is an organization to which Section 170(e)(1) does not apply, with the result that only the ordinary income portion of a gain shall be recognized.

We respectfully request your careful consideration of the attached summaries explaining the position of this Committee with respect to these recommendations.

Sincerely,

WALDO B. LYDEN,
Chairman, Tax Committee.

SECTION 231 OF H.R. 13270—COMMENTS

MOVING EXPENSES (SEC. 231 OF BILL AND SEC. 217 OF IRC)

In today's rapidly changing economic situation, it is essential to move employees from one location to another to follow customers or be responsive to the needs for in-customer-plant manufacturing lines which avoid the problem of shipping empty cans from the place of manufacture to the place of packing. Reimbursements to employees for the extraordinary expenses occasioned by moves do not constitute economic income to employees, as in our industry most of these employer-requested moves are lateral with no increase in either position or salary. To tax as income, allowances granted employees to cover out-of-pocket expenses in conjunction with a move is, for practical purposes, confiscation of capital and is not payment of personal living costs.

Accordingly, the adoption of Section 231 is urged with the following four changes:

1. It is virtually impossible to locate a residence, have the title searched, and arrange for a mortgage within a period of 30 consecutive days. Consequently, the minimum time which should be allowed under the proposed Internal Revenue Code Section 217(b)(1)(D) should be 60 days instead of 30 days.
2. The limitations provided in proposed Section 217(b)(3)(A) are unreasonably small in view of 6% to 10% commissions on sales of real estate, mortgage and financing fees, and legal costs in conjunction with sale and acquisition of homes. It is recommended that the dollar limit on deductible expenses described in Sub-Para. (C) or (D) of Sec. 217(b)(1) be fixed at $1,500 instead of $1,000 and that the deductible amount under Sub Section 217(a), attributable to a qualified residence sale, purchase or lease expense should be limited to $2,500 without reduction for allowance under Sub-Para. (C) or (D) of Para. 217(b)(1).
3. In order to avoid material hardship particularly in metropolitan moves, Section 217(c)(1)(A) should provide a 20-mile minimum rather than the proposed 50-mile minimum, and be based on road miles.
4. Under proposed Code Section 82 as provided in Section 231(b) of the Bill, withholding of income tax would be required even for reimbursement of transportation. A sentence should be added to proposed Section 82—"No withholding of income tax at source is required on reimbursements of moving expenses deductible under Section 217 of this chapter."

SECTION 521 OF H.R. 13270—COMMENTS

REAL ESTATE DEPRECIATION (SEC. 521 OF BILL AND SECS. 167 AND 1250 OF IRC)

The intent of Section 521 of the Bill is to correct the situation where losses generated in the earlier years on real property investments are used to shelter other high tax income. The only exemption provided in the Bill is for residential housing. We respectfully request that exclusions also be allowed for owner-occupied industrial and commercial buildings.

We agree with the provision for recapture of accelerated depreciation in excess of straight line as ordinary income in the event such industrial or commercial buildings are sold at a gain.

SECTION 221 OF H.R. 13270—COMMENTS

LIMITATION ON DEDUCTIONS OF INTEREST (SEC. 221 OF BILL AND SECS. 163 AND 1202 OF IRC)

The enactment of Section 221 of the Bill would seriously restrict the source of capital for corporations to construct warehouses. Corporations presently are able to make financial arrangements for the construction of warehouses pri-

marily due to the present treatment of building depreciation and allowance of interest expense as a full deduction.

If the above Bill were enacted, investors would not be attracted toward financing warehouse and plant construction. We therefore request favorable consideration be given to the Administration's request for the complete elimination of this Section of the Bill.

SECTION 331 OF H.R. 13270—COMMENTS

DEFERRED COMPENSATION (SEC. 331 OF BILL AND SEC. 1354 OF IRC)

The Tax Committee of the Can Manufacturers Institute, Inc., respectfully recommends that Section 331 Deferred Compensation be deleted from the proposed Tax Reform Act of 1969, H.R. 13270. Our reasons for this recommendation are as follows:

1. The Can Manufacturers Institute's membership consists of 49 can companies representing over 90% of the industry's sales. Many of the members are small companies whose need for management and professional employees is always of the utmost importance. Unfunded and unqualified deferred compensation arrangements are important incentives in hiring and retaining these key personnel. This Section in the proposed Bill would largely nullify these incentives.
2. This provision would add greatly to the already complex tax computations of retirement and deferred income and will greatly increase the record keeping and retention of the companies, employees and Government.
3. The use of tax rates of prior years for a tax on the current year's income is not only complex, but is inequitable in that the principle of a graduated tax on current taxable income is violated. Tax rates are representative of the current economic conditions and are measured by the amount of the individual's income actually received in the current taxable year.
4. The effect of this provision would be to increase the tax at retirement. This is inconsistent with other Governmental programs for the retired and aged of our country.

SECTION 515 OF H.R. 13270—COMMENTS

CAPITAL GAINS AND LOSSES, TOTAL DISTRIBUTIONS FROM QUALIFIED PENSION, ETC., PLANS (SEC. 515 OF BILL AND SEC. 402 OF IRC)

Section 515 of the Bill would amend Section 402(a) and 403(a)(2) of the Code to limit capital gains treatment on lump-sum distributions from qualified employee trusts to the sum of all benefits accrued by the employee in plan years beginning before January 1, 1970 and the portion of benefits accrued in subsequent plan years which are not allocable to employer contributions.

Generally lump-sum distributions from qualified pension plan trusts are the exception rather than the rule. However, lump-sum distributions from profit-sharing plan trusts, frequently in the form of employer securities, are becoming increasingly more common. This is particularly true with respect to employee stock purchase plans. Employee stock purchase plans generally require a lump-sum distribution when an employee retires. Under present law any income recognized in the year of distribution is entitled to capital gains treatment.

The intent of the Bill is to provide highly compensated employees with a more realistic effective tax rate. It is inconsistent with these objectives to restrictively tax relatvely small distributions in this manner. Dstributions of $10,000 or less should escape this treatment with the addition of the following language to Section 402(a)(5) as proposed: "(C) or $10,000".

SECTION 704 OF H.R. 13270—COMMENTS

AMORTIZATION OF POLLUTION CONTROL FACILITIES (SEC. 704 OF BILL AND SEC. 168 OF IRC)

The Tax Committee of Can Manufacturers Institute, Inc. is gratified with the recognition of the importance of pollution control facilities and commends Congress on trying to relieve the tax burden on affected industries.

We strongly recommend, however, that the definition of the facilities be broadened to include anything that deals with pollution control and that the mandatory certification by federal and state agencies be eliminated.

If certification elimination is not deemed feasible then this Committee of Can Manufacturers Institute, Inc. feels that at least the need for dual certification should be dropped.

SECTION 201 OF H.R. 13270—COMMENTS

CHARITABLE CONTRIBUTIONS (SEC. 201 OF BILL AND SECS. 170 AND 83 OF IRC)

1. As drafted, Section 201 includes effective dates of December 31, 1969; May 26, 1969; April 22, 1969; and the "date of enactment." In order to facilitate compliance, we recommend that a uniform effective date of taxable years beginning after December 31, 1969, be applied to the entirety of the Section.

2. With respect to new IRC Section 83 provided in Bill Section 201(c) some confusion has arisen as to whether the "Limitation" in IRC Section 83(b) would apply to a contribution to a private foundation making a qualifying distribution under Section 170(e)(3)(B) IRC. The confusion arises because the proposed language of Section 83(b) IRC does not make it clear that a private foundation making a qualifying distribution under Section 170(e)(3)(B) is an organization to which Section 170(e)(1) IRC does not apply. We believe the intention is to include a contribution to a private foundation making such a qualifying distribution and to tax only the ordinary income portion of any gain resulting from the contribution. We recommend that the language of Section 83(b) be clarified to provide for this treatment.

AMERICAN PAPER INSTITUTE,
New York, N.Y., September 30, 1969.

Hon. RUSSELL B. LONG,
Chairman, Committee on Finance, U.S. Senate, Washington, D.C.

DEAR SENATOR LONG: We would like to express our views concerning specific sections of the tax reform bill, H.R. 13270, from the point of view of tax equity, economic effects, and the complexity of proposed tax law changes.

Our comments follow the order in which these sections appear in the bill, separated into the broad categories of changes affecting individuals and those affecting corporations.

CHANGES PRIMARILY AFFECTING INDIVIDUALS

EMPLOYEE MOVING EXPENSES (SEC. 231)

Personal mobility is basic to an efficient, productive economy and should be supported by Federal legislation designed to reduce individual hardships and financial burdens. While approving in substance the broadening of the moving expense deduction proposed in this bill, we suggest the following changes:

1. Based on the experience of many companies in our industry, we recommend that the aggregate maximum allowable deduction should be not less than $5,000 for other than "bare-boned" moving expenses (i.e. expenses for pre-move house-hunting trips, temporary living expenses at the new job location, cost of selling and buying homes or lease cancellation expenses) without any regard to any limitation for any individual category. Two member companies, for example, with approximately 650 relocations report that the average moving expenses subject to the proposed $2,500 limitation was $6,000 and $6,700 respectively. These two companies also report average total moving expense reimbursements (including "bare-boned" expenses) of $10,100 and $9,000 respectively.

2. The proposed 50 mile test discriminates against urban area moves. This section should retain the 20 mile limitation, but it should be based on road miles rather than straight-line measurements. Further, there should be no mileage limitation in situations where employees move solely at the employer's convenience.

3. Under the proposed new provisions, a taxpayer must include all reimbursements for moving expenses in gross income, and then is allowed to deduct expenses to the extent permitted under the moving expense deduction limitation. The initial inclusion of expenses in gross income results in correspondingly higher tax withholding for which the individual cannot claim a refund until the following tax year. This proposal is burdensome, unnecessary and confusing. Moreover, this provision would result in inequitable tax treatment for some taxpayers, especially where there are gross income taxes involved.

4. The effective date should be modified to allow deductions for reimbursed expense items retroactive to January 1, 1969, in view of the fact that even under the liberalized rules employees are paying tax on non-existent income.

DEFERRED COMPENSATION (SEC. 331)

We believe that the restrictions on deferred compensation are unsound and impractical, that they would create serious administrative problems, and that they are not in keeping with the stated objectives of "tax reform" for the following reasons:

1. There is a shortage of qualified top level professional and managerial talent available to the nation's business community, and deferred compensation arrangements play a significant role in the incentive systems required to attract, retain and develop key personnel to their maximum productive capacity.

2. Deferral of income should not be discouraged, particularly in an era when inflation is a real problem. From the individual's standpoint, it is certainly sound planning to defer some income to the retirement period, when it is needed to maintain a standard of living reasonably commensurate with the standard achieved during active business life.

3. In effect, the proposed tax treatment would actually tax a person relatively more severely the older he becomes. This is inconsistent with other programs for the retired and aging which are designed to help maintain a reasonable standard of living.

4. The reasoning and philosophy of Revenue Ruling 60-31 is appropriate and should be continued. Basically the principles are that unfunded (and "unqualified") and unsecured contracts (plans) do not create any constructive receipt of income and thus there is nothing to tax.

5. Income should be taxed at rates in effect when received. These rates are representative of economic and political conditions at that time, and are commensurate with the amount of income actually received.

6. Raising government revenues cannot reasonably be cited as an objective of the proposal since it would not reach even $5 million until 1972. Through projections which may be highly problematical the price tag by 1979 has been set at a maximum of $25 million, surely not worth the probable adverse effects.

7. The techniques proposed, of computing tax in the year received according to the individual's tax status many years before, would create a monumental record keeping, record retention, computation and recomputation problem for companies, affected employees, and government tax auditors.

Changes Primarily Affecting Corporations

STOCK DIVIDENDS (SEC. 421)

While this section of the Bill has no immediate effect on our industry, we feel that the proposed amendment has certain technical deficiencies that should be eliminated. Specifically, under the Bill, common stockholders would be taxed on the receipt of stock dividends even in situations where their proportionate interests remain the same. This situation occurs when a corporation has convertible preferred stock (not protected for dilution) as well as common stock outstanding, and a stock dividend is declared payable to all common stockholders. Unless the Bill is revised to take into account the distinction investors draw between common stock and the less speculative preferred stock, the passage of Section 421 will obviously reduce the use of convertible preferred stock as a financing device. Accordingly, this would result in an increase in the cost of raising investment capital from its already all time record high.

EARNINGS AND PROFITS ADJUSTMENT FOR DEPRECIATION (SEC. 452)

Although designed to eliminate issuance of nontaxable distributions, this provision could result in unwarranted double taxation of United States corporate shareholders entitled to a foreign tax credit under Internal Revenue Code Sections 902, 960 or 1248.

For the purpose of computing its earnings and profits, a corporation is to deduct depreciation on the straight-line method. This would have the effect of increasing the taxable income of any foreign corporation which uses accelerated depreciation deductions. Coupled with a situation in which the foreign tax rate is below the United States level, the resulting tax liability to United States shareholders could, in effect, represent an amount exceeding the effective United

States corporate tax rate. In addition to potential loss of foreign tax credits, this provision would unduly complicate accounting and record keeping activities of foreign subsidiaries.

We therefore recommend further clarification of the language in Section 452. It should be made clear that this provision does *not* apply to computations of foreign tax credits, but is applicable only to computations designed to determine the taxability of dividends.

DEPRECIATION OF REAL ESTATE (SEC. 521)

While we realize that this section was intended to eliminate abuses, we feel that the proposed changes place an undue restriction on the appropriate use of accelerated depreciation by American industry. This has become even more vital in view of the threatened repeal of the 7% investment credit. We recommend that the proposed restrictions on the use of accelerated depreciation not be extended to owner-occupied-and-used. industrial and commercial buildings. Accelerated depreciation should be permitted for industrial plants, as well as for special purpose structures and machinery and equipment, all of which are essential components in the modernization of this nation's productive facilities to keep pace with foreign competition.

AMORTIZATION OF POLLUTION CONTROL FACILITIES (SEC. 704)

The American Paper Institute commended the House Ways and Means Committee for some recognition of the importance of giving tax incentives to industry in order to promote the installation of pollution control facilities that will provide social benefits for all. However, we felt then and still feel that the proposed 60-month amortization election will provide neither meaningful tax incentives nor the cash flow industry requires to undertake the tremendous investments needed for pollution control equipment. The enclosed Table A demonstrates that the proposed 60-month amortization election provides less tax relief than the present tax treatment, and also indicates alternatives that may well have to be considered if this nation's pollution control objectives are to be attained in the foreseeable future.

With respect to the certification of pollution control facilities required to establish eligibility for the special amortization deduction, it is suggested that there be *one* certifying authority rather than two, and that this authority be the state, interstate or Federal agency which has established Federally approved water or air quality standards applicable to the subject facility pursuant to the Federal Water Pollution Control Act or the Federal Clean Air Act; that the performance standard which the pollution control facility must meet in order to qualify for the amortization deduction shall be conformance with applicable water or air quality standards; and that the proposed grant of authority to the Secretaries of Interior and of Health, Education and Welfare (Section 168(e)) to "promulgate minimum performance standards" for the purposed of Subsection (d) be deleted from the bill (H.R. 13270).

GENERAL COMMENTS

The American Paper Institute continues to oppose repeal of the investment credit for all of the reasons cited in my statement of May 22, 1969 before the House Ways and Means Committee and my testimony of July 14, 1969 before the Senate Finance Committee.

However, in view of the September 17, 1969 vote for your Committee to approve repeal, we strongly urge consideration of broader and more liberal transition rules along the lines discussed in my testimony before your Committee on July 14, 1969 (copy enclosed).

With particular reference to this Committee's decision concerning the investment credit, the American Paper Institute strongly recommends implementation of other tax reforms such as revision of depreciation rules (including elimination of the outmoded reserve ratio test) to encourage plant modernization. We feel the present proposals are heavily biased against corporations and capital investors, and if implemented without suggested modifications would result in further disruption of the investment-consumption economic relationship and a serious deterioration of this country's foreign trade position.

Further, in order to reduce inequities resulting from confusion and uncertainty we recommend that with the exception of Section 231 (Employee Moving

Expenses) all provisions of this proposed legislation be effective on or after January 1, 1970.

Finally, we strongly support efforts designed to clarify and simplify the Internal Revenue Code, such as those represented by the American Institute of Certified Public Accountants "Recommendations for Amendments to the Internal Revenue Code", submitted to Wilbur D. Mills, Chairman, House Ways and Means Committee, in July 1969.

Respectfully submitted.

EDWIN A. LOCKE, Jr., *President.*

TABLE A.—COMPARISON OF ALTERNATIVE FINANCIAL INCENTIVES FOR INDUSTRY TO CONSTRUCT WATER POLLUTION CONTROL FACILITIES USING A $100 OUTLAY FOR FACILITIES AS AN EXAMPLE

			Other alternatives			
	Present tax treatment [1]	1969 reform bill	Minimum Federal grant, 50 percent and present tax treatment	1-year writeoff and 14-percent investment credit	1-year writeoff and 7-percent investment credit	Present writeoff and 14-percent investment [1] credit
	(1)		(2)	(3)	(4)	(5)
1. Industry share of $100 outlay for facilities	$100.00	$100.00	$50.00	$100.00	$100.00	$100.00
Tax benefits: 48 percent (present top rate on corporations)	48.00	48.00	24.00	48.00	48.00	48.00
7-percent investment credit [2]	7.00		3.50	7.00	7.00	7.00
Additional 7-percent investment credit				7.00		7.00
2. Total tax benefits	55.00	48.00	27.50	62.00	55.00	62.00
3. Net cost to industry, before considering time value of money	45.00	52.00	22.50	38.00	45.00	38.00
4. Net cost to industry, after considering time value of money	54.90	57.06	27.50	40.40	47.10	48.20
5. Benefit to industry of each alternative compared to present tax treatment		(2.16)	27.40	14.50	7.80	6.70

[1] Depreciation writeoff over the Treasury Department's approved guideline life of 16 years using the sum-of-the-year-digits method, one of the accelerated methods permitted for Federal income tax purposes.

[2] Investment tax credit has been applied to the total industry share of the $100 outlay although under present law the investment credit is not allowed on land and buildings. It is hoped that any incentive legislation would extend the credit to the total industry share of such outlays.

JULY 11, 1969.

MEMORANDUM PRESENTED BY EDWIN A. LOCKE, JR., PRESIDENT OF THE AMERICAN PAPER INSTITUTE TO THE SENATE FINANCE COMMITTEE ON JULY 14, 1969

RECOMMENDATIONS CONCERNING INVESTMENT CREDIT TRANSITION RULES CONTAINED IN H.R. 12290

The American Paper Institute strongly supports retention of the investment tax credit as a basic part of our tax law. However, if, contrary to our recommendation, there is repeal or suspension of the investment tax credit, industry will be faced with serious inequities unless very careful attention is given to the transition rules in H.R. 12290. Our review indicates that the transition provisions in H.R. 12290 do not provide for equity in all situations.

To correct these deficiencies we recommend the following:

1. The "phase-out" provision should be eliminated entirely, or at the very least modified by advancing the phase-out date from December 31, 1970 to December 31, 1971.

If the "phase-out" provision is eliminated, it would enable companies to claim full credit for all property qualifying under the binding contract or other transition rules, regardless of when such property is placed in service.

If the "phase-out" provision is modified by advancing the phase-out date from December 31, 1970 to December 31, 1971, it should be coupled with an advance of the termination date to December 31, 1975, or December 31, 1976, thus allowing all property placed in service before this later cut-off date to qualify for at least a partial credit.

2. In addition to the "binding contract" provision, there should be further tests which would qualify projects for the credit. Experience in our industry shows that major engineering and feasibility studies are completed well in advance of formal commitments. Under such circumstances a taxpayer should be able to show through "facts and circumstances" a "substantial commitment" prior to the effective date of repeal. Among the facts which could be used:

(*a*) Substantial sums have been expended for engineering and/or feasibility studies,

(*b*) Loan agreements have been negotiated,

(*c*) Official authorization by the Board of Directors has been granted,

(*d*) Construction started and project completed within a reasonable time.

Attached is an outline, developed with assistance from engineering and financial people in the industry, of the various steps taken in connection with a major capital project and the stages at which commitments develop. We believe it will be helpful in visualizing the problems and inequities involved for our industry under the transition provisions in H.R. 12290.

3. With respect to the equipped building rule, the plant facility rule, and the machinery and equipment rule, it is suggested that 25% rather than 50% of the "aggregate adjusted basis of all property . . ." be considered sufficient to qualify for the credit. Certainly 25% of total cost represents a substantial commitment, especially when the commitment was made under the assumption that this project would qualify in full for the credit, without restrictions such as the "phase-out" or new "carry-over" limitations.

4. With respect to the amortization of pollution control facilities, it is suggested that taxpayers be permitted to elect a one to five year write-off instead of the proposed five year amortization period, to encourage companies to increase their pollution control expenditures and thus advance the date of their compliance with Federal pollution control standards.

Moreover, in the interests of both equity considerations and simplification of procedural rules, the "primary purpose" of investment in any facility should determine its eligibility for amortization deduction. If the primary purpose for constructing a facility is pollution control, the entire investment should qualify for rapid write-off regardless of any costs recovered through by-products derived from operation of the facility.

5. With respect to the certification of pollution control facilities required to establish eligibility for the sixty-month amortization deduction, it is suggested that there be *one* certifying authority rather than *two*, and that this authority be the state, interstate or Federal agency which has established Federally approved water or air quality standards applicable to the subject facility pursuant to the Federal Water Pollution Control Act or the Federal Clean Air Act; that the performance standard which the pollution control facility must meet in order to qualify for the amortization deduction shall be conformance with applicable water or air quality standards; and that the proposed grant of authority to the Secretaries of Interior and of Health, Education, and Welfare (Section 168(e)) to "promulgate minimum performance standards" for the purposes of Subsection (d) be deleted from the bill (H.R. 12290).

The proposed system of dual certification, based in most cases on two different sets of performance standards—(1) those set by state or interstate agencies and approved by the appropriate Federal department under the applicable Federal Water Quality or Federal Clean Air Acts, and (2) those set by the appropriate Secretary (Interior or HEW) under the provisions of this bill (H.R. 12290)—will, if adopted, delay and add confusion and cost to the anti-pollution effort of industry and of the Federal and State Governments because the two sets of standards will either be the same and therefore redundant or different and therefore clearly in conflict. We recommend that this bill (H.R. 12290) require but one certification, issued by the state, interstate or Federal agency that established the water or air quality standards that apply to the facility involved in the application, and that performance standard required of the pollution control facility be that it meets the water or air quality standards which apply to the facility.

6. The special limitation on the amount of unused credits which may be used as carryovers to the taxable year should be eliminated or modified, because the incidence of this provision falls most heavily on companies with a fluctuating profit pattern and high carryovers. These firms may lose much or at least a portion of the tax credit for which they have qualified under all other provisions.

7. The effective date of this bill should be advanced to the date when Congress enacts such legislation. Any earlier date would be inequitable in view of the many uncertainties surrounding provisions of this bill and their interpretation.

Steps in a Typical Major Capital Project in the Paper Industry

1. Feasibility studies

The first steps taken in any major capital project involve a number of feasibility studies. The first step in determining the feasibility of the program is a study of the need and the value of the program from the point of view of marketing. These studies include analysis of the competitive position of the company as to mill location, source of supply of raw materials, and similar considerations. A second step will involve engineering studies made to determine construction costs and mill profitability. These steps are conducted in some cases internally and in others by outside contractors and consultants. In the latter connection, it is likely that contract commitments will be undertaken at this stage for the performance of these services.

During the period before announcement, up to twelve months before announcement, substantial efforts must be made to make sales commitments for the products to be manufactured to justify the project. As a result of these efforts, long term contract commitments may be made with prospective customers. Up to 60 to 70% of the production may be committed in order to provide a firm economic base for the project. These contracts call for delivery of the product upon specific dates regardless of whether the project goes forward or is completed.

Prior to announcement, a whole range or other commitments may have been made depending upon the particular case involved. For example, options may have been entered into in connection with the acquisition of the plant site or land purchase agreements may have been executed. Also, a number of arrangements some involving commitments, will have been made with members of the local community chosen for the site. Licenses and zoning changes may be initiated.

2. Board authorization and public announcement

Assuming the feasibility studies of the project are favorable, budgets will be developed and specific proposals will be submitted to and adopted by the Board of Directors. These proposals are in substantial detail, including long-range forecasts of sales and earnings and substantial supporting operating data listing the specific types of equipment and estimated costs. Naturally, the financial data included in the proposals are based on the allowance of investment credit, either as a direct reduction of the project cost, or in the project cash flow needed for financing the project.

Important practical commitments may flow from the public announcement of such a program. From the point of view of competition, once the announcement is made the intent of the company is known as to the type of product, the capacity and the mill location. At this point, more efforts will be made to commit that portion of the facility's production which has not yet been contracted for.

3. Financing

During the initial stages, one of the considerations will be the financing of the project. If outside financing is required, commitments will be made and loan agreements negotiated. It is possible in many cases that the loan agreement will be closed prior to the start of physical construction. Financing arrangements are based on the cash flow generated by the project. To the extent that the capital expenditures are internally financed, they also rely heavily on the cash flow generated by the project. Cash flow projections include the benefits which result from the investment credit as well as accelerated depreciation. If these benefits are removed and it is necessary to proceed with the program in any event, outside financing may then be necessary to make up the difference. If the need for outside financing as a result of the loss of these benefits becomes evident after the program is approved, larger costs may be involved, and the program penalized. For obvious competitive reasons, this penalty cannot be compensated for by an adjustment in prices.

4. Construction of projects

Construction may progress in many different forms. Depending on company practice and the type of project, work may be done completely on the basis of one contract, it may be done under multiple contracts executed at different times as they are needed, or work may be done internally.

Within three months following the announcement of the project, steps are normally taken to place equipment orders. In some cases, construction contracts are entered into and work begins on the preparation of the plant site.

A. *Machinery and equipment.*—Immediately after orders are placed with large equipment manufacturers, they will enter into agreements with their suppliers and sub-contractors. Normally these will be based on contracts and other business arrangements with the suppliers. These will result in the accumulation of substantial commitments prior to the actual manufacture of the machine itself. Upon placement of the order, the manufacturing cycle begins and expenses in connection with engineering, purchasing and manufacturing will be incurred by the equipment manufacture. Depending upon the size of the equipment involved, the manufacturing cycle will be from 5 to 18 months. Because heavy equipment makes up the largest part of our capital expenditures, the longer cycle is more typical.

In general, installed equipment represents approximately 76% of total mill costs. (The remaining portion is made up of buildings, overhead, etc.) Approximately 43% of total mill costs represent the cost of equipment before installation. The remaining 33% represents installation costs of which labor is the major component. While most of the basic long-lead-time equipment of the mill will be on order at the very initial stages of a project, the installation costs, constituting about one-third of total costs, will be expended over the entire period of construction. The heaviest expenditures in this category occur in the first 6 months of the second year of the project. In many cases, expenditures relating to the installation costs will not be committed until the expenditures are made. It is with regard to these expenditures that informal and oral orders and other communications, which are of doubtful binding effect, number in the hundreds on major projects.

B. *Plant construction.*—Coincidental with the manufacture of the equipment by the machine supplier, construction of buildings and equipment foundations is proceeding. Where construction on a whole mill is involved, this work may involve substantial long term contract commitments under which burdensome penalties would be incurred if the project were delayed.

As already indicated, multiple contracts may be used, and these are negotiated and concluded from time to time during the long construction period. Finally, the construction may be handled internally without any contract, the work being done and properties acquired as they are needed.

C. *Installation.*—The first deliveries of major machinery and equipment will begin approximately 12 to 15 months following the approval of the project. Delivery will normally be over a period of about 6 months. Completion of the project normally occurs 2 years from the date of approval. The suppliers may install the equipment. It may be installed by others under separate contract or it may be installed internally.

Statement of Dr. Martin A. Larson, Board of Policy Member, Liberty Lobby, Washington, D.C.

SUMMARY

I. H.R. 13270
- **1. Its apparent objective.**
- **2. What it accomplishes.**
- **3. How it fails:**
  - **(a) Foundations**
  - **(b) Real estate industry**
  - **(c) Cooperatives**
  - **(d) Depletion allowances**
  - **(e) Churches**

II. LIBERTY LOBBY TAX EQUITY PROGRAM
- **1. General provisions:**
  - **(a) Taxation of all personal and business income under invariable schedules.**
  - **(b) Termination of all deductions, allowances, etc.**
  - **(c) Establishment of:**
    - **(1) Exemptions of $8,000 for single persons, up to $15,000 for family.**
    - **(2) Rates of 20% on any portion of taxable income below $15,000; 25% between $15,000 and $50,000; 50% exceeding that level.**
  - **(d) Simplification of the Code.**

2. How it can be achieved:
   (a) Federal Reserve
   (b) Churches and related organizations
   (c) Foundations
   (d) Pension, welfare, and other exempt funds
   (e) Tax exempts in competition
   (f) Depletion allowances
   (g) Gambling
   (h) Exempt securities
   (i) Taxation of capital gains
   (j) Trust funds
   (k) Miscellaneous tax avoidance.

III. CONCLUSION

This statement is submitted representing the views of LIBERTY LOBBY's 20,000 member Board of Policy and on behalf of the 240,000 subscribers to our monthly legislative report, *Liberty Letter*. Our Board of Policy has voted overwhelmingly in favor of tax equity.

LIBERTY LOBBY supports H.R. 13270 as an important step in the right direction, but urges careful consideration of the tax equity program outlined in this statement.

I. H.R. 13270

1. ITS APPARENT OBJECTIVE

After studying the Treasury and Administration proposals for tax reform as well as the 15 volumes of testimony presented by some 600 witnesses before the House Ways and Means Committee, and H.R. 13270, I am forced to conclude that this mighty labor has as its principal objective the hope of staving off an imminent revolt by middle-income taxpayers. These are the people who obey the laws, pay their bills, and maintain their families. They are also the people who have been paying 85% of the personal federal income tax, and directly or indirectly, about 95% of all other taxes.

These victims of tax inequity are now in open or suppressed revolt; for they have begun to understand what a fraud the high rate schedules of the Internal Revenue Code are. They know now that it is regressive—that those with million-dollar incomes pay only about 20%, instead of 77 or 91%. They have begun to realize that many billions of dollars of income are excludable not only from adjusted gross but also from gross income, and that the taxable income is usually only a small percentage of the actual.

They have also learned that there are multitudes of corporations and exempt organizations which receive untold billions of business revenues on which little or no income tax is paid.

The middle class, therefore, is clamoring ominously in a mounting and persistent drive for tax equity. In this, LIBERTY LOBBY has been a highly articulate spokesman.

2. WHAT IT ACCOMPLISHES

The Tax Reform Bill of 1969 is an important step in the right direction; it proves conclusively that simply by curbing a small fraction of government financial profligacy and by closing perhaps 15% of the loopholes a $22 billion reduction is possible for middle and low-income taxpayers. Termination of the surtax means a lessening of their burdens by some $10 billion; something like $9.25 billion of relief is being granted to middle and low incomes; and by phasing out the auto and telephone excises another $3 billion will be lifted from their backs.

When the new rate schedules are implemented in 1971, the income of a single person will be exempt up to $1,700; and that of a four member family up to $3,500. The standard deduction will be increased to 15% or $2,000. Taxes on single persons earning $3,000 will be reduced by 45%; at $10,000, the reduction will be 13.5%; at $15,000, the levy will drop from $3,154 to $2,806, or 11%. For families of four, taxes on earning of $4,000 will be reduced by 53.6%; at $10,000, the tax will drop from $1,114 to $958, or 14%; at $15,000, the reduction will be 10.5%; and at $25,000, 5.5%.

This is at least a significant beginning.

3. HOW IT FAILS

However, the bill falls far short of what it should and could do. While the cry has been for simplification, John Knight of the Detroit *Free Press* noted

in his syndicated column that these tax revisions are so complicated that they "will maintain lawyers and tax accountants in luxury for years to come." And Walter Trohan of the Chicago *Tribune* remarked caustically that this bill is a patchwork of new loopholes.

Even worse is the fact that almost every revision reflects a compromise with entrenched and powerful pressure groups who have no intention of surrendering their vast preferences and immunities. The people of this country have been promised and they expect basic tax reform. But this bill simply nibbles at the edges of the problem that is gnawing at our vitals.

Under the complex system of laws enshrined in our Internal Revenue Code, American wealth has gradually been amassed by exempt or partially exempt and very wealthy individuals and corporations. Unless these privileged persons and organizations learn from the lessons of history and act wisely, they will suffer the fate of the Bourbons, who never forgot anything or learned anything. By gaining a stranglehold upon the resources of this Nation, they are creating an explosive situation which, unless remedied, must one day eventuate in violent expropriation. This has happened so often in the past that it is simply the historical norm. Our Internal Revenue Code and Social Security system have become the instruments to accomplish the virtual pauperization of our productive classes. If we wish to preserve the republic we now enjoy, it is necessary that we permit the creation and expansion of a very large and solidly based middle class, all the members of which have a profound stake in the preservation of this society. If we reduce our skilled workers, our faithful and law-abiding citizens, our independent profesional and business people, to the status of economic pawns living on the ragged edge of poverty and insecurity, they will have nothting to lose; and in the day of crisis, they will annihilate the American way of life.

In this limited space, I can discuss only a few provisions of the 368-page Tax Reform bill which typify its shortcomings. But first let me point out that it does nothing to tax the vast revenues of private investment funds owned by exempt organizations. It does not propose any levy on the multi-billion dollar profits of private cooperatives or place any restriction on the operation of federal or quasi-federal business enterprises. It does not subject appreciation in estates to the capital gains tax. It still permits huge estates to pass untaxed unto the third or fourth generation through the creation of trusts. And it is extremely vague and esoteric in many of its complex formulations.

(*a*) *Foundations*

The bill includes some long-needed restrictions on self-dealing, political activities, and perpetual control by the donors or creators. What it fails to deal with is the danger posed by the transfer of enormous amounts of capital from tax-paying to tax-exempt corporations. It is not simply or even primarily a question of policing foundations to make sure that they continue to operate as charities or philanthropies of some kind. Actually, there can never be a full-fledged charity as long as it is controlled by private managers who have the power of determining what benefactions it will provide.

As more and more billions flow into tax-free foundations, the general tax-base must continue to shrink. Congressman Patman advocated a 20% tax on the gross business revenues of foundations; but the House Ways and Means Committee, yielding to manifold pressure, reduced this to 7.5%.

Foundations will not be created and endowed without some encouragement from taxing authorities. But the advantages and preferences which have been granted them are far greater than necessary to motivate their establishment and are out of all proportion to their social value. If foundations wish to do some good, they should begin by making a proper contribution to the maintenance of society and for the good of all.

(*b*) *Real estate industry*

It is true that the bill abolishes double depreciation on commercial investments and permits the 150% rate only for original users. But it still permits the first users of luxury apartments to take double depreciation, which enables their promoters to deduct huge operational losses from other income. No depreciation except straight-line should be permitted on any real estate.

(*c*) *Cooperatives*

Farm co-ops and similar private enterprises are required only to pay 20% of their net profits in cash and the remainder in non-negotiable allocation divi-

dends to their members. Those who receive these payments are then forced to pay the tax, which often exceeds the cash dividend. The co-op can thus retain its income to purchase or destroy its competitors.

The new bill attempts to deal with this inequity, but as usual, ends up with an inadequate compromise. It provides that the allocation dividends are to be redeemed at par within 15 years. In the meantime, the co-op pays no taxes and has the use of the funds thus withheld.

The farm co-ops have now branched out into every conceivable business, including huge oil refineries, automobile agencies, furniture, hardware, restaurants, etc. They did a business of almost $21 billion in 1966, of which less than 15% was in farm supplies.

If such enterprises cannot survive except by tax avoidance, they have no moral right to exist. Farm cooperatives should pay taxes at this time of not less than $2 billion a year, and their shareholders or members should be taxed only on the cash dividends they receive and at regular rates.

Among quasi-federal corporations, we have the REA, first authorized as a temporary agency in 1935. For its electric and telephone operations, it had borrowed $7,882,000,000 by 1966 at 2% from the federal government. Very little of this has ever been repaid; and about 75% of the revenue received by the REA co-ops is drawn from urban communities, where private companies have long been ready and anxious to supply power. It is conservative to estimate that the REA is now costing the American taxpayers at least $600 million a year.

(*d*) *Depletion allowances*

The Tax Reform Bill reduces depletion allowances on some 100 minerals by about 30%, and those on gas and oil from 27.5 to 20%; it proposes that carved-out production payments be treated as loans; and, as I understand it, foreign operations are to be reported separately from the domestic. These reforms may increase Treasury revenue by well over $1 billion. Since the federal tax paid by the 22 largest oil companies from 1962 through 1966 was about 6% on a net income of about $24 billion, it is possible that the oil industry in the future may pay something like 15 or 20%.

This, however, is not enough. There is no reason why the extractive industries should enjoy huge depletion allowances for something they have not even purchased while a 7% manufacturers tax is placed on automobiles and while all of us must pay an excise tax of 11 or 12 cents on every gallon of gas flowing from the pump.

(*e*) *Churches*

In 1968, CBS made a documentary TV program called *The Business of Religion*, in which I was privileged to participate. CBS polled members of Congress, many clergymen, and representatives of the laity; the overwhelming response from everyone was that churches should at least make full disclosure of all commercial activities and should pay taxes on all unrelated business income. Not a single substantive voice was raised in public in defense of the peculiar and extraordinary preferences and immunities of the churches.

There was probably no single element in the Internal Revenue Code concerning which basic reforms were so universally and confidently expected. Churches and sacerdotal orders have been permitted to engage in every conceivable kind of business, including girdle factories, distilleries, TV and radio stations, book publishing, newspaper enterprises, and even illegal traffic in liquor and gambling. In the book *The Churches: Their Riches, Revenues, and Immunities*, you will find literally hundreds of church businesses described and identified.

It is indeed true that the Tax Reform Bill has removed from Sec. 511(a)(2)(A) the right of churches and conventions and associations of churches to operate untaxed and unreported competitive business; however, while closing one loophole, the revision has created several new ones. Churches are granted a five year moratorium for divestiture and may continue to operate existing businesses tax exempt until 1976. Furthermore, churches are to be given 15 years of untaxed and unreported income from purchase-and-leaseback operations, which will be long enough to see most of us into our graves.

No audits are ever to be made of churches, and it is clearly implied that no reports will be required from them even if they engage in prohibited activities after the moratorium expires. Although many other 501(c) organizations, such as fraternal organizations, social clubs, and many other kinds of membership groups will be taxed even on passive investment income, churches are specifically exempted from this requirement. Finally, only that portion of any real estate or

other income-producing property owned by a church and still financed by borrowed money will be subject to taxation. Since the net income from real estate is very small while heavy interest payments are being made, the tax during the first years of ownership will be negligible; and, when the mortgage is liquidated and the net income large, there will be no tax at all.

It is very significant that no one in IRS below the rank of District Director will even be permitted to question a church because of any violation; and we know from long observation that the Service has shown little interest in or concern over the unlawful activities of church-related organizations. At the same time, it will harass a wage-earner over a disputed $25 deduction; and will, with persistent ferocity, pursue an honest businessman even into a pauper's grave when he is ensnared in one of the traps which are planted throughout the Code.

As it refers to churches, it is obvious that this Bill offers far less in the way of reforms than the people rightly expected. We hope that the Senate will at least reduce the moratorium to one year, require all churches to report fully all unrelated business activity to their memberships and to the government, and give any IRS agent the power to audit church reports. Churches should also be taxed on investment income, like clubs, fraternities, and other membership organizations.

II. Liberty Lobby Tax Equity Program

1. GENERAL PROVISIONS

Liberty Lobby's tax equity program calls for the following:

(a) Taxation of all personal and business income under invariable schedules.

(b) Termination of all deductions, allowances, exclusions, etc., except business expenses and normal property depreciation.

(c) Re-establishment of the original income tax philosophy, under which no portion of any person's income necessary to maintain a decent contemporary living standard should be subject to income taxation.

(d) Establishment of these personal exemptions based upon the foregoing concept (rather than upon dire poverty levels):

(1) $8,000 for single persons.

(2) $10,000 for a couple or head of household with one dependent.

(3) Up to $15,000 for a family of seven.

(4) Additional exemptions up to $1,500 or 10% of income for contributions to an irrevocable trust.

(e) Establishment of this rate schedule:

(1) 20% on any taxable portion of income below $15,000.

(2) 25% on income between $15,000 and $50,000.

(3) 50% on income exceeding that level.

(f) Simplification of the Code so that it would comprise no more than 50 pages and could be understood by a high school graduate.

This program would enable IRS to reduce its cost of operation by from 50 to 75%; it would save taxpayers many hundreds of millions of dollars in the preparation of their returns; and it would produce an additional $20 billion in revenue for the U.S. Treasury.

2. HOW IT CAN BE ACHIEVED

We are not asking for anything impossible or unrealistic; there can be no reasonable opposition to tax equity or difficulty in its establishment, except as it is opposed by entrenched and privileged interests, dedicated to their own ambitions for aggrandizement at the expense of the people.

In this analysis, we do not even take into account what every one can easily know—namely that the federal government is spending from $16 to $18 billion a year on so-called "research"; investigators who have tried to discover who is doing this, where it is being carried on, or what tangible results have accrued have run into blank walls of concealment. No one seems to have the faintest idea of where this money goes or what it is spent for.

It is also general knowledge that the Defense Department has been wasting at least $10 or $20 billion a year on projects shortly canceled or abandoned. Further, its procurement methods and policies constitute a national scandal.

In these two areas alone, therefore, the federal budget could easily be reduced by at least $20 billion without reducing the scope or efficiency of any useful federal program.

Anyone who comprehends elementary economics realizes that the surtax cannot reduce inflation—it has certainly resulted in the exact reverse. When huge sums of money are placed in the hands of bureaucrats or transferred to nonproducers; and when the government spends beyond its income, the only possible result is inflation. If the government would, on the contrary, spend less than its income; pay off a portion of the national debt; leave more money with those who have earned it and who also produce goods or services for the market place, inflation would cease, interest rates would fall, prices stabilize, funds would become available for residential and commercial construction, and our economy could proceed on an even keel. The fierce desire of politicians and bureaucrats to suck the blood of the people so that they can live like royalty and hand out largesse where it will be most effective in the consolidation of their power and prestige—this, I say, is the cause of the great American woe.

Nevertheless, as we have noted, in this analysis we will take no account of the waste already mentioned; nor will we assume that federal expenditures must be reduced, except in a notorious instance. Even on this basis, we can demonstrate that the LIBERTY LOBBY program for tax equity is entirely realistic and that it would even produce more than $20 billion of additional revenue.

The following statistics and totals are based upon 1965 levels of income and taxation. In that year, the personal federal income tax produced $49,329,000,000; in 1970, the estimate from this source is $90 billion, an increase of about 80%. Although the totals for all types of taxation and tax avoidance have grown similarly, the ratios have remained substantially constant. The following totals are documented in my book *The Great Tax Fraud*, which cites sources in detail.

If single persons had enjoyed exemptions of $8,000, couples $10,000, and families up to $15,000, total revenues from the personal income tax in 1965 would have been reduced by $24 billion. This is based on the assumption that a rate schedule of 20, 25, and 50%, as advocated by LIBERTY LOBBY, had been in effect for different levels of income. By the same yardstick, the comparable reduction in 1970 would certainly have been no less because reductions resulting from cost-of-living exemptions have certainly not increased more rapidly than incomes exceeding $25,000 and $50,000. Capital gains alone increased from $14.5 billion in 1963 to more than $20 billion in 1966.

The following data is based largely upon research done in preparation for writing *The Great Tax Fraud* and *The Churches: Their Riches, Revenues, and Immunities*. Our statements concerning the Federal Reserve Bank are taken from the book of the same title by H. S. Kenan.

(*a*) *Federal Reserve*

We have a weird monster known as the Federal Reserve Bank, which is a private entity created by Congressional act in 1913, but which has actually assumed the power of issuing money. Some $40 billion of currency now in circulation has been printed by the U.S. government for this Bank and delivered to it on order. Thereupon, the government gives the Bank interest-bearing bonds in return for its own money. The Bank then uses the bonds as collateral for loans equal at least to twice the value of the securities. The Bank, therefore, draws triple interest on a vast reserve that never cost it one dime. As a final insult to the taxpayers, the Federal Reserve Bank pays no income taxes on its fantastic profits.

If the federal government were again to assume its constitutional prerogative of issuing the Nation's money or currency, this would have saved the taxpayers at least $3 billion in 1965 and $4 billion in 1969–70.

(*b*) *Churches and related organizations*

Here we see perhaps the most fantastic situation conceivable. In addition to all revenues from hospitals, from the normal income of their educational institutions, from sales and subscriptions according to newspaper and publishing enterprises, etc., their incoming cash flow in 1968–69 is about $22 billion. Of this only some $9 billion comes from voluntary contributions in the form of pledges, tithes, offerings, and personal gifts. About $6.5 billion is derived from business operations, investment income foundation grants, and tax-exempt bequests. And another $5.5 or $6 billion consists of government grants and subsidies, all of which are prohibited under the First Amendment and various Supreme Court decisions.

If the business income of churches and their grants from foundations were taxed, and if the capital appreciation of gifts and bequests were subjected to capital gains taxation; and, finally, if government subsidies to them were terminated, the Treasury would be richer by at least $7 billion a year.

(c) Foundations

If foundations were taxed on their business revenues at regular corporation rates and if contributions to them were subject to capital gains taxation on appreciation over base, Treasury revenue would be increased by about $3 billion a year.

We therefore offer the following suggestions:

(1) Funds or other property contributed to foundations should be exempt from gift or estate taxes, but should be subject to capital gains taxation on appreciation above base.

(2) No deduction against other income should be permitted for such contribution.

(3) Because of gift and estate tax remission, foundations should be carefully supervised to make sure that allocations are made only to truly public charities; that no self-dealing takes place; that donor-control is promptly terminated, especially if this is a corporation; and that all business revenue is disbursed on a current basis.

(4) Foundations should be taxed forthwith at a rate of 20% on business revenues, and this should gradually be increased to the rate levied upon other corporations.

(5) Foundations should be given the right to convert to unsupervised private corporations by the payment of an estate or gift tax equal, perhaps, to half the maximum which would otherwise have been required, after a predetermined period of years.

(d) Pension, welfare, and other exempt funds

There are now some 180,000 pension and welfare plans in operation, which have reserves of about $125 billion. In addition, hundreds of labor unions and other exempt organizations have countless billions which are invested in bonds or other commercial ventures, all of which yield revenue. They compete in the market with taxpaying money-lenders. If the revenues for all such accumulations were to pay the normal tax, the Treasury would receive about $4 billion of additional income.

(e) Tax exempts in competition

We have a tremendous and rapidly growing complex of partially or completely tax-exempt corporations, some private, some semi-public, others purely federal, all of which in combination carry on business totalling tens of billions, on which very little tax is paid. In this general category, we find huge, private utilities, like the Salt River Project of Arizona; the REA co-ops, financed with 2% federal money; a fantastic system of federal reclamation and power installations, whose irrigational functions are relatively of minor importance, and in which nearly $20 billion is invested. There is also a very large and rapidly growing system of credit unions, mutual savings banks, and denominational insurance companies—none of which pay a dime in taxes; and many mutual and shareholding insurance companies, as well as savings and loan associations, all of which are taxed at very low rates.

And we might add that although the Post Office has a virtual monopoly in the delivery of mail, we may include this government operation with the other tax-exempt businesses. This is a $7 billion boondoggle which requires a subsidy from the taxpayers of about $1.5 billion a year. Meanwhile, A.T. & T. pays taxes of all kinds that run into several billion dollars a year.

If all these operations were private enterprises paying normal taxes, Treasury revenues would be improved by about $8 billion a year.

(f) Depletion allowances

There are more than 100 minerals, all of which have enjoyed allowances ranging from 5% to 27.5%. If all of these were terminated—as they should be—the Treasury would be enriched by at least $5 billion.

(g) Gambling

Here again we have a strange American anomaly, which reminds one of Prohibition. Well meaning people outlawed alcoholic beverages in 1919; but, with a sigh of relief, the Volstead Amendment was repealed in 1933. In the meantime, a great underworld which bade fair to destroy the whole fabric of organized society was created; hoodlums ran rampant while they satisfied the thirst of millions. In the Twenties, hundreds of millions were spent for the purpose of extirpating this burgeoning underworld—but all to no avail.

Today, the federal government alone collects about $4.5 billion in excise taxes on the sale of such beverages.

Unfortunately, people will drink and they will gamble, regardless of the law: this is most regrettable, but neither religion nor education can extirpate or even reduce the desire and compulsion to do both. At the present time, we have an underworld doing an illicit gambling business of about $100 billion, the profits from which are used in part to corrupt law enforcement officials and in part to penetrate and often to control large segments of legitimate business everywhere.

There is only one way to remove this baleful cancer: gambling must be legitimized. It could become a government function, or, even better, it could be made a private but carefully supervised private operation.

If this were done, the federal treasury would at once be enriched by at least $10 billion a year.

(*h*) *Exempt securities*

In 1969, the total of exempt securities has risen beyond $130 billion. When the revenues from these are fully taxed, they should yield the treasury more than $2 billion.

(*i*) *Taxation of capital appreciation*

Gifts to charity, churches, foundations, etc., are free from capital gains taxation; the same is true of estates passing from a decedent to his heirs. If all such transfers were subject to capital gains taxation on appreciation over base, Treausry income would be enhanced by about $4 billion a year.

(*j*) *Trust funds*

In 1963, banks and other institutions had already become the custodians of well over $60 billion in trust funds, set up by wealthy individuals for the purpose of avoiding estate taxation. Also, hundreds of millions every year escape the same tax through gifts.

We believe that if these loopholes were closed, Treasury income would increase by about $5 billion annually.

(*k*) *Miscellaneous tax avoidance*

Ingenious indeed is our Internal Revenue Code. It is supposed to tax all income at steeply progressive rates; but then we discover at the very outset that there are 18 categories of income (some of them very large) not even includable in gross income! As we proceed in this statutory jungle, we find that it is possible for a million-dollar income, especially if it is derived from investments or capital gains, to escape all income taxation!

But these escape hatches, loopholes, allowances, exclusions, deductions, etc., are available only to those who deal in large sums of money and who can purchase the services of experts who know the provisions of the Internal Revenue Code more intimately than do the bureaucrats who administer it or the members of Congress who vote to establish them.

Once I wept briny tears of sympathy for the rich who were supposedly paying a 91% federal income tax, in addition to heavy state levies. Then one day I met a tax specialist who did the accounting and investing for several movie stars whose names are household words on several continents. His services consisted in reducing the taxes on million-dollar personal incomes to something like 10%.

This was a revelation to me.

Even greater was the shock when I learned that such tax avoidance was not only quite legal, but virtually universal among the rich elite. Why should THEY worry about high taxes or inflation? They paid very little of the former and grew richer every hour as a result of the latter!

To analyze how the elite have been escaping taxation would take too much space, but there is one example. Recently the chairman of the board of one of the largest banks in the country called me in Phoenix from New York City and related what he did, with *complete legality:*

For 1967, his personal income tax was $104,000. His 1968 liability would have been $140,000. But by studying and taking advantage of various loopholes, he reduced his taxes to—exactly ZERO! Now he is eager to outlaw such tax avoidance in the future.

Closing the loopholes by which the elite have avoided taxation would enrich the Treasury at least $4 billion every year. Nor does this sum duplicate others already listed, for this revenue would come almost entirely from revenues which, in the past, have not even been reported as gross income.

III. Conclusion

We have, then, the following effect upon Treasury revenue through the establishment of tax equity:

	Billion
Reduction (1965 level), personal U.S. income tax	$24
Gains:	
The Federal Reserve	4
Churches, etc	7
Foundations	3
Exempt investment funds	4
Tax exempts in competition	8
Depletion allowances	5
Gambling	10
Exempt securities	2
Capital appreciation on gifts, bequests, etc	4
Trust funds in estates	5
The elite	4
Total gains	56
Net increase for treasury	32

This is no idle dream. In order to implement this program and establish a just social order based on tax equity, all we need is a courageous Congress, made up of statesmen who are more concerned over the welfare of the next generation and that following than they are about obtaining funds to finance their next election campaign.

It is as simple as that.

Thank you very much for the opportunity to present our views for the record.

Statement of the National Education Association, by John M. Lumley, Assistant Executive Secretary for Legislation and Federal Relations

The National Education Association welcomes this opportunity to present its views during the current Congressional debate on reform of the nation's tax laws. The Association, representing more than two million professional educators in 9000 state and local affiliates, has a deep interest in school finance at every governmental level and in the patterns of taxation which apply to school revenues. The general policy of NEA regarding financial support of the schools is embodied in three resolutions adopted by the Associations Representative Assembly at its July 1969 convention:

Basic Financial Support

The National Education Association believes that public education should be supported from public tax sources to ensure that each citizen has an educational program for the highest level he is capable of achieving. This is the only true meaning of equality of educational opportunity.

The Association also believes the tax systems of the federal, state, and local governments should share equitably in supporting public schools. Special apportionments of federal and state funds shoud be provided to encourage experimentation and promote improvements in educational practice.

The total impact of the tax systems supporting schools should be proportionate to the ability of the taxpayers to pay without undue hardship on any one group. No one tax should bear a disproportionate share of the cost. Outmoded and restrictive tax rate and indebtedness limitations must be removed. The tax systems should be continually reviewed to ensure an equitable distribution among individual taxpayers, among school systems, and among levels of government.

Federal Support of Public Education

The National Education Association seeks federal support of public education in line with the following principles:

The National Education Association seeks federal support of public

1. That federal programs comply with current civil rights statutes and judicial decisions.

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b. That there be substantial general federal support of the whole of public education. . . .

TAX LAW REVISION

The National Education Association believes that the tax laws at all levels of government must be completely revised to bring about more equitable tax treatment of all citizens.

While NEA is concerned with equitable tax legislation, it is also concerned with *adequate* taxation and the closing of loopholes which have permitted wholesale raids on the Federal Treasury.

At the present time, the Federal Government is bearing just a shade over seven per cent of the nation's school costs. State governments provide 40.9% of the funds needed to operate the schools, and local taxpayers provide the remaining 51.9%. NEA believes that the federal share of school finance must ultimately be increased to a full third, and the Association now has bills before Congress that would move us toward that goal.

To achieve excellence in education, we must have a solid and just tax foundation. The proposed tax reform bill, HR 13270, is a significant breakthrough in this respect. It represents the kind of bold thinking that is needed to shake loose the monstrous inequities that hit-or-miss amendments build into a tax system over the years. Nevertheless, as educators we must recommend that this Committee consider the following provisions of HR 13270 and their possible effects on the future condition of our education system.

1. Municipal bonds

NEA is particularly concerned about Sections 601 and 602 of HR 13270, which provide for an election on an issue by issue basis by a state or local subdivision to issue taxable bonds in exchange for a federal interest subsidy ranging from 30 to 40 per cent during the first five years, and between 25 and 40 per cent thereafter. If an issuer elects not to issue fully taxable bonds and receive the subsidy, it will continue to issue bonds without receiving a subsidy.

We believe that state and local governments are faced with a difficult choice under these provisions. Rendering bonds taxable would discourage purchase by banks and other large money interests as well as by individual taxpayers. Furthermore, reliance upon the Federal Government for the means to make bonds competitive in the market place could erode local autonomy, since it is likely that federal criteria for granting the subsidy would be spawned by this legislation. The ultimate result could be complete control of state and local financing. This would be extremely damaging to the public schools system, which already labors under heavy-handed federal regulation.

The alternative route, electing to issue tax-exempt bonds, would lead directly and speedily to increased burdens on property owners. Some issues, especially in communities with low credit ratings, would go begging. Others, due to maximum interest statutes, simply could not compete in the commercial market unless the state legislatures increased maximum interest rates. In this case, the only method for financing school bonds would be increased tax levies. The record of the past few years shows increased resistance to new levies and school bonds.

The dilemma we have outlined indicates that the present method of financing school construction is not working as intended and is not working well. Nor is the proposal in Sections 601 and 602 of HR 13270 a significant improvement. What is needed is substantial federal aid for school construction. This is borne out by the fact that secondary school enrollments will continue to rise rapidly through 1972 (due to the 'baby boom' of the mid 1950's), and that minimum population projections through 1975 indicate no slackening of the need for new facilities. Moreover, secondary schools cost more to build, to staff, and to operate. Teaching materials and equipment are more expensive than those used in the elementary schools.

We believe that the ultimate solution to this problem will not be found in the proposed legislation, but rather in a restructuring of federal spending priorities.

2. Unrelated business income

The programs of organizations such as the National Education Association and its affiliates would be adversely affected by the advertising tax proposed under Section 121 of HR 13270. While we agree with the principle that income from activities which do not 'contribute importantly' to the organization's exempt functions should be taxable, we believe that neither the Internal Revenue Service nor the House of Representatives has come up with satisfactory criteria

and definitions. In the case of the National Education Association and its state affiliates, advertising revenue makes it possible to disseminate research findings, reports on improved teaching methods, and other kinds of information whose purpose is to upgrade the skills of the professional membership—i.e., teachers. The dissemination of this information is intimately connected with the exempt functions of the Association and its affiliates, and advertising income in the monthly journals is absolutely essential to the continuation of this activity.

The proposed bill would tax advertising revenues of organizations such as NEA, and place them at a disadvantage to commercial enterprises, since it would comprise a gross receipts tax to which the business community is not subjected. For example, the proposed bill would not allow the deduction of production and other costs incident to producing the advertising income. To maintain publication, membership dues would have to be increased, and since these dues are tax exempt, the net gain to the Federal Treasury would be minimal. And the side effects of such taxation, taken as a whole, would be catastrophic to the association.

3. Charitable contributions

The nation's public and private colleges and universities rely heavily on the contributions of concerned citizens, foundations, and other private sources for operating revenues. Continued reluctance by Congress to appropriate adequate sums under existing legislation makes these private contributions more and more important. NEA applauds those sections of HR 13270 which encourage increased contributions to the private sector, and urges this Committee to retain and strengthen such provisions.

On September 18, 1969, the American Council on Education submitted detailed testimony to this Committee on the matter of charitable contributions. The National Education Association concurs with the views expressed by the Council and the 16 other education organizations which joined with it in the September 18 statement.

4. Retirement income tax credit

Millions of teachers and other employees in a number of states are not covered by social security, belonging instead to their own local or state public employee retirement system. Under present law, social security benefits are tax free, but retirement income from other pension plans is taxable.

To alleviate the inequity of this situation, the retirement income tax credit was introduced in 1954. Its purpose was to extend approximately the same tax treatment to retired public employees as is due regular social security beneficiaries.

Under present law, the maximum tax credit is 15% of $1524 and is correspondingly reduced by any amount of earned income above a certain level as well as the receipt of other tax-free income.

The base figure, $1524, is computed on the average maximum individual social security benefits paid per year. This figure has not been updated since 1962.

Since 1962, social security benefits have been adjusted upward by seven per cent in 1965 and by 13 per cent in 1967. Unfortunately, the retirement income tax credit has not been correspondingly increased. One of the glaring omissions in HR 13270 is a provision to remove this inequity.

NEA commends to the attention of this Committee a bill, S 2968, introduced September 29 by Sen. Abraham Ribicoff. This bill would increase the base figure to $1872, and thus make the tax treatment of individuals not covered by Social Security equivalent to those who are. We therefore urge that the Committee incorporate the provisions of S. 2968 in the tax reform bill, thus benefiting the more than half million older Americans who depend on the retirement income tax credit.

IN SUMMARY

The National Education Association opposes the provisions of HR 13270 on taxation of municipal bonds, since neither of the alternatives suggested would improve substantially the marketability of such bonds.

The Association strongly objects to the proposed tax on the advertising revenues of tax-exempt organizations, when such revenues are clearly related to the exempt functions of the organization.

NEA supports the increase of the limitation on charitable contributions from 30 to 50 per cent, and endorses the proposal that donors of appreciated long term and intangible property be entitled to deduct the full fair market value of the property without including the unrealized appreciation in income.

The Association recommends language to make the retirement income tax credit for members of state and local public employee retirement systems equivalent to that enjoyed by persons receiving social security benefits.

INTERNATIONAL LONGSHOREMEN'S & WAREHOUSEMEN'S UNION,
Washington, D.C., September 5, 1969.

HON. RUSSELL LONG,
Chairman, Committee on Finance,
U.S. Senate, Washington, D.C.

DEAR MR. CHAIRMAN: With some 700 witnesses asking to be heard on H.R. 13270, the "Tax Reform Act of 1969," and in light of my appearance before the Committee in opposition to the surtax extension where I also summarized our position on tax reform and tax relief, I am requesting that this letter and the attached statements be included in the hearing record.

I am enclosing a statement on H.R. 13270, a portion of the Report of the Officers to our April, 1969 Convention, and a resolution adopted by that Convention on tax reform.

I would, at this point, simply like to emphasize that we consider an increase in the personal exemption from $600 to $1200 to be the most urgent item in any meaningful consideration of tax reform and tax relief. Unless working people, who will receive precious little "relief" from H.R. 13270, obtain genuine tax justice, our nation faces a crippling of essential services as overburdened taxpayers strike back against school and hospital bond issues, etc.

We recognize that doubling of the exemption is expensive as well as overdue, but are confident that more thorough-going reform will pay for it. As *Business Week* editorialized on August 2: ". . . if narrowing a loophole is good, why isn't eliminating it better? If a 27½% depletion allowance for oil is an outrage, why is 20% tolerable?"

Sincerely,

ALBERT LANNON,
Washington Representative.

STATEMENT OF ALBERT LANNON, I.L.W.U. WASHINGTON REPRESENTATIVE TO THE COMMITTEE ON FINANCE, U.S. SENATE IN RE H.R. 13270, "TAX REFORM ACT OF 1969"

TAX REFORM

The cost of running government is enormous. As Americans come to expect more in services and better schools, housing, medical care, and transportation among other things, the costs are going to keep on rising. We are convinced working people are willing to pay their fair share.

Under our present tax system, however, working people have been burdened with the heaviest share of the tax load while special interest groups enjoy a wide range of money-saving amendments to the tax laws. Instead of a progressive tax structure—in which the tax load is supposed to be distributed according to ability to pay—those in the lower earnings brackets pay a higher proportion of their income in taxes than do those in the upper brackets. The average working person now puts in at least a day-and-a-half out of each five-day work week just to pay his taxes.

According to a recent study made by the magazine *U.S. News & World Report*, families with incomes under $3,000 per year pay 34 percent of their income in taxes; families in the $5–7,000 range pay 33 percent; and families in the $10,000 to $15,000 bracket pay 31 percent of their earnings in taxes. But families exceeding $25,000 pay 28 percent or less of their earnings in taxes.

What is more, the Internal Revenue Service reported that in a recent year 45 persons with incomes over $1,000,000, and 115 persons with incomes from $500,000 to $1,000,000 paid no federal income taxes. But people with poverty-level incomes or less pay about $6 billion a year in federal taxes. Over the years, the taxes paid by working people have to make up for the taxes lost through loopholes, exemptions and privileges enjoyed by high salaried executives with lucrative stock option plans, stock and bond traders and coupon clippers, real estate speculators, and multi-million dollar corporations.

A radical change to make our entire tax structure truly progressive is long overdue.

The tax laws of this country are a complex and almost unintelligible mix of rules, regulations, and loopholes. The most we can recommend here are basic reforms which attack the most flagrant inequities in the system, which will ease the tax burden on our members, and which will be equitable for all working people. That program follows:

1. Abolish the surtax. A 10 percent federal surtax—introduced by President Johnson and apparently to be continued by the Nixon administration—is a tax on your federal income tax. A 10 percent tax on top of your already high federal tax bill.

2. Increase personal exemptions from $600 to $1,200. When the $600 exemption was originally enacted 21 years ago it was the intent of Congress that that was the amount necessary for a taxpayer to feed, clothe, and house a dependant. Obviously, the present $600 allowed does not meet that minimum standard.

3. Raise the standard deduction of 10 percent with a $1,000 maximum to 15 percent with a $2,000 maximum. Rather than wrestling with itemized deductions, most working people choose to take the standard 10 percent deduction. Under present conditions, a person who can itemize is often able to write off more than 10 percent of his earnings. To bring the standard deduction in line with present economic realities it should be raised to 15 percent with a maximum of $2,000. This single step would provide significant relief for middle-income taxpayers.

Each of these three points would provide direct and immediate relief for the wage-earning taxpayer by lowering the government's take. What are the alternative sources of revenue for the government?

TAX LOOPHOLES COST $50 BILLION A YEAR

In its recently released study of the tax system, the Treasury Department estimated that all so-called tax loopholes (including those which may benefit some working people) cost the government from $50 to $53 billion a year. These billions are ultimately passed on to the tax bills of the taxpayers who do not benefit from the loopholes, meaning most of us. We are getting stuck for the bill. The special privileges and loopholes must be closed. A minimum program to do so follows:

1. Repeal the capital gains provision.

Under existing law the owners of stocks and real estate, mainly wealthy speculators, pay only a 25 percent tax on the profits they enjoy through buying and selling. The capital gains provision deprives the government of about $8.5 billion a year compared to what the government would get if such income was taxed at the rates applicable to wages and salaries.

2. Recover the taxes on capital gains which are lost at death.

The owners of stocks or real estate pay taxes on the profits of their dealings only while they are alive. If they should die before disposing of such property, the increased value of that property is never taxed. Rather, the value at the time of death of the owner becomes the new tax base for the heirs. It is estimated that this loophole alone costs the government and other taxpayers about $2.5 billion a year.

3. Tighten the regulations on charitable deductions and crack down on the tax-free foundations.

A modest gift from a wealthy man to his favorite "charity"—perhaps a foundation that he sets up himself as a tax haven—often satisfies existing law and lets him off tax free.

There are now more than 30,000 private, tax-free foundations in the United States. They save tax dollars for wealthy people in many ways. For example, a person can make a tax deductible contribution to a foundation, and then turn around and lend himself money from the foundation at a minimal interest charge. Likewise for land holdings. A person can donate land to one of these foundations—a tax deduction—then rent the land from the foundation—a business expense—and then turn around and lease it out for far more than the rent he pays. Also, foundations are free to invest in many businesses, and the money they earn from their investments is all tax free. They can pass the profits on in large salaries, so-called professional fees, and in large endowments to "worthy causes."

END DEPLETION ALLOWANCES

4. Eliminate the oil and mineral depletion allowances.

The oil and mineral depletion allowances are, perhaps, the most dramatic example of corporate tax abuse. The oil depletion allowance provides that the first 27½ percent of the profits from oil wells are tax free, and the first 23 per-

cent of profits from minerals extraction are tax free. As a result of this and other tax advantages most oil companies pay less than 5 percent tax on their profits. For example, one oil company received a $425,000 refund on $65 million in earnings over a six-year period. A modest cut in both rates to 15 percent would save individual taxpayers an estimated $800 million a year.

5. Repeal the 7 percent investment tax credit.

Corporations are now allowed to deduct from their taxes 7 percent of the money they spend on new machinery and equipment. With the economy operating at only 85 precent of capacity, such a tax break defies rational justification. The investment tax credit costs the government over $2 billion a year.

6. Eliminate the tax break for a corporation's subsidiaries.

Corporations are allowed a tax rate of 22 percent on the first $25,000 of their earnings and they pay 48 percent on their profits in excess of $25,000. What many companies have done, retail stores are a good example, is to operate many or all of their stores or plants as separate corporations, despite the fact that they all have the same owners. The companies are then able to enjoy the lower rate on the first $25,000 in profits that each of the subsidiaries makes.

This list of reforms could be easily expanded. We support higher corporate income taxes, tightening the tax rules on stock options and other forms of deferred compensation for corporation executives so that such earnings are taxed like wages and salaries, cracking down on the so-called "gentleman farmers" who invest in farms on the side so as to enjoy the tax write-offs for farm losses, taxing the earnings of churches and social clubs which engage in business ventures unrelated to their main purposes, and ending the tax advantages resulting from conglomerate mergers.

President Nixon has announced his support for tax incentives to companies doing business in ghetto areas, and to companies willing to train the hard-core unemployed. Unless such incentives are coupled with higher corporate income taxes across-the-board, the President's program will simply become another tax dodge for the corporate community, the price of which will have to be borne by the individual taxpayer.

All of the points listed above are a minimal trade union program for federal tax reform. Such changes would (1) ease the tax burden on the individual taxpayer, and (2) shift that burden to those most able to pay.

The federal tax system in Canada, modeled in part after ours in the States, shares many of the regressive features of our system. But the Canadian government has gone much further than ours in recommending changes in the system.

THE CARTER REPORT

On February 24, 1967, the long-awaited Report of the Royal Commission on Taxation—the Carter Report—was released. We agree with the Canadian Labour Congress that the Royal Commission's guiding principle will virtually revolutionize the tax system.

The Commission has urged that all forms of income—wages, stock dividends, capital gains, real estate transfers, etc. be treated exactly the same for tax purposes. For example, the Commission noted, "A dollar gained through the sale of a share, bond or piece of property bestows exactly the same economic power as a dollar gained through employment or operating a business." We concur.

The total effect of the Commission's Report will be progressive. It shifts much of the tax burden in Canada from those least able to pay to those best able to pay. It is estimated that Canadians earning less than $5,000 a year will have their taxes reduced by 10 percent, and Canadians earning from $5,000 to $7,000 a year will have their taxes cut by 7 percent.

We commend the Commission's Report to American tax reformers, and join Canadian labor in urging the prompt adoption of the Report by the Canadian government.

STATEMENT OF POLICY NO. 6

FEDERAL TAX REFORM

The cost of running government is enormous. As Americans come to expect more in services and better schools, housing, medical care, and transportation among other things, the costs are going to keep on rising. Working people—are willing to pay their fair share, but they have been burdened with the heaviest share of the tax load while special interest groups enjoy a wide range of money-saving amendments to the tax laws.

Instead of a progressive tax structure—in which the tax load is supposed to be distributed according to ability to pay—those in the lower earnings brackets pay a higher proportion of their income in taxes than do those in the upper brackets. The average working person now puts in at least a day-and-a-half out of each five-day work week just to pay his taxes.

A radical change to make our entire tax structure truly progressive is long overdue.

We recommend basic reforms which attack the most flagrant inequities in the system:

1. Abolish the surtax.
2. Increase the personal exemptions from $600 to $1,200.
3. Raise the standard deduction of 10 percent with a $1,000 maximum to 15 percent with a $2,000 maximum.

So-called tax loopholes cost the government from $50 to $53 billion a year These billions are ultimately passed on to the taxpayers who do not benefit from the loopholes, meaning most of us. The special privileges and loopholes must be closed. A minimum program to do so follows:

1. Repeal the capital gains provisions.
2. Recover the taxes on capital gains which are lost at death.
3. Tighten the regulations on charitable deductions and crack down on the tax-free foundations.
4. Eliminate the oil and mineral depletion allowances.
5. Repeal the 7 percent investment tax credit.
6. Eliminate the tax break for a corporation's subsidiaries.

Statement of Pierce S. McDonnell, Esq., of Warrenton, Va., and Cleveland Heights, Ohio

My name is Pierce S. McDonnell of Warrenton, Fauquier County, Virginia.

I am a practicing lawyer, a Member of the Virginia Supreme Court of Appeals, and of the Bar of the United States Supreme Court.

Also, in regard to financial expertise as an economic expert, re certain non-Federal bond issues which are now exempt from Federal taxation under existing statutes, I have also been retained as a consultant.

After graduating from Case Western Reserve University, I completed my legal education at Yale; Graduate Business—Harvard; M.A. in Economics, Georgetown, and did my PhD work in Business Administration at Columbia University.

This morning I listed to the testimony and interrogation of the Honorable Charles McC. Mathias, Jr., of Maryland. My position is identical in many ways to the views presented by Senator Mathias with two major exceptions.

1. Agriculture

He spoke of the importance of the cattle and horse industry in the State of Maryland. I wish to point out to your Committee the horse and cattle industry is very important to the Commonwealth of Virginia, particularly in Fauquier County. The quality of the breeding of our fine horses is known throughout the world sales market.

Farms owned and operated by Admiral Lewis L. Strauss, of Culpepper, and Judge Howard Smith, of Broad Run, are famous throughout the United States.

This witness urges your Committee not to destroy by the pending legislation before you what Virginians have worked so hard for so many generations to build up and operate with financial success under the free enterprise system.

May I strongly recommend that no changes be made in the existing law re capital gains from income from the sale of livestock.

2. Bonds

This section of my testimony deals with the proposed removal of the present tax exemption of non-Federal bonds issued by quasi-government and other political units below the state level as political subdivision thereof.

A. I oppose the provisions of H.R. 13270 for the same sound reasons as outlined by previous witnesses. The mere threat that the Congress may pass the pending provisions has depressed the bond market. It is now playing havoc with the traditional method that sales of certain Federal tax-exempt bonds, particularly state and municipal.

B. Other non-Federal tax bonds exempt from Federal taxation. In 1961 (privately distributed) and in 1964 I wrote a book entitled, "The Law of Turnpikes". Both were published by the National Academy of Sciences. The statutes of 37 states provide that the bonds issued by these authorities shall be at fixed statutory rate and have been exempt like State and Municipal bonds from Federal taxation.

These business entities . . . turnpikes, toll bridges, etc. . . . are self-financed through the sale of revenue bonds Senator Long's State had a successful pioneer program in this field; Senator Williams' State (in contact with Pennsylvania) also were early entrants in the program to build fine transportation facilities for the American public of the Eastern Seaboard area. All projects, in both these States, were financed by tax-exempt bonds.

As an individual who has been associated for over twenty years professionally in some of the problems raised by H.R. 13270, I believe that your Committee should not be politically maneuvered into a position where you will force another self-supporting industry into a financial jam where it will be almost practically unable . . . or absolutely unable . . . in terms of current bond sales conditions . . . to sell their low rate tax-exempt revenue bonds.

In closing, a word about the foundations proposals legislatively suggested by the Administration. I agree that the proposed tax on investment income be reduced to 2%.

STATEMENT OF WILLIAM D. MCFARLANE, WASHINGTON, D.C.

Mr. Chairman and members of the Finance Committee, I appreciate your allowing me the privilege of presenting my views in support of (I hope) your early approval of a more far reaching tax reform measure for the benefit of the low and middle income and elderly group ($7,000 to $20,000) who are now bearing most of the burden of the income taxes collected.

As a former member of congress (1933–39) from Texas, and a retired trial attorney of the Department of Justice (1941–66) who has been confronted with and confounded by this "tax reform" subject matter for many years—I will briefly review some of the congressional record concerning this matter. When the Revenue bill of 1938 was before Congress I pointed out some two dozen "loopholes" or exemptions contained therein and urged their elimination, as did other members of congress, but we met with little success. Senator Russell Long has pointed out in his remarks on "Tax Legislation" July 15, 1969, some of the many so-called "tax Reform" amendments to the Revenue Act since 1913 approved by congress that are now considered loopholes, many of which are contained in H.R. 13270 now pending before this committee. The congress has considered these so-called tax reform amendments which are now a part of the Revenue Act, for the past several decades and extensive hearings have been held thereon, but little had been accomplished to arouse the congress and the public, until the Secretary of the Treasury Joseph W. Barr spoke to the Joint Economic Committee of Congress on January 17, 1969 and presented a report showing a $128.3 billion of income tax revenues expected in fiscal year 1970 and stressed the point that *our tax system needs reform now*. Secretary Barr stated that "We face now the possibility of a taxpayer revolt if we do not soon make major reforms in our income taxes. The revolt will come not from the poor but from the tens of millions of middle-class families and individuals with incomes of $7,000 to $20,000, whose tax payments now generally are based on the full ordinary rates and who *pay over half of our individual income taxes* . . . People are concerned and indeed angered about the high income recipients who pay little or no Federal income taxes." Secretary Barr then pointed out that there were "155 tax returns in 1967 with adjusted gross incomes above $200,000 on which no Federal incomes taxes were paid, including 21 with incomes above $1,000,000."

Former Commissioner of Internal Revenue Mortimer H. Caplin in the September 1969 *Readers Digest* states that: "A recent Treasury Department analysis showed *that a whopping $45 billion is lost to the government each year through tax privileges of all kinds.*" He then recommends a broad tax reform program to become effective *now* which will "broaden the base of Federal income tax by eliminating the preferential provisions which enable some people with very large incomes to pay little or no tax, and some industries to pay tax at far lower rates than others. Our overall objective should be to treat all forms of income alike and to provide equal treatment for persons with equivalent real income."

I heartily agree with the above statement and specifically recommend the following tax reforms: 1. Remove Preferential Treatment for Capital Gains & Losses.

2. Provide the necessary tax relief for low and middle income families and for the elderly by eliminating the complex retirement income credit and special exemptions in the current law in favor of a flat $2,500 exemption for single persons over 65 and $4,200 for couples where both are over the age as provided in the existing law and regulations.

3. Eliminate the tax exemption on State and Municipal Bonds issues.

4. Eliminate preferential treatment for corporations.

5. Withhold taxes on interest and dividends at the source as is now done for wages and salaries.

6. Repeal of the inflationary 7 per cent investment tax credit enjoyed by the corporations amounting to $3.3 annually.

RECENT STUDIES AND HEARINGS HELD ON TAX REFORM LEGISLATION

Assistant Secretary of the Treasury Stan Surrey's two year study on needed "tax reform" presented a comprehensive program of some 2 dozen specific proposals which would have taken some windfalls from the privileged and granted some relief to lower income families which amounted to about $11 billion. This four volume tax reform study along with the House Ways and Means tax reform studies of the past decade (involving some 2 dozen volumes) were not acted upon but were passed on to the Nixon Administration.

Even though the Republican Platform recognized "The imperative need for tax reform will have our priority attention," the President did not even send a tax reform message to Congress for more than three months after he entered office and even though the House Ways and Means Committee had already held extensive tax reform hearings (13 volumes) before the President's tax reform message was received—his message when finally received contained only ten specific recommendations which the Treasury Officials "Summary of His Tax Proposals" stated that "The net revenue change of the entire package will be small—the revenue increases of reform measures will be largely offset by the revenue losses from the relief measures."

THE HOUSE TAX REFORM BILL H.R. 13270

The tax reform bill passed the House August 7, 1969 by a vote of 394 to 30 and provided for a $7.3 billion tax reduction primarily for the low and middle income group and this reduction was offset by a $4.9 billion in added revenues anticipated from the sweeping reform measure. This bill would remove 2.2 million poor families from the tax rolls and would "end taxation for a total of 6 million Americans."

THE PRESIDENT'S RECOMMENDATIONS TO THE SENATE FINANCE COMMITTEE

The President now recommends to this Committee that the revenue loss of $2.4 billion in H.R. 13270 should be scaled down by about half by (1) Restoring the "phase out" in the proposed low-income allowance at the rate of $1 tax for $4 income as contrasted with the $1 to $2 curve in his original proposal; (2) Raising the present standard deduction of 10 per cent with a $1,000 ceiling to 12 per cent with a $1,400 ceiling instead of 15 per cent with a $2,000 ceiling; (3) Liberalizing taxation of single persons as compared to married couples through a new rate schedule; (4) Reducing corporate taxes by an estimated $800 million in 1971 and $1.6 billion by 1972 thereby reducing the net increase in corporate taxes in H.R. 13270 from $4.9 billion to $3.5 billion. In other words the House bill which provides some tax relief for low and middle income brackets of $7.3 billion when fully implemented is offset by $4.9 billion in higher taxes—about half of which would come through repeal of the 7 per cent investment tax credit which benefit the corporations have received through the years. None of the above computations include revenue effects of the end of the income tax surcharge which H.R. 13270 would extend at a reduced rate of 5 per cent through June 30, 1970. The Senate has already considered and eliminated the income tax surcharge effective January 1, 1970 and it is to be hoped that date stops the surtax.

PREFERENTIAL TREATMENT FOR CAPITAL GAINS AND LOSSES SHOULD BE ELIMINATED

The Treasury looses $8.5 billion annually through capital gains and losses preference rules. The House bill picks up only $635 million of this loss. Instead of trying to remedy this situation the Treasury recommends the retention of the 6 month definition of long term gains and proposes to keep the 25 per cent maximum tax limit on capital gains which recommendation would lose $210 million more than the provisions of H.R. 13270. The President contends he needs more for the many expanded and new programs advanced—here is a good place to start getting some greatly needed funds.

LOW AND MIDDLE INCOME FAMILIES AND THE ELDERLY ARE ENTITLED TO MORE TAX RELIEF—NOT MORE TAXES PILED ON THEM

This 40 million mass of low and middle income taxpayers who earn from $5,000 to $20,000 a year—pay over half of the $81,800 billion of the Federal individual income taxes. Yet, because they do not have a well financed lobby here in Washington, D.C. such as the Nation's Corporate hierarchy, big oil, big utility, big foundations, big banks, etc., here to represent them—they have not had any special exemptions written into the income tax laws through which they can take advantage of the special provisions that riddle the tax code. H.B. 13270 provides tax relief mostly to the low, middle and higher income groups of $7.3 billion when fully implemented, however, the Treasury now recommends that this amount be reduced by $2.5 billion. More than half the above tax reduction will go to those persons in the higher income tax brackets who comprise less than one fourth of the tax payers. And as above pointed out, neither the House bill nor the Treasury recommendations now propose to liberalize any tax treatment for the elderly. The complex Retirement Income Credit and special exemption in the law should be eliminated in favor of a flat $2,500 exemption for single persons over 65 and $4,200 for couples where both are over the age as provided in the existing law and regulations.

ELIMINATE THE TAX ON STATE AND MUNICIPAL BONDS

Corporate bonds are taxed and all State and Municipal Bonds should be taxed. The House bill included tax free interest on State and Municipal bonds in the calculation of a 50 per cent minimum tax. The Treasury would allow individuals to accumulate huge amounts wealth, tax free, by this loophole. This exemption through which the wealthy escape taxation should be eliminated.

ELIMINATE PREFERENTIAL TREATMENT FOR THE CORPORATION

The House bill increased the taxes on corporations by only $4.9 billion and the Treasury recommends that this amount be reduced to $3.5 billion. Corporations only paid $28,700 billion in Federal income axes in 1968 as compared with the individual income taxes paid of $68,700 billion about 90 per cent of which taxes were paid by individuals with incomes of less than $20,000. The Treasury's proposed reduction of corporation income taxes and increase in the individual income taxes justifies the statements of the tax experts and members of congress that this is "A sell out to the wealthy and the corporations."

ALL INTEREST AND DIVIDEND INCOME TAXES SHOULD BE WITHHELD AT THE SOURCE AS IS DONE FOR WAGES AND SALARIES

The Democratic Party was founded on the principles of "Equal rights to all—and special privileges to none" and this should be the broad principle upon which our income tax laws, as well as all other laws are founded. All taxes on interest and dividends should always have been withheld at the source the same as has been done for wages and salaries.

REPEAL THE 7 PER CENT INVESTMENT TAX CREDIT

The 7 per cent investment tax credit would be repealed outright for projects begun after April 18, 1969 under the provisions of H.R. 13270—with the few exceptions therein made—and this action would allow an ultimate gain of $3.3 billion. The House Ways and Means Committee concluded that the stimulus to investment provided by the 7 per cent credit, which permits this 7 per cent of the

83-865—69—pt. 2——26

cost of new equipment to be deducted directly from income taxes owed by the corporations was actually contributing to the present inflation, and should be eliminated.

CONCLUSION

I believe in the principles upon which the Federal income tax was established—that all persons and parties concerned should be taxed according to their ability to pay and that no one be asked to bear more than his just share of that burden because of the special tax benefits accorded others.

Many of our people go to bed hungry every night—programs and services badly needed dealing with poverty, education, and the needs of our cities, schools, rivers, harbors, air pollution, etc. cannot be carried on because our Government cannot find the money with which to meet these responsibilities.

By promptly eliminating the above mentioned "loopholes" this congress will be performing the greatest possible service to all the people of this great country of ours—and we can then go forward knowing that we are receiving honest fair treatment for all our people and for approved worth while programs and services.

By promptly eliminating the loopholes in our income tax, scaling down and reducing the rates 50 per cent, we will still be able to collect more income taxes than are now being collected. Yes, and our country will be happier and more prosperous.

TESTIMONY OF ROBERT V. MOSS, JR., ON BEHALF OF THE UNITED CHURCH OF CHRIST

I am Robert V. Moss, Jr., President of the United Church of Christ. Our national office is at 297 Park Ave. South, New York, New York, 10010 and our Washington office is at 110 Maryland Ave. N.E., Washington, D.C. 20002.

The United Church of Christ was formed on June 25, 1957 by the merger of two of America's oldest denominations, the Congregational Christian Churches and the Evangelical and Reformed Church. It has approximately 7,000 local churches, with slightly over two million members. The representative body of the United Church is the General Synod, which meets biennially.

The Seventh General Synod met this June 25 to July 2, 1969. Its 744 delegates from across the nation, among other things, adopted a pronouncement on tax reform, entitled Sharing the Cost of Government Fairly, which I am privileged to file with you today.

I should note for you the participation by the local churches in the preparation of this statement. During the last seven years, the Church circulated two study documents on tax reform among the local churches for their reaction and comment. From those comments a specific proposal was prepared and circulated this spring. Three-fourths of the bodies responding voted to support the statement or something close to it. The final drafting and adoption at the Synod thus reflect attitudes back home as well as at the convention itself.

SIGNIFICANT ASPECTS OF STATEMENT

There are three aspects of this pronouncement which strike me as especially significant.

(1) This is surely one of the most non-self serving statements to be filed with this Committee. We ask nothing for ourselves. In fact, we recommend the closing of one loophole favoring churches, i.e. the taxing of church owned properties and businesses not related to normal religious pursuits. Our primary concern has been for the welfare of the general community of which we are a part. We are even studying taxation of church property per se and some local churches contribute to local governments in lieu of tax payments.

(2) Our recommendations for the closing of loopholes are generally tougher than the provisions enacted by the House of Representatives. For example, we recommend that the preferential treatment afforded capital gains be "eliminated"—not merely reduced by lengthening the waiting period to one year—and that the preferences extended to the oil and [illegible] investors should be "ended"—not merely reduced from 27½% to 20%.

(3) We did not put in a plea for tax reduction. Although we have previously called for a reduction in national armaments and are gravely concerned over the high military expenditures, we realize that there are vast human needs which require large government funding. Thus we have not dealt in this pronouncement

with the amount of taxes needed but only with the obligation of each person to pay his share. Our title, SHARING THE COST OF GOVERNMENT FAIRLY, is accurate.

SUMMARY OF STATEMENT

After general statements of principles and tax criteria, our statement proposes the following tax reforms:

(a) interest paid on state and local government bonds should be taxed like other income, with federal government grants or loans to offset any increased interest costs;

(b) corporations should be allowed to deduct dividend payments as a business expense, as they now deduct interest payments;

(c) preferential treatment afforded capital gains "should be eliminated" with provisions for averaging the gains over the years involved;

(d) provisions for averaging income generally should be simplified and extended;

(e) preferential treatment extended to oil, gas and mineral industries should be ended and only depreciation deductions allowed;

(f) estate and gift taxes should not be levied on transfers to the surviving spouse;

(g) the inheritor of property of increased value should take the decedent's cost base for the property;

(h) spurious foundations should not confer benefits of tax deduction;

(i) businesses and property of churches, etc. unrelated to their normal religious pursuits should be taxed at the standard rates;

(j) there should not be a minimum threshold limiting deductions for small contributions;

(k) persons under or near the poverty line should not be taxed;

(l) increases in Social Security should come from general revenues rather than increased taxes on workers' wages.

And now, Mr. Chairman, I file with you our entire statement.

SHARING THE COST OF GOVERNMENT FAIRLY, A PRONOUNCEMENT OF THE UNITED CHURCH OF CHRIST, ADOPTED JULY 1, 1969

Christians recognize that government has an important place in the providence of God in meeting His purposes and human needs. Christian stewardship regards the payment of taxes, levied through the democratic process, as a public duty, and their responsible use as a public trust. In the interest of justice, we insist that the revenues necessary to meet the expenses of government must be apportioned with utmost fairness.

TAX CRITERIA

Taxes, while primarily a source of governmental revenue, intentionally or unintentionally also affect the economic and social process. Tax policy, therefore, requires difficult choices to be made in accordance with the relative weight given to diverse, sometimes contradictory, norms. The following criteria, however, are basic in a just system:

1. *Adequacy.* Taxes should provide adequate revenue for the government.

2. *Simplicity.* The law should be understandable to the taxpayer and relatively easy for both taxpayer and government to administer.

3. *Distributive Justice.* Taxes should fall on taxpayers in accordance with their ability to pay. While income is not the only element in a measure of ability to pay, it is proper for individuals with higher incomes to be taxed at successively higher rates, other things being equal. Regressive taxes—which take a larger share of income from the poorer taxpayer than from the richer—should be used sparingly and avoided entirely whenever possible.

4. *Neutrality.* Taxes should not create artificial incentives for making economic decisions except where explicitly intended as a matter of public policy. Even then, the end sought may be more effectively and forthrightly achieved through properly designed controls and incentives.

5. *Vitality.* Both the nature and extent of taxation should be designed to enhance rather than inhibit economic efficiency, healthy non-inflationary growth, and productivity in a socially constructive manner.

6. *Encouraging voluntary agencies.* The tax structure should continue to stimulate the use and development of voluntary agencies for their salutary contributions to our life.

SHORTCOMINGS OF OUR TAX SYSTEM

In the light of these principles, we believe that major reliance should be placed on the income tax. But we call attention to certain shortcomings in present United States tax policy.

1. *The Tax System Does Not Meet the Test of Equity.* Since 1913 the United States has accepted the principle that a person's income tax should be related to his ability to pay, and that those enjoying greater income should contribute a larger percentage in taxes than those with a smaller income. Nevertheless, this rule is inequitably applied in practice. The mass of our citizens, who work for wages and salaries, pay full tax on their incomes. Yet in 1965 individuals reporting incomes over $1 million paid, in the aggregate income taxes amounting to less than 31% of the net taxable income which they actually reported. They paid far less than this percentage of their total income, although the *nominal* rate scale called for a tax of at least 67%.

In 1967, there were 155 Americans with incomes in excess of $200,000 who paid no federal income tax at all. (Testimony of former Secretary of the Treasury Joseph Barr before the Joint Economic Committee of the Congress.) At the other end of the income scale there are persons who pay income tax on annual incomes of less than $2,000, in addition to Social Security payroll taxes and a host of state and local taxes.

These disparities are not due to dishonesty in reporting. In great measure they are the result of legal "loopholes" which favor certain forms of income as over against others or apply inconsistent criteria in defining the (untaxed) cost of earning income.

These inequities were intensified by the 10% surtax of 1968. This measure taxes at a still higher level those of moderate income who already pay taxes. It taxes at a minimum rate, or not at all, those who are able to escape a full share of the tax burden.

Tax reform, largely deferred when taxes were reduced in 1964 and substantially denied when taxes were increased in 1968, is important to counteract the prevailing bitterness and sense of injustice. It would assure that the burden will fall fairly on all the American people, not just on those powerless to secure preferential tax immunity or relief.

2. *The Tax Base Does Not Meet the Test of Adequacy.* The federal tax base has been eroded by many provisions that permit vast amounts of real income legally to avoid inclusion in net taxable income. As a result, those who can benefit are too much concerned with the technicalities of tax avoidance; and a high rate scale is applied to those forms of income which are fully taxed. Our direction must be toward a broader tax base involving fewer tax preferences, with a consequent reduction in rates.

3. *Tax Inequities Prevent Counterbalancing Fiscal Policies.* In order to carry out its responsibilities to eliminate unemployment and inflation, the government needs effective tools and techniques. One of the most important ways of achieving these objectives is by adjusting income tax rates to counteract adverse economic trends. To be most useful, however, these changes must be enacted as soon as such problems appear. So long as our tax law is laden with complexities and inequities, Congress will be reluctant to alter tax rates to meet national economic requirements.

4. *The Inequities of the Federal Law Become Inequities in State Taxation.* Many states compute their own income taxes on a base that is identical with that for the federal tax, except for minor modification. As a result, the state income tax heightens the inequities of the federal tax. This inequity is intensified by state reliance on property, sales, and other taxes that have undesirable impacts on economic efficiency, urban development, housing, and the living standards of the poor. States cannot take the lead in tax reform without increasing the compliance burdens of taxpayers. Reform at the federal level, therefore, is essential for the improvement of state fiscal systems.

PROPOSED REFORMS

We recognize that a revision of the federal tax structure involves many technical questions. Nevertheless, we ask for correction of certain glaring and obvious deficiencies.

1. All personal income, whatever its source, should for tax purposes be treated on essentially the same basis, and be subjected to a graduated rate of taxation which is progressively heavier as the total amount increases. Any exceptions must

be fully justified by a vital social or economic purpose, and must be scrutinized particularly as to their effect upon the less affluent members of society.

2. In the interest of greater equity and adequacy, the following steps should be taken to correct existing preferences and inconsistencies:

(a) Interest paid on bonds hereafter issued by state and local governments should be taxed like income from other investments. In order to make this change financially feasible for state and local governments, federal grants and/or low interest loans to such governments must be provided to offset the otherwise increased interest costs. This would be preferable and cheaper than the present hidden subsidy by tax exemption, which is no longer required by constitutional interpretations.

(b) Corporations should be allowed to deduct cash dividends as a business expense in determining their taxes, just as interest payments are now deducted. This would eliminate "double taxation" and tend to encourage the sale of new stock.

(c) The present preferential treatment afforded most capital gains should be eliminated and such gains should be taxed at the same rates as any other income. Provisions should be made for *averaging* the gains over the years involved to prevent unduly high rates for a single year. It is contrary to most notions of fairness that capital gains income should be taxed at lower rates than income earned as wages or salaries. Such preference also injects an artificial influence into business decisions. There are better ways to improve the vitality of our economy.

(d) Provisions for averaging income for tax purposes should be simplified and extended to taxpayers not presently enjoying this advantage. Persons who receive the bulk of their income in a relatively short period of their working life tend to pay higher income taxes over their lifetimes than those receiving their income more evenly throughout their productive years.

(e) The preferential treatment extended to taxpayers who invest in oil, gas and mineral properties should be ended. Depletion deductions, like depreciation deductions available to taxpayers in other fields, should be limited to the amount of the taxpayer's actual investment.

(f) Federal estate and gift taxes should be revised to permit a husband or wife to receive property from the spouse tax free; but the law should not permit wealthy families to avoid estate taxes for generations by the use of long term trust arrangements.

(g) Provisions permitting profits on property appreciated in value to escape tax free at the owner's death should be changed so that where no inheritance tax is paid, the recipient of the inherited property takes the decendent's basis for the property.

(h) Property contributed to spurious, tax-haven foundations which do not significantly serve social purposes should no longer confer the benefits of tax deduction on the individuals who created them.

(i) Businesses and property of churches, foundations, educational and charitable organizations, but unrelated to their normal religious, educational and humanitarian pursuits, should be taxed at the standard rates applicable to business and property not so owned.

(j) We oppose use of a threshold principle below which charitable gifts would not be deductible.

3. The income tax should be completely eliminated for those below the property line, and should not fall so heavily upon those immediately above the property line that they are thereby brought below it. Millions of citizens living below the subsistence level already pay unduly large portions of their income in income, sales, Social Security, and other taxes.

4. Any future increases needed to augment our Social Security trust funds for higher benefits to persons below or near the poverty level, should come from general revenues, principally the graduated income tax, rather than from increased taxes on the low-income worker's take-home pay. (How best to assure a reasonable minimum income to those living in poverty is not the subject of this pronouncement. Better Social Security, an improved welfare system and the use of a negative income tax for these purposes are still under review by the C.C.S.A.)

We recognize that these initial efforts will not eliminate all inequities, but they will provide a worthy beginning. We must remove any ground for the cynicism which results when the tax system favors the citizen who can afford a lobbyist or a high priced tax advisor, and places a disproportionate share of the cost of maintaining the peace or eliminating want upon those who are below, at, or

immediately above the poverty level. The sense of shared enterprise and purpose will be real and deep only when each person who is required to help finance the national effort knows that each of his fellow citizens is sharing the burden as he is, and that all income is given equal treatment.

STATEMENT OF THE COMMITTEE ON TAXATION OF THE NEW YORK CHAMBER OF COMMERCE, SUBMITTED BY FRANK A. BRADY, JR.

The Committee on Taxation of the New York Chamber of Commerce welcomes the opportunity to file this statement on the Tax Reform Act of 1969 for your consideration and incorporation in the printed record of the hearings held on this bill by the Senate Finance Committee.

The New York Chamber of Commerce is the oldest Chamber of Commerce in the United States, having completed two hundred years of operation in April 1968. During this time the New York Chamber of Commerce, as spokesman for New York City's business sector, has taken an active role in the framing of tax legislation on the City, State and Federal levels. Official New York Chamber of Commerce records show that at a Chamber meeting on May 2, 1769, the membership approved a resolution congratulating the New York merchants for their boycott of British goods as a protest to the passing of an act by the British Parliament imposing duties on tea, paper, glass, etc. In more recent actions, the New York Chamber was an early proponent of the ten percent surcharge on individual and corporate income tax and its extension and currently, the Chamber vigorously opposes the repeal of the seven percent investment tax credit.

In presenting this statement, the Committee on Taxation of the New York Chamber of Commerce will comment on only a few of the items of H.R. 13270. This bill has so many provisions that it is impossible to study, identify, analyze and comment on all of its issues in the time permitted to us. Failure to include comments in this statement on many of the items in H.R. 13270 should not be construed as either agreement or disagreement with these provisions. The Committee found many commendable provisions in the bill. Such changes as the reduction in rates, liberalization of the deductions for job-related moving expenses and the increase in the standard deduction represent positive steps towards real tax reform. On the other hand, there are other provisions which we strongly oppose.

Before presenting its views, the Committee would like to make some general observations on this bill. We would like to note the long run economic implications of the bill and comment on the legislative procedure surrounding it. Against the background of these general comments we will review specific provisions of H.R. 13270.

LONGER-RUN ECONOMIC IMPLICATIONS

The United States is facing a crucial task of financial statesmanship. The House, caught between discontent among American people over high taxes and inflation, passed a Tax Reform Bill—H.R. 13270—that, if enacted, would, in the view of the Chamber, have harmful consequences for future output, productivity and efficiency of the U.S. economy.

Inviting as its relief provisions may appear to many taxpayers, the bill is apt to have adverse economic effects that outweigh the benefits stressed by its sponsors. It would favor consumption in that it would provide massive tax relief to people in income brackets that share a high spending proclivity. By the same token, it would hurt investment in that it would increase the tax burdens on people in brackets that generate the bulk of savings, reduce the liquidity of U.S. capital markets and discourage the supply of savings for investment, especially in those sectors of the economy where innovations will call for rising amounts of venture capital. The bill would also increase the share of tax burdens borne by business.

These longer-run implications of tax changes embodied in the House bill presently under consideration are crucial for the future of our country. For tax policy—as, indeed, all economic and financial policies—ought to be geared at increasing output, productivity and the efficiency of the economy. Continuing efforts to enlarge the entire productive basis of the U.S. economy are essential to maintain a much larger future population and to satisfy the desires of people for rising living standards. They are also essential to help redress the U.S. international trade and balance-of-payments and thus to safeguard the standing of the dollar in the world.

The Chamber endorses, therefore, the statement by the Secretary of the Treasury on September 4th that the bill "is weighted in favor of consumption to the potential detriment of the nation's productive investment." It also endorses the Secretary's statement that cuts in individual taxes—while most desirable—cannot be carried out "without due consideration for other national needs. . . . Even though this Administration is determined to pursue a prudent spending policy, we simply do not know enough about the future to commit ourselves today to the degree of tax reduction embodied in H.R. 13270."

LEGISLATIVE PROCEDURE

On August 1, 1969, the House Committee on Ways and Means completed work on this 368 page tax reform bill, H.R. 13270. In a week's time the bill cleared the House Rules Committee, was debated briefly on the floor and passed by the House Rules Committee, was debated briefly on the floor and passed one week, Members of the House could thoroughly read and digest the bill and reason through the consequences of the myriad changes embodied in H.R. 13270.

There is no historical legislative precedence where a tax bill was rushed through the House of Representatives in such a short period without ample time for study and review by legislators, businessmen and other affected parties. In a similar manner the Senate Finance Committee has agreed to have a tax reform bill ready for floor action by October 31, 1969. In our opinion the amount of time that has and will have elapsed since House passage and the October 31, 1969, target date is totally inadequate for a proper study of H.R. 13270. We wish to note for the record that all the expert opinion with which we consulted have agreed on this point. The length of the bill and the many facets of tax policy that it will change prevent a proper and studious examination of this bill for the perparation of a detailed statement to meet the October 3, 1969, deadline for submission of statements.

We note that the title of the law proposed by H.R. 13270 is the Tax Reform Act of 1969. We agree that tax reform is needed, but real constructive tax reform cannot be rushed through Congress. The term "tax reform" connotes constructive improvement in terms of equity of the tax burden and administrative simplification of our tax code. It is our contention that if H.R. 13270 is rushed to the Senate floor by October 31, 1969, it will not achieve meaningful reforms which its proponents claim it can attain. On the contrary unless enough time is allowed to study the collateral ramifications of this bill, we will end up with an even more inequitable sharing of the tax load than we now have and the Internal Revenue Service will have an administrative nightmare trying to carry out its provisions. The Committee should consider the difficulties of compliance by the majority of citizens who have in the past and will continue to do their best to pay their equitable share of taxes. A hastily enacted bill is bound to contain contradictions, omissions, and unnecessary complications which will either confuse the taxpayer or add to his expenses by forcing him to hire expert tax advice. The necessary preparation of tax forms by the Internal Revenue Service to comply with the many changes should also be considered in the Committee's deliberations of this tax bill.

There are also provisions in H.R. 13270 which provide for retroactive changes in the tax laws. To arbitrarily set an effective retroactive date after business decisions have been made based on the existing tax codes does not in any way connote "tax reform". This is another manifestation of the haste and lack of formal statutory procedure which has characterized the processing of H.R. 13270 so far. There is no national emergency, economic recession, or fiscal crisis which necessitates speedy action on a tax reform bill. On the contrary, employment has attained a new high of 78.2 millions, the business situation is quite stable, and for the first time the Federal Budget has a good chance of increasing the surplus which was achieved for fiscal 1969.

We believe that it would be a prudent and acceptable course of the Senate Finance Committee would postpone its October 31, 1969 deadline for reporting the bill as it is impracticable. It would benefit all concerned if the Committee set a target date for sometime next year. This would allow Members of Congress and other interested parties the necessary time to thoroughly analyze the many facets of H.R. 13270 and present their views to this Committee. In our view, pushing the target dae ahead to 1970 is the only way that it will be possible to come up with a bill that meets the needs of the nation by providing meaningful tax reform. Simply—"Haste Makes Waste"—and there is no justification or need for hasty Senate action on H.R. 13270.

PROPOSED 50 PERCENT MAXIMUM ON EARNED INCOME (SEC. 802)

Section 802 of H.R. 13270 is supposed to provide for a 50 percent limit on the taxation of earned income. This represents a recognition on the part of the House Ways and Means Committee that the problems to which this bill is addressing itself are created by the excessively high tax rate structure. The Committee on Ways and Means concluded that one of the most effective ways to prevent the use of established tax reducing arrangements in the employer-employee area and to forestall the development of new ones is to reduce the incentive for engaging in such arrangments by ending the abnormal progressively high tax rates on earned income. The Committee on Taxation of the New York Chamber of Commerce wholeheartedly endorses the achievement of this objective but urges that the reduction should apply equally to all income, whether earned or unearned.

Limited to earned income, Section 802 of H.R. 13270 will not allow all individuals in the above 50 percent tax brackets the benefit of the 50 percent tax rate limit. This would be the case where an individual also has other forms of income. As the proposal now reads all such other income is piled on top of the earned income for purposes of computing the tax on it. In other words, the higher the earned income, the higher it will make the tax on the other income.

We submit that the tax relief on earned income should apply equally to all income but, if not, the taxes on earned and unearned income should be computed without reference to each other. In this way the incentive to generate more earned income would not be penalized. We also submit that deferred compensation payments are earned income. Deferred compensation is usually earned by an employee over a period of several years. It is a payment for working. Therefore we recommend that the provision in Section 802 which states that deferred compensation is not to be considered earned income be deleted.

CAPITAL GAINS (SECS. 221, 301, 302, 461, 511, 514)

The committee on Taxation of the New York Chamber of Commerce is opposed to the changes in capital gains tax embodied in the above-listed provisions of H.R. 13270. The need for capital investment in manpower training and capital facilities to provide employment for the disadvantaged and also all future entrants into the labor force has never been more pressing. In addition, vast amounts of capital will be needed to carry out our extensive urban redevelopment programs. It is inconceivable, with such a need for capital investment, that changes to harmfully reduce the incentive of the investing public have been passed by the House of Representatives.

The proponents of these changes in capital gains taxation claim they are necessary in the interest of tax equity. They argue that under current law a few hundred taxpayers are able to escape their share of the tax burden and that the proposed changes in the capital gains tax provisions will make these individuals carry their share. In attempting to bring these few hundred people into the tax paying group proponents ignore the special nature of capital gains and the vital need to encourage the flow of private investment capital into the economy. The Committee on Taxation of the New York Chamber of Commerce believes everyone should pay a fair share of taxes but the measure of fairness needs to reflect the interests of the nation and the well-being of its economy and people.

Capital gains are a vital ingredient of our economic system. Equity capital has been the life blood of our economic growth. For this reason Congress saw fit over a long period to devise a set of capital gains tax provisions which would encourage the vital investment of equity capital in the business sector of our economy. The Committee on Taxation is convinced that the proposed capital gains changes in H.R. 13270 would drastically reduce the rewards of investing risk capital and thereby depress the incentive to invest.

For these reasons the Committee on Taxation of the New York Chamber of Commerce is opposed to the following tax changes in the treatment of capital gains embodied in H.R. 13270:

Section 514.—The extension of the holding period before an asset can qualify as a long term capital gain from six months to twelve months. Extension of the holding period will decrease the liquidity of investment capital at a time when there is a severe capital shortage.

Section 511.—Elimination of the 25 percent alternative tax rate for net long term capital gains in the case of individuals. In effect this is nothing more than an increase in capital gains tax rates from 25 percent to 32½ percent for a small group of high income taxpayers. This 25 percent alternative tax rate was designed

to increase the incentive of this group, which is the prime source of venture capital, to invest their capital in new and expanding businesses. This incentive to invest is still a vital and critical element of our economic system.

Section 461.—Increasing the alternative long term capital gains rate for corporations from 25 percent to 30 percent. The House Ways and Means Committee argues that this increase is necessary because of the increase in the 25 percent alternative tax on individuals (Section 511 above). There is no justification for increasing the alternative capital gains tax rate for corporations just as there is no justification for increasing the alternative capital gains tax rate for individuals. Furthermore, there are many differences in the tax laws as applied to individuals and corporations and therefore any argument that some parallel treatment is required is without merit.

Section 221.—Limitation of investment interest deduction to $25,000 over the total of net investment income and long term capital gains. As this proposal is written it discriminates against the investor who has no investment income and must pay the interest costs out of earned income. In addition to the extent that some taxpayers would lose their interest deduction, this provision is a move toward a tax on gross income.

Section 301.—Limit on tax preferences in excess of $10,000. By placing a ceiling of 50 percent on the amount of a taxpayer's total income—adjusted gross income plus the tax preferences—which can be excluded from tax, this provision of H.R. 13270 sets a bad precedent as it suggests a change in basic tax policy—a move toward taxing gross income rather than net income. In addition the Committee on Taxation of the New York Chamber of Commerce believes in no event should three of the five listed tax preferences be subject to tax. They are:

(*a*) Tax-exempt interest on state and local bonds
(*b*) The excluded one-half of net long-term capital gains
(*c*) Appreciation in property donated to charity which is deducted as a charitable contribution but not included in gross income.

Section 302.—Allocation of deductions. By making the taxpayer allocate his itemized personal deductions proportionately between his taxable income (adjusted gross income less non-allocable expenses) and his tax preference income is objectionable as it also represents a move toward a tax on gross income rather than net income. It is the type of provision which would complicate the tax laws to such an extent that the investor will not be able to reach an investment decision without the advice of tax experts. The Committee on Taxation of the New York Chamber of Commerce believes both Section 301 and 302 will deter needed capital investment in our economy.

TAX TREATMENT OF STATE AND LOCAL BONDS (SECS. 601 AND 602)

The Committee on Taxation of the New York Chamber of Commerce is opposed to any change in the tax treatment of interest income on state and municipal securities. It is not in the sphere of activity of the Committee on Taxation to offer comments on the constitutionality of the proposal in H.R. 13270 which encourages states and localities to issue bonds the interest on which would bear federal taxation. However, it should be noted that if this provision were enacted along with the Limit on Tax Preferences and the Allocation of Deductions provisions of H.R. 13270, the legal doubts under prior decisions will surely be contested in the courts. The uncertainty during the prolonged period of court procedures can only compound the confusion that these proposals have already created in the state and municipal bond market.

The economic rationale of Section 601 and 602 of H.R. 13270, which deal with the tax treatment of state and local bonds, is seriously questionable. Capital expenditures of states and municipalities are normally financed through the issuance of tax exempt securities. Today the need for increased capital expenditure by these governmental units in the attack on our number one domestic problem, the urban areas, is more pressing than ever before. Since the release of H.R. 13270, encouraging states to issue taxable securities in preference to tax exempt securities, this segment of the bond market has been in a shambles. Many states and municipalities have withdrawn or cancelled bond offerings as the successful marketing of these issues was highly in doubt. This doubt was not the result of a question of the issuer's ability to pay since the rating services gave them an excellent rating. The doubt is the result of the uncertainty of the taxable status of the interest income from these bonds because of the taxing proposals contained in H.R. 13270. Meanwhile, all the badly needed cap-

ital projects which were to be financed by the revenue from these issues have been delayed indefinitely or scrapped completely.

The Report of the House Committee on Ways and Means accompanying H.R. 13270 states that due to the increased amount of marketings of state and local bonds, the issuing authorities have been offering bonds with higher yields. As a result the Report states that high income individuals and institutions, who are the biggest buyers of these securities, have been receiving a significantly higher tax benefit than needed to bring them into the state and municipal bond market. It is ironic that House passage of H.R. 13270 has undermined the very municipal bond market which the Report claims it would strengthen in favor of the issuing agencies. The Committee on Taxation of the New York Chamber of Commerce believes that the increase in yields on tax exempt obligations is the result of temporary capital market conditions. Actually between 1963 and July 1969 the yield on state and local bonds has increased 2.51 percent as against a 2.07 percent increase in long term U.S. Governments and a 2.89 percent increase in corporate bonds.[1] Once the current inflationary pressures are brought under control and there is a return to more orderly conditions in the capital markets, these yield ratios will return to normal levels. Meanwhile the attempt to change current yield ratios by tax legislation as H.R. 13270 proposes to do is only tampering with natural market forces.

Purportedly there are two principal reasons for the proposals in H.R. 13270 to change the tax treatment of interest income on state and local bonds. The first reason is to curtail the rise in interest rates on these issues by federal subsidization of the interest payments, thereby reducing the interest costs to the issuing governmental agency. From the reaction of the investing public as evidenced by the turmoil in the municipal bond market since House passage of H.R. 13270, this bill will only create problems for the issuing agencies.

The second reason is to subject to tax the tax free interest income that a handful of wealthy individuals receive from tax exempt securities. Actually only 38 percent of tax exempt bonds now outstanding are held by individuals, and since House passage of H.R. 13270, only 10 percent of the new issues are being purchased by individuals. The majority of these people pay taxes on other forms of income and at high marginal rates because they are in high income brackets. These people chose to buy tax exempt securities which have a lower yield than taxable bond issues because of the bond's security and tax exemption. In theory if they purchased a taxable corporate bond, the tax they pay on the interest income would reduce their net return to the level of the return on a tax exempt issue. Admittedly a handful of wealthy individuals can escape taxation via ownership of tax exempt securities. However, it is inconceivable that Congress would pass a law which would seriously curtail the ability of state and local governments to raise the necessary money to meet capital expenditures just to correct a tax shelter used by a handful of wealthy people.

The price of alleged tax equity in the above situation is too high and it will only create more problems for states and localities. The principal revenue sources for these governments are income, sales, and property taxes and those receipts must be allocated to pay the operating expenses of these governmental units. These revenue sources could not possibly be considered to underwrite capital expenditures. Thus the only source for money for capital expenditures is the bond issue unless the states and localities increase their taxes. Such increased taxes would, of course, be borne in a large part, by home owners, most of whom are the middle income taxpayer that H.R. 13270 is supposed to help. Finally, encouraging the issuance of taxable bonds and taxing the interest on tax exempt obligations under the Limited Tax Preferences and the Allocations of Deductions provisions of H.R. 13270 will dry up the only source of money for these desperately needed capital projects.

FOREIGN TAX CREDIT (SEC. 431 AND 432)

United States business has the ability to compete successfully abroad and, in doing so, to resolve many problems. It has not, however, ever developed a system of overcoming double taxation. Since the nation in which income is derived has the obvious and sovereign right to tax it, the United States tax law has recognized this by providing a foreign tax credit. It has in effect many treaties with other nations in which such credit is a keystone provision and which recognized that

[1] Federal Reserve Bulletin, August 1969, page A84, Board of Governors, The Federal Reserve System.

the home country of the taxpayer must defer to the country where income is derived.

In the light of these basic facts we find the proposals regarding foreign tax credit in H.R. 13270 to be completely unacceptable. The bill, for example, in effect questions whether sovereign nations can levy income taxes above a certain rate or level and that if they do, the United States will say they were doing something other than exercising their tax authority. Would the United States which now almost totally relies on the income tax for its revenue accept this kind of challenge to its tax laws and soverignty if the facts were reversed? Obviously, it would not.

We recommend against any change in the foreign tax credit provisions and especially recommend against changes applicable only to certain industries.

NATURAL RESOURCES (SEC. 501(A))

Section 501 of H.R. 13270 calls for a reduction of percentage depletion rates on oil and gas and on certain other hard minerals, and either reduces or denies, in the case of oil and gas, percentage depletion on production from foreign mineral deposits. We do not believe such action is in the best interests of this country and we recommend against any changes in the taxation of natural resources income such as is proposed for depletion as well as the Limited Tax Preference and Allocation of Deductions provisions applicable to this type of income.

The reduction of the oil and gas rate from 27½% to 20% forms the background for the reductions in the House Bill for the other minerals. In so doing it must be recognized that, despite the political appeal, such action seriously affects a fundamental provision of our tax system which can be traced back to 1926. This is important because the allowance of percentage depletion at these levels has become fully integrated into the economics of the minerals industry, particularly the oil industry. The price structure, the methods of operation, the amount of exploration and development activity, in fact every facet of the minerals industry has developed with allowances at present levels. While critics may clamour for specific, but unavailable, hard evidence that consumers will suffer by such reductions, common sense tells us that such a fundamental change in finances of an industry will have adverse effects on the ultimate purchasers of mineral products.

In reducing or eliminating depletion on foreign deposits it must be recognized that the Bill before this Committee would place United States investors in oil and other minerals in a less competitive position abroad. Because deposits of minerals are not unlimited, an inability to compete, even for a few years, will result in a permanent loss of control to foreign developers of a part of the world's available commercial mineral deposits. Furthermore, failure to develop such deposits will have an adverse effect on the already serious U.S. balance-of-payments problem through reduced exports of U.S. equipment employed in such activities and increased reliance on imports of minerals not available in domestic deposits. It is difficult to understand these changes in foreign depletion allowances when it has been officially admitted that U.S. tax revenues would not be expected to increase if they became law.

CONCLUSION

As noted in our opening statement we found many commendable provisions in H.R. 13270 and also other provisions which we strongly oppose. The Senate Finance Committee has the opportunity to report out a bill embodying the two basic components of meaningful tax reform—a more equitable distribution of the tax burden and administrative simplification of our tax code. We submit that this formidable challenge cannot be successfully met before the current October 31, 1969 deadline for reporting out a bill for full Senate action. The Committee on Taxation of the New York Chamber of Commerce urges the Senate Finance Committee to delay final action on H.R. 13270 until 1970. By so doing the Senate Finance Committee will have ample time to work out and then to report out truly significant tax reform legislation.

CHRYSLER CORP.,
September 9, 1969.

Re H.R. 13270 (the Tax Reform Act of 1969).
Subject: Effect on formation of capital.

COMMITTEE ON FINANCE,
U.S. Senate,
New Senate Office Building,
Washington, D.C.

GENTLEMEN: Chrysler welcomes the opportunity to submit written comments with respect to H.R. 13270, the Tax Reform Act of 1969. *This particular statement is concerned with the adverse effect which certain provisions of the bill when considered together would have upon the formation of capital, especially by corporations.*

Americans have increasingly come to rely upon investment in securities of public corporations as a means of participating in our nation's economic growth, even though the income of corporations is, in effect, subject to double taxation: first, to the corporation as earned and then to the shareholder when distributed. Understandably, shareholders or potential shareholders are concerned with the after-tax profits of the corporations in which they invest, not only because dividend policies of corporations are generally based upon after-tax profits but, more importantly, because funds which are wisely reinvested have the effect of increasing the value of their stock.

The Tax Reform Act of 1969 would severely reduce after-tax corporate profits, thus adversely affecting profit accumulations and, consequently, investment in croporate securities. As Secretary of the Treasury, David Kennedy, pointed out in his testimony before the Committee on Finance on September 4, 1969, the bill contains a "bias . . . against investment in favor of consumption."

The major emphasis of the bill is not deflationary but a redistribution of wealth from individual shareholders of corporations to individuals who are not shareholders. Of the $6.8 billion in income tax relief for individuals projected for calendar year 1972, $4.9 billion would be funded through increases in corporate taxes, according to Secretary Kennedy. These increases would be derived primarily through provisions relating to (i) the retroactive repeal of the investment tax credit, (ii) a 5% increase in corporate capital gains rates, (iii) capital gains recapture, and (iv) limitations on the availability of accelerated depreciation methods. There is neither equity nor justifiable economic benefit in such a drastic siphoning of funds out of industry.

While Chrysler is cognizant of the present economic and social problems of our country, it would appear that the advantages to be derived from maintaining capital investment requires that a substantial corporate tax rate reduction be incorporated in the bill. This is especially true in view of the additional taxes imposed upon corporate taxpayers by this bill and the continued double taxation of corporate income.

Yours very truly,

BRIAN T. O'KEEFE,
Assistant Comptroller.

PHILADELPHIA BAR ASSOCIATION,
Philadelphia, Pa., October 1, 1969.

Re H.R. 13270.

COMMITTEE ON FINANCE,
Senate of the United States,
Washington, D.C.

GENTLEMEN: Set forth in this letter and the accompanying attachments are the comments of the Section on Taxation of the Philadelphia Bar Association in its study of H.R. 13270 referred to as the Tax Reform Bill of 1969.

The study made by the Section on Taxation was not concerned with the broad social economic and political considerations related to the proposed legislation. Rather the study was undertaken to determine whether the provisions of the Bill raise questions or present problems of inconsistency, omissions or unintended benefits or hardships.

The comments submitted herewith have been approved by the membership of the Section on Taxation, involving approximately 150 practicing lawyers specializing in the field of taxation. Contained in this letter are comments on three subjects of broad scope raised by the proposed legislation, namely ques-

tions of retroactivity, effective dates and special purpose legislation. In the attachments accompanying this letter are comments of a technical nature with regard to specific provisions in the Bill identified at a later point in this letter.

(*a*) *Retroactivity.*—Several of the provisions in the Bill alter considerably the taxation of investments which were committed prior to the effective date of the proposed legislation. Perhaps the outstanding example of such investments is the purchase of state and local bonds which at the time were free of Federal income taxation. Section 301(a) of the Bill, if applicable, would tax such interest notwithstanding that the indebtedness in question was acquired by the taxpayer prior to enactment and even prior to any serious proposal being offered to tax such securities. While the proposed change in law would be applicable to years beginning after December 31, 1969, the legislation is retroactive in the sense that it applies so as to materially and adversely affect an investment made prior to the effective date

Other types of transactions affected in the same manner are the equipment and real estate ownership and leasing ventures undertaken at a time when obtaining accelerated depreciation and interest deductions in the full amount available under the law were material inducements in making the investment. Our review has disclosed that economically sound ventures previously entered would be converted into a net economic loss by reason of the denial of deductions for interest and accelerated depreciation by the operation of Section 302 of the Bill (the allocation of expense proposal), and to some extent Section 221 (the limitation of interest deduction proposal) and 301 (the limitation on tax preference proposal). Subjecting accelerated depreciation on real estate assets previously acquired to full recapture in the event of sale (Section 521(b) of the bill) would also substantially change the economic feasibility of many existing real estate transactions.

In the case of all such rental transactions, the tax law made it feasible for lessors to enter into low rental deals with lessees who, by paying less rent, thereby generated more income subject to tax or, in the case of Government lessees (such as in the case of the Post Office leasing program), provided the Government with a bargain rental that was possible only because of the tax saving by reason of deducting all of the interest and accelerated depreciation related to the transaction, as well as being able to realize a capital gain on the later disposition.

With respect to all of the foregoing, the proposed changes in the tax law referred to will create an unreasonable hardship. Fundamental fairness should require that, as in the case of the repeal of the investment credit (as well as its suspension in 1966), the new rules should be applicable only with respect to transactions entered after the effective date and should exempt transactions entered prior to that time. No matter how clear the case for repeal or change in the law is, a taxpayer would be treated unduly harshly by a change in the rules after he had made economic commitments in good-faith reliance on existing law.

In Section 521 of the Bill, changes are made in the rules relating to the depreciation of real estate, but those rules are not made applicable with respect to transactions which were undertaken or committed prior to the date specified in the Bill. No satisfactory reason appears for failing to except from the operation of the following provisions of the Bill transactions consummated or property acquired, constructed, reconstructed, or erected pursuant to a binding contract entered into before a specified effective date:

(i) Limitation on deduction of interest—Section 221 of the Bill.

(ii) Limitation on tax perferences, particularly with reference to tax-exempt municipal bonds and accelerated depreciation of assets previously acquired—Section 301 of the Bill.

(iii) Allocation of deductions, particularly with reference to accelerated depreciation of assets previously acquired (as an item of preference) and interest incurred with regard to the purchase of assets previously acquired (as an allocable expense)—Section 302 of the Bill.

(iv) Accumulation trusts, relating to the taxation of prior accumulations in the case of existing trusts that would otherwise not have accumulation distributions subject to tax—Section 341 of the Bill.

(v) Real estate depreciation recapture, with respect to accelerated depreciation of assets previously acquired—Section 521 of the Bill.

The policy decision to put an end to tax shelter devices is not challenged; that is a question as to which reasonable minds may differ. However the basic inequity in altering the tax treatment of transactions entered at a time when the tax law clearly provided an incentive to make such an economic commitment is indis-

putable, particularly when persons entering into such transactions had every reason to make the good-faith assumption that the tax laws would not be changed in a manner which would substantially prejudice their position. The proposed changes in the law will not simply result in a greater tax being paid; in many instances the proposed changes will result in the investor incurring more tax than economic benefit by reason of his having made the investment. Such a set of rules should not be applied to a transaction undertaken prior to the change in the law.

(*b*) *Effective dates.*—The bill contains a variety of effective dates, many of which predate enactment and, indeed, predate the actual submission of the bill. In most of such instances, the proposed effective date coincides with the day when a Treasury Department official or a member of Congress proposed a change in the law. While many such pronouncements were widely publicized, certainly most of the general public and a substantial number of tax practitioners were not immediately informed regarding the possibility of a change in the law. Moreover, until a bill is submitted the scope of the proposed change is unclear.

In many instances the proposed changes with respect to which early effective dates are in the bill are not of the sort which should require the change to be made as of the date the proposal was first mentioned prominently. For example, a change in the installment sales rules has a proposed effective date of May 27, 1969, notwithstanding that the revenue effect of a later date would be inconsequential as a matter of national significance. To the uninformed parties who did not tailor their transactions to the revised rules, the tax hardship could be serious. To permit installment sales, for example, or for any of the more truly "loophole plugging" provisions to become effective at or after enactment will certainly not upset any established rule of propriety.

Holding to an effective date of April 18, 1969 with regard to the repeal of the investment tax credit is understandable; insisting upon an effective date prior to enactment with regard to the installment sale provision, the repeal of the alternative capital gain tax, the change in the treatment of long-term capital losses, the elimination of accelerated depreciation in the case of the acquisition of used real estate, and many other such retroactive dates serve only to create administrative problems and hardships in the case of those taxpayers who are less likely to have a continued relationship with a tax advisor, and is inconsistent with basic principles of fairness.

It is suggested that, except with regard to the repeal of the investment tax credit, the effective dates should not precede the date of enactment and in many instances should conform to more easily identifiable points in time such as the end of the calendar year.

(*c*) *Special Legislation.*—The Internal Revenue Code has been criticized for the special legislative enactments forming part of it which have nothing whatever to do with a broad-based and generally applicable set of principles dealing with the taxation of the nation's income and the distribution of its burdens. Special provisions applying broadly to farmers, small business, natural resources, financial institutions and the like are justifiable because distinctions are often appropriate to be made as a matter of national tax policy. However, the narrow attempt to make certain so-called conglomerate acquisitions less attractive, though possibly justifiable as an anti-trust measure, has no relevance as a matter of national tax policy, either from the standpoint of raising revenue or distributing its burdens.

Specifically, Section 411 of the Bill erects a set of artifically contrived rules that cannot be justified except on the basis of concluding that a line would have to be drawn somewhere. To include within the framework of a presumably broad-based taxing act a limited scope provision such as Section 411, which might not catch the "worst offenders" and has a relatively negligible revenue estimate, is not justifiable. Section 411 fails in regard to the questions of consistency, and beyond that it is not practicable to assess the potential unintended benefits or hardships that may be realized by reason of the involved standards set forth.

Attached to this letter, but an integral part hereof, are comments with regard to specific provisions contained in the Bill. The comments with respect to each of the following sections of the Bill are contained in attachments lettered as indicated below:

Section 101, "A"; Sections 211–13, "B"; Section 221, "C"; Sections 301–2, "D"; Section 331, "E"; Sections 341–42, "F"; Sections 411–14, "G"; Section 421, "H"; Sections 431–32, 452, "I"; Section 461, "J"; Sections 511, 515, "K"; Sections 521, "L"; Sections 601–2, "N"; and Section 703, "O".

The comments contained in this letter and the accompanying attachments arose out of the study undertaken by members of the Section on Taxation solely for the purpose of providing the Senate Finance Committee with the benefit of the technical knowledge and experience of the tax bar of Philadelphia. Although a variety of viewpoints with regard to the wisdom of the proposed changes has been expressed by the members of the Section, no attempt was made to evaluate the Bill in terms of its political, social or economic aspects. The indulgence of your Committee and staff in reviewing the comments would be greatly appreciated.

We hope that these comments will be of benefit to the Committee, and if further elaboration is considered desirable, please do not hestitate to call upon the Section.

Very truly yours,

JOSEPH W. PRICE III,
Chairman.

COMMENTS RELATING TO SECTION 101 OF H.R. 13270

(a) Section 4943—Uncertainty in voting percentage test

The permitted holdings by a private foundation in a business corporation is limited to "20 per cent of voting stock." How is that percentage to be determined? Are options to purchase shares, conversion privileges into or out of voting shares, and similar share potentials to be considered?

We would favor considering maximum option exercises in determining outstanding shares, but in any event we suggest that some clear-cut rule be adopted.

(b) Section 4943—Disposal of excess holdings

The provisions of Section 4943 appear to infer that a foundation must dispose of shares to reduce its holdings to the required maximum percentage of voting stock. Why is the foundation required to "dispose" of shares to reduce its holdings, when its holdings can be reduced in other ways? For example, can the issuance of additional shares or reduction in proportionate voting by the foundation's shares satisfy the reduction requirement? If such methods of reduction are considered permissible, the Bill or committee report should so state; if such methods of reduction are not considered permissible, that intention should also be clarified and hopefully reconsidered.

(c) Section 2055(e)—Estate tax deduction

The blanket denial of deduction for certain charitable bequests does not take into consideration the existence of irrevocable trusts providing gifts to charity, where the corpus will be included in the decedent's gross estate because of retained interests, etc., but no deduction is allowed under the Bill. Similarly, existing wills of decedents who will die shortly after enactment may provide for a pour-over to an existing trust that provides for a charitable gift that will not be deductible.

In each of the foregoing cases the parties may be powerless—either legally or practically—to change the terms of the trust. Some relief should be afforded by exempting trusts which cannot legally be altered and by providing a one-year transition period to get wills straightened out.

(d) Section 642(c)—Amounts set aside for charity

The Bill proposes to repeal the deduction for amounts set aside by an estate to make gifts to charity. Since typically estates make no distributions during administration, estates should be permitted to deduct such accumulations since otherwise all income during probate would be subject to tax.

Where a trust provides for income payments to an individual for life with the remainder going to charity, capital gains allocable to corpus (and hence not includible in distributable net income) would be subject to tax.

The deduction now permited by Section 642(c) should be continued for amounts not includible in distributable net income.

(e) Section 509(a)(3)—Definition of a private foundation

The Bill excludes from the definition of a private foundation organizations which are organized and operated exclusively for the benefit of a so-called 30 per cent charity under existing law, provided that the organization is "operated, supervised or controlled by" a so-called 30 per cent organization and it is not controlled by a disqualified person. The terms "operated, supervised or controlled" are not defined in the Bill and the Committee Report does not clarify the intended use of the terms except to refer to certain examples of organizations expected to qualify.

Because the functioning of the organization is stated in the disjunctive, each of the words "operated, supervised or controlled" requires a definition, or as a minimum the functions of the private foundation which are to be subject to supervision or control should be set forth. In view of the fact that the major thrust of the changes in regard to private foundations has to do with insuring the proper use of funds and the channeling of such funds to appropriate organizations, it is suggested that the definition be addressed to those objectives.

Accordingly, in view of the fact that subsection 509(a)(3)(A) requires the organization to benefit a public charity, it would seem that the "control" test should be met if the public charitable organization has responsibility for control and investment of funds, notwithstanding that the designation of the specific charitable beneficiary would be determined by a person other than an organization described in subparagraphs (1) or (2) of Section 509(a). This is certainly the case when all of the income of the foundation is to be disbursed for charitable purposes annually and the period of time during which principal may be retained by the foundation is limited by an ascertainable standard.

It is recommended that subsection (c) be added to Section 509, to read as follows:

> "(c) RULE FOR APPLYING PARAGRAPH (a)(3)(B).—In applying subparagraph (B) of paragraph (a)(3), an organization is operated, supervised, or controlled by an organization described in paragraph (1) or (2) if the following conditions are met:
>
> "(1) all of the income of the organization is required to be distributed annually; and
>
> "(2) the assets are held, and the investment and disbursement thereof are supervised, by one or more organizations described in subparagraph (1) or (2) of paragraph (a)."

COMMENTS RELATING TO SECTIONS 211, 212 AND 213 OF H.R. 13270

(a) Section 1251(d)—Application to subchapter S corporations

In the case of a partnership, proposed Section 1251(d)(5) provides that each partner is to take into account separately his distributive share of items of the partnership which are relevant under this section. Why is there no similar provision made for Subchapter S corporations?

A new subparagraph should be added to Section 1251(d) to provide that, in the case of a Subchapter S corporation, each shareholder's share of items which are relevant to the application of Section 1251 should be taken into account separately by him, and then the limitations of Section 1251(b)(2) should be applied at the individual level.

(b) Section 1251(b)3—Carryback of farm net losses

Where a taxpayer has an income from farming operations for one or more years and then has a farm net loss within the meaning of proposed Section 1251(e)(2), the Bill would apparently require the addition of the farm net loss to the excess deductions account if the net loss was either offset against non-farm income for the same year, or if the loss was carried back and offset against income from farming operations during the three preceding years.

This causes an unintended hardship, for example, in the case where a taxpayer realizes farm net income during the first year to which proposed Section 1251 applies, and in the second year realizes a farm net loss which offsets non-farm income for that year. That taxpayer will be required to add the farm net loss to his excess deductions account, without any reduction in that account for the farm net income realized in the previous year. However, if, for instance, a farm net loss was incurred in the first year to which proposed Section 1251 would apply, and then the taxpayer had offsetting farm net income in the following years, the excess deductions account would be eliminated. Obviously, the result should not depend on the sequence of the loss and profit years.

We would suggest that the following new subparagraph (C) be added at the end of proposed Section 1251(b)(3) (after deleting the word "and" at the end of subparagraph (A) and inserting it at the end of (B)):

> "(3) * * * there shall be subtracted from the account—
>
> * * * * * * *
>
> (C) an amount equal to the farm net income for any year to which a farm net loss could have been carried back under Section 172 (relating to the net operating loss deduction)."

(c) Sections 1251(b)(5)(A) and 1251(d)—Transfers to controlled corporations

Taking into account the effect of proposed Sections 1251(b)(5)(A) and 1251 (d), there is a seemingly unfair result to an individual who transfers his farming business to a controlled corporation.

Although proposed Section 1251(b)(5)(A) does not provide for the transfer of the excess deductions account to a corporation in a Section 351 transaction, proposed Section 1251(d)(3) does provide that there will be no gain recognized, generally speaking, on the disposition of "farm recapture property" in a Section 351 transaction. Rather, proposed Section 1251(d)(6) seeks to tax the gain following a Section 351 transaction by treating a proportionate amount of the stock received in a Section 351 transaction as "farm recapture property."

The inference from these provisions seems to be that if an individual transfers his farming business to a controlled corporation under Section 351, he himself would retain the excess deductions account, and his corporation would create one only if it subsequently experiences farm net losses. We believe that it would be more equitable to provide for a transfer of the excess deductions account to the corporation, so that subsequent farm net income from the transferred business could be used to reduce or eliminate the excess deductions account. This particularly should be so where the proprietor of the farm business is the controlling shareholder of the transferee corporation (i.e., in situations where there are no other transferors who join in the plan of reorganization). To accomplish this result, we suggest that the references, in proposed Section 1251(b)(5)(A), to Section 371(a), 374(a) and 381 be deleted and that proposed Section 1251(d)(6) be deleted in its entirety.

(d) Section 1251(d)(5)(B)—Gain on transfers to partnerships

Although Sections 1245 and 1250 of the present law (on depreciation recapture) provide that no gain is to be recognized under those sections to a contributing partner if Section 721 applies, proposed Section 1251(d)(5)(B) inconsistently, and we believe inequitably, requires the recognition of ordinary income to a partner under Section 1251 upon his contribution of farm recapture property to a partnership, so long as the other partners contribute no farm recapture property or contribute farm recapture property having a lesser value. Under proposed Section 1251(d)(5)(B), it will only be the well advised taxpayer that will be able to avoid recognition of gain on the contribution by including in his partnership agreement a provision allocating to the contributing partner all gain upon the disposition of farm recapture property contributed by him.

As [illegible] previously suggested in the case of the transfer of farm recapture prop[illegible]y to a controlled corporation, we, here, also suggest that no gain be recognized on the transfer of farm recapture property to a partnership, but rather that proposed Section 1251(b)(5)(A) be amended to provide for the carryover of the excess deductions account to the partnership. Proposed Section 1251 (d)(5)(B) would be amended accordingly, and would also add that any gain in the subsequent disposition of the farm recapture property could, if so provided in the partnership agreement, be allocated exclusively to the contributing partner. This suggestion would allow any excess deductions account inherited from the contributing partner to be eliminated by subsequent farm net income. This result, we believe, is more equitable than requiring a partner to recognize gain, even though subsequent farm net income is sufficient to eliminate the excess deductions account of the partnership or of the contributing partner.

(e) Section 1251(e)(2),(3)—Application of net operating loss deduction to definition of farm net income and farm net loss

The definition of farm net income in the Bill is simply the excess of the gross income derived from the trade or business of farming over the deductions allowed or allowable by *Chapter 1* which are connected with that business. Literally, a net operating loss deduction arising from a carryback or carryover of a net loss from a subsequent or preceding year, would be a deduction allowed by Chapter 1 and would reduce farm net income for the current year.

This result is presumably unintended since the loss itself in the year of origin would result in an addition to the excess deductions account. We recommend that proposed Section 1251(e)(2)(A) be amended to exclude deductions in Chapter 1 allowable under Section 172 (net operating loss deduction).

(f) Section 1251(e)(4)—General definition of farming

We believe that a general definition of "farming," now absent from the Bill itself and from the House Ways and Means Committee report, is appropriate. Although such a definition is not necessary in the Bill itself, we suggest that

the definition presently contained in Sections 1.61-4(d) and 1.174-3 of the Regulations be incorporated at the appropriate place in the report of the Senate Finance Committee.

(g) Section 1251—Effective dates

We suggest that the effective date provisions of the Bill be clarified in the Senate Finance Committee's general and technical explanations to indicate that:

1. Deductions allowable with respect to farm land under existing Sections 175 and 182 for taxable years beginning before December 31, 1969 do not have to be taken into account for purposes of proposed Section 1251(e)(3).
2. If our proposal is adopted to change proposed Section 1251(b)(3) to allow farm income for a preceding year to be taken into account in reducing an excess deductions account, then only farm net income for years beginning after December 31, 1969 should be taken into account.

(h) Section 1231(b)(3)—Clarification of definition of livestock

Proposed Section 1231(b)(3) refers to "livestock" held "at least 365 days after such animal normally would have first been used" for draft, breeding, sporting, or dairy purposes. We believe that there must be some clarification regarding the precise date that the holding period begins.

We suggest that the Senate Finance Committee's report provide that the Regulations will incorporate certain presumptions as to the time or age at which animals of various breeds will normally be considered to be usable for draft, breeding, sporting or dairying purposes.

(i) Section 270—Use of the term "activity"

Proposed Section 270 discards the phrase "a trade or business" in present Section 270 in favor of the term "activity." We do not understand why this change was made, unless the term "activity" is intended to cover activities described in existing Section 212.

We believe also that the use of the term "activity" coupled with the elimination of the exception in the present Section 270 for "specially treated deductions," creates additional confusion. The proposed amendment to Section 270 is so broadly worded that the Service could contend that the deduction of items such as interest and taxes, if attributable to a business or other activity which the Service thought was not carried on with an expectation of making a profit, could be disallowed even though they are expressly deductible under Code sections other than 162 and 212.

We suggest that the word "activity" be deleted throughout the new Section 270 and that the phrase "trade or business or an activity described in Section 212" be reinserted. We also recommend that the following new subsection be added to Section 270:

> "(c) LIMITATION.—Nothing in this section would prevent the deduction of any item which is otherwise deductible under the provisions of this Chapter whether or not it is connected with the carrying on of a trade or business or with an activity in Section 212."

COMMENTS RELATING TO SECTION 221 OF H.R. 13270

(a) Section 163(d)(4)(A)—Limitation on partnerships

Since the provisions of proposed Section 163(d)(4)(A) are to apply at the partnership level, the result that will follow with regard to certain partnerships is that where the partnership suffers a loss, interest expenses will be deductible only to the extent of $25,000 and that amount will have to be allocated among all the partners even though there may be a substantial number of them. Thus, the partners would not be able to deduct their proportionate share of the interest expense even though they had other net investment income or long-term capital gains.

Especially in view of the fact that an individual's proportionate share of a partnership loss would reduce other investment income, this result appears unduly harsh, and we recommend that proposed Section 163(d)(4)(A) be deleted.

(b) Section 163(d)(1) & (2)—Order of applying carry forwards of disallowed investment interest

Both proposed Sections 163(d)(1) and (2), and the proposed amendment of Section 1202 cannot be properly applied unless there is clarification whether in-

vestment interest is allowed first in the amount of $25,000, then in the amount of the net investment income, and lastly, in the amount of net long-term gain, or in some other manner.

We recommend that the Bill specify the order of allowance of investment interest, and specifically substitute the following language for so much of Section 163(d)(1) as precedes subparagraph (a):

"(1) IN GENERAL.—In the case of a taxpayer other than a corporation (except an electing small business corporation as defined in Section 1371(b)), the amount of interest allowable as a deduction shall be limited to the sum of the following amounts and shall be allowed in the following order—. . ."

(c) Section 163(d)(3)(A)—Uncertainty in definition of investment income

No provision is made in the Bill's definition of investment income for the inclusion of recapture income with respect to property such as rental property or a franchise which may give rise to investment income. But for Sections 1245, 1250 or proposed Section 1252 these amounts would be capital gains and presumably the type of income which it was intended could be offset by investment interest. We recommend that the Bill be amended to so provide.

Proposed Section 163(d)(3)(A) does not make it clear whether tax exempt interest qualifies as "interest" and, therefore, investment income. If it does not, then it is not clear whether that portion of tax exempt interest required to be taxed by Bill Section 301 relating to limit on tax preferences would qualify as investment income. The Bill should be amended to specifically provide that all includible income from interests is included in investment income.

The Bill includes in investment income net short-term capital gains only if they are derived from the disposition of property held for investment, while, no such limitation is placed on income from interest, dividends, etc. Furthermore, the question of whether investment is to be distinguished from "speculation" arises. We recommend that the Bill be amended so that the only limitation on investment income is to income not derived from a trade or business, and this limitation should apply equally to all items.

An amended Section 163(d)(3)(A) should be rewritten, as follows, to effect the three recommendations made above:

> "(A) INVESTMENT INCOME.—The term 'investment income' means the gross amount of includible income from interests, dividends, rents and royalties, recapture income described in Sections 1245, 1250, 1251 and 1252, and net short-term capital gains derived from the disposition of property but only to the extent that such gross income or such gains are not derived from the conduct of a trade or business."

(d) Section 163(d)(3)(B)—Reduction of investment income by nondeductible expenses

Investment expenses are defined in the Bill as all deductions allowable under Section 164(a)(1) or (2), 166, 167, 171, 212 or 611 directly connected with the production of investment income. However, the Bill fails to take into account those expenses which, pursuant to Section 302 of the Bill relating to the allocation of deductions, are not deductible. It is not presently clear whether or why investment income should be reduced by such expenses.

We recommend a revision of Section 163(d)(3)(B) to make it clear that otherwise deductible items, which are disallowed under proposed Section 277 are not included in investment expenses.

(e) Section 163(d)(3)(D)—Uncertainty in definition of investment interest

The definition of investment interest fails to advise the taxpayer how substantial the motive to "purchase or carry property held for investment" must be. Must the indebtedness be incurred solely to purchase investment property, or need the desire to purchase investment property be only one of a number of motives. We recommend that there be a requirement that the motive to carry property held for investment be the primary motive for incurring the debt.

The provision should also be clarified to recognize the possibility that all "investment income" need not always arise from "investment" property; it may also arise from property held for the production of long-term capital gains.

COMMENTS RELATING TO SECTIONS 301 AND 302 OF H.R. 13270

(a) Section 277—Need for basis adjustment

While proposed Section 218(c) provides that disallowed tax preferences attributable to Section 1250 property and to certain farm net losses increase the

basis, for the purposes of determining gain or loss on the sale or other disposition of the asset to which they relate, there is no corresponding adjustment to take into account the disallowance attributable to allocating a portion of the taxpayer's expenses to that portion of the accelerated depreciation which has not been taken into income.

We believe that the failure to provide for a basis allocation in the case of a disallowance under Section 277 is inconsistent with the basis adjustment provided in the similar situation of disallowed tax preferences. Moreover, a failure to provide a similar adjustment in connection with amounts disallowed under Section 277, to the extent ordinary income is realized on a later sale of the property, will result in what we regard as unintended double taxation.

(d) Sections 84 and 277—Adjustment for interest on debt incurred to carry tax-free obligations

In both the Bill Section relating to the limitation on tax preferences and the Section relating to the allocation of deductions, tax exempt interest is treated as a net amount after reduction by the amount of any deductions for expenses applicable to tax exempt income which are disallowed under Section 265(a)(1). No reduction is provided, however, for interest on indebtedness incurred or continued to purchase or carry tax exempt obligations, which is disallowed as a deduction under Section 265(a)(2). We do not understand this distinction nor do we think that such a distinction is logical.

We recommend that both proposed Sections 84 and 277 be revised to define tax exempt interest as the net amount after reduction by both the amount of any deductions for expenses applicable to tax exempt income which are disallowed under Section 265(a)(1) and for interest on indebtedness incurred or continued to purchase or carry tax exempt obligations, which is disallowed as a deduction under Section 265(a)(2).

Comments Relating to Section 331 of H.R. 13270

Section 1354(a)—Need to aggregate all deferred compensation payments

While proposed Section 1354(a) provides a minimum tax on deferred compensation payments in excess of $10,000, it does not make it clear that deferred compensation payments from all sources received by an individual during any taxable year are to be aggregated, and that the minimum tax is to apply to the excess of the aggregate over $10,000. We suggest that the proposed section be adjusted to so provide.

Comments Relating to Sections 341 and 342 of H.R. 13270

(a) Sections 665 through 669—Effective date provisions and burdens of compliance

While we believe that the unlimited throwback rule is extraordinarily complicated, and would make the administration of trusts accumulating income for perfectly legitimate family reasons extremely difficult, cumbersome, and expensive, we recognize that this is a broad question of tax policy, and will make no suggestions on the overall revision. However, the effective date provisions of Bill Section 341 seem objectionable in that they would operate retroactively with respect to income accumulated during the past five years when neither the trustee nor the beneficiary had any notice of the need to keep records by reason of a distribution of accumulated income which might be made at some further time, e.g., upon attaining majority of a beneficiary who now happens to be five years old.

It is suggested that the effective date provisions be modified, so that the new rules would apply only to transfers in trust made after the effective date of the Bill, or alternatively, that they would apply only to income accumulated after such date.

(b) Section 668(b)(2)(B)—Restriction on use of "exact" method by unborns

The Bill provides that if a beneficiary was not yet born, with respect to a year to which part of the trust income which is distributed relates, the so-called "exact" method of computation may not be used. We see no reason why a beneficiary who was not alive for the entire period of accumulations cannot use the "exact" method at least with respect to those years during which he was alive.

We suggest that this discrimination be corrected.

(c) *Section 677—Accumulations for benefit of a grantor spouse*

In view of the unlimited throwback rule, it seems that this provision is of little significance. It is, therefore, questionable whether the complexities, which this provision may generate in situations where there is a lack of family harmony by taxing the husband on income payable to the wife, is justifiable.

In view of the proposal for the adoption of an unlimited throwback rule, it is suggested that the proposed amendment of Section 677 is not warranted.

COMMENTS RELATING TO SECTIONS 411, 413, AND 414 OF H.R. 13270

(a) *Section 279(c)(2)—Use of adjusted basis of assets in ratio of debt to equity*

The ratio of debt to equity has long been used as an aid in determining whether certain securities were debt or equity. As pointed out in the Report of the House Committee on Ways and Means, the debt-equity structure of a corporation helps one decide whether it is reasonable to expect the corporation to meet its obligations to pay the principal and interest on the bond or debenture when due.

Proposed Section 279(c)(2) determines this ratio by valuing the assets at their adjusted basis. There seems to be little justification for using adjusted basis in an attempt to determine whether or not an issuer can make good.

We suggest that proposed Section 279(c)(2) be revised to change the valuation of assets in determining the debt-equity ratio from "adjusted basis" to fair market value.

(b) *Section 279(f)—Definition of "sources without the United States"*

We suggest that, for purposes of clarity, proposed Section 279(f), containing an exemption in the case of certain acquisitions of foreign corporations where substantially all of the earnings of the acquired corporation for the three year period preceding the acquisition is from "sources without the United States", should contain a reference to the appropriate definition under Subchapter N.

(c) *Section 1232(a)(3)(B)—Original issue discount in the hands of donees.*

While this provision provides rules relating to the treatment of original issue discount by the purchaser of a bond, no such rules are provided for a donee or legatee.

We suggest that proposed Section 1232(a)(3)(B) be revised to determine any appropriate adjustment for previously included original issue discount in the hands of donees and legatees.

(d) *Sections 6049(a)(1) and 6049(c)—Reporting requirements*

The reporting requirements of this provision, as now written, are only relevant to the original holders of bonds with original issue discount. The reporting requirements do not take cognizance of the fact that subsequent owners will report as income amounts different than would an original owner.

We suggest that the reporting requirements be amended to reflect the fact that the payor corporation will report to the Service amounts which may be a variance with those which a subsequent holder will report as income.

(e) *Section 249—Clarification of "a normal call premium"*

Proposed Section 249 limits the premium deduction on the acquisition of an issuer's convertible indebtedness to "a normal call premium." However, the statute does not define what "a normal call premium" is.

We suggest that a definition of the term "a normal call premium" be added to proposed Section 249.

COMMENTS RELATING TO SECTION 421 OF H.R. 13270

(a) *Section 305(b)(2)—Extent to which stock dividends shall be taxed*

The proposed statutory language, literally read, would tax the full amount of the stock distribution received by shareholders whose proportionate interests in assets or earnings and profits were increased, even though only part or even none of the stock distribution directly increases such proportionate interests. Thus, if a common stock dividend is distributed on one class of stock and both common stock and cash dividends are simultaneously distributed on another class of stock, not all of the stock distributed on the first class has the effect of increasing the recipient shareholders' proportionate interests in the assets or earnings and profits of the corporation. Another example would occur if a common on common dividend were distributed at the same time as a cash dividend on preferred stock,

in which instance the common shareholders' interests in the net assets of the corporation might be considered to have been increased, not by reason of the distribution of common stock but rather by reason of the cash payment to the preferred shareholders. Presumably no tax on the common stock distribution is intended in such a situation.

We suggest that under proposed section 305(b)(2) stock dividends be treated as distributions of property to which section 301 applies only to the extent that the stock distribution itself causes an increase in the proportionate interests of the recipients.

(b) Section 305(b) (2)—Uncertain meaning of "proportionate interests . . . in the assets or earnings and profits"

Broadly speaking, the term "proportionate interests" may refer either to the relative interests of shareholders of different classes in the existing net assets of the corporation as of the moment of the distribution, or to the relative sizes of the potential claims which the shareholders of different classes may have against future assets or earnings of the corporation in the event of dividend or liquidating distributions.

If the former test is adopted (i.e., the relative interests of the shareholders in the earnings and profits or assets of the corporation on the date of the distribution), the question arises whether book values or fair market values of the corporation's assets are to control in making the necessary measurements. Additional problems may develop concerning the treatment of convertible securities or stock purchase rights in measuring proportionate interests.

If the proportionate interests in assets or earnings are to govern, it may be doubly difficult to determine the effect of convertible stock or stock rights, if the conversion or exercise price exceeds the current value of the subject stock. In such an instance, it may be uncertain at the time of the distribution whether there ever will be an alteration in the proportionate interests of shareholders. A corresponding problem could arise upon the distribution of a class of stock which participates in future earnings or liquidation proceeds only when such earnings or proceeds exceed certain levels.

In an effort to achieve greater certainty, we suggest that the test be based on proportionate interests in the corporation's assets (at fair market values) or earnings and profits as of the time of distribution instead of proportionate interests in potential assets or future earnings. We further recommend that in measuring such proportionate interests all conversion privileges and rights to purchase stock be deemed to be exercised unless the conversion or exercise price exceeds the fair market value of the subject security by more than 10%.

(c) Section 305(b)—Circular treatment of section 306 stock

Under existing section 306(c)(1)(A) the term "section 306 stock" includes stock received in a distribution, any part of which was not includible in gross income by reason of section 305(a). Under the proposed legislation, however, in order to determine whether a stock dividend is excluded from gross income under section 305(a), it may be necessary in applying the tests of section 305(b) to know whether the distributed stock is section 306 stock.

While it does not matter how this circle is broken from the standpoint of achieving certainty in application, it might be noted that taxation of dividends in preferred stock at the time of distribution under section 305(a) would render section 306 inoperative with respect to most of the distributions now covered by it. On the other hand, leaving such distributions in preferred stock untaxed under section 305 would create an anomolous situation where distributions of common stock might be taxed under section 305 whereas simultaneous distributions of a "senior" preferred stock would not.

(d) Section 305(c)

This section is a broad authorization to the Treasury to prescribe Regulations under which certain changes in conversion ratio, changes in redemption price, and redemptions will be taxed as dividends to those stockholders whose proportionate interests in earnings and profits or assets are increased thereby.

The potential scope of the authorized Regulations is quite broad and could well exceed that which is necessary to cope with abuses of the type outlined in the House Committee Report. For example, the proposed statutory authorization would not only permit the Regulations to tax certain shareholders in connection with periodic redemption plans (which the House Committee Report suggests may have the effect of cash and stock dividends on different classes of stocks),

but also would seemingly permit taxation of a non-redeemed shareholder in some instances when another shareholder is redeemed in a "one-shot" realignment of the shareholdings in the corporation. The harshness of the tax result in this and other redemption situations is accentuated in cases where shares have been redeemed for an amount equal to or exceeding their pro rata share of the value of the corporation's net assets, so that the remaining shareholders have either not increased, or have suffered a decrease in, the value of their holdings, even though their proportionate interests in the corporation have increased.

Similarly, whereas annual changes in the conversion ratio or redemption price of a security might indicate a disguised stock dividend, convertible preferred stock may be issued under terms provided for only one or two conversion changes or changes in redemption price during the life of the stock, these changes being designed to encourage conversions at an early date with the objective of simplifying the corporation's capital structure. It is doubtful that the proposed legislation is intended to tax such changes as dividends to the shareholders whose interests may be favorably affected thereby.

We suggest that the proposed legislation, or at a minimum the Senate Finance Committee Report, more clearly delineate the scope of the new rules. Thus, in connection with stock redemptions section 305 may be limited to redemptions pursuant to periodic redemption plans or redemptions involving 10% or less of the shareholdings of the redeemed shareholders. Provisions for changes in conversion ratios or redemption price designed to have the effect of disguised dividends should be distinguished from similar provisions designed with other goals in mind.

(*e*) *Section 317(a)*

The proposed amendment to section 317(a) (and a corresponding change in section 305(a)) was intended to cause all stock dividends on preferred stock to be taxable. The Report prepared by the Staffs of the Joint Committee on Internal Revenue Taxation and the Committee on Finance (August 18, 1969), at page 63, indicates that an exception was intended to this rule to permit anti-dilution distributions on convertible preferred stock to be received tax-free. The proposed statutory language should be atlered to admit such an exception.

(*f*) *Effective date provisions—unfairness of January 10, 1969, effective date*

Despite the promulgation on January 10, 1969 of Treasury Regulations providing in substance for several of the proposals embodied in the House Bill, it is quite possible in view of the controversial nature of these Regulations that distributions may have been made after January 10 which would have been taxable under the Regulations but which were made with the conviction that the Regulations were broader than permitted by the statute. Moreover, the January 10, 1969 Regulations do not appear to correspond in all respects to the proposals in the House Bill. Since there is substantial doubt as to the interpretation, scope and even validity of certain provisions of the January 10, 1969 Regulations, it seems unduly harsh to make the effective date of any provisions of the proposed legislation retroactive to that date.

COMMENTS RELATING TO SECTIONS 431, 432, AND 452 OF H.R. 13270

(*a*) *Section 904(a)—violation of treaty law*

In requiring an adjustment of the foreign tax credit limitation, in a year where income is derived from a country in which a loss was previously incurred, the drafters of the Bill apparently overlooked the fact that the proposed amendment may well violate many tax conventions with foreign countries. In most of the tax conventions, the United States had consented to give credit for the taxes imposed by the other state. As a matter of treaty law, the credit to be given is based upon the Revenue Act in force at the time the tax convention becomes effective.

The proposed amendment would result, under certain circumstances, in a unilateral abrogation of United States treaties, an unintended result that the Senate Finance Committee should be made cognizant of.

(*b*) *Section 904(g)—Effect in civil law countries*

We believe that the House of Representatives, in approving Section 432 of the Bill, designed to place a limitation on the foreign tax credit paid on "foreign mineral income", was not aware of the scope of the change they were making. The apparent reason for the Bill was that certain foreign income taxes imposed on mineral income should be considered royalties and should not give rise to

foreign tax credit. However, under civil law, which law governs most of the countries of the world, mineral rights are owned or controlled by the sovereign. Since proposed Section 904(g) would limit the foreign tax credit if a foreign government holds substantial mineral rights with respect to the property, the amendment may well deny substantial credits to United States companies even though there is no royalty incurred in the foreign taxes paid.

We believe that this amendment represents an unwarranted discrimination against a certain class of foreign income and should be deleted.

(o) *Section 312(m)—Effect of the change in earnings and profits on foreign source income*

The proposed amendment of Section 315 of the Code, to provide for the computation of earnings and profits based on straight line depreciation has an unusual and unintended effect, we think, on the taxation of income derived by United States taxpayers from foreign sources. If the computation under present Section 902 of the Code, are modified by proposed Section 312, the following unintended changes will take place in the amount allowable as foreign tax credits. For example:

1. Foreign tax credits will decrease as foreign earnings and profits increase;
2. United States shareholders with subpart F income may have income which they would not otherwise have attributed to them;
3. Domestic corproations with subpart F income would have increased income and decreased tax credits; and
4. "Greater" minimum distributions will be required of subpart F income.

It is suggested that the amendment of Section 312 be reconsidered in the light of its effect on subpart F income and the amounts of foreign tax credits allowed, and if the results mentioned above are not intended, proposed Section 312(m) should specify that it is inapplicable to foreign companies.

Comments Relating to Section 461 of H.R. 13270

Section 1201(a)—Need to clarify effective date

Bill Section 461(c) indicates that the amendment increasing the corporate capital gain rate from 25% to 30% is intended to apply to "sales and other dispositions after July 31, 1969". Assuming that the aforesaid language refers to the transaction and not the accounting method (or other method of reporting) which governs, it is too broad and at best is open to various interpretations. For example, are payments received pursuant to an installment sale made before July 31, 1969, taxable at 25% even though the payments are received after July 31, 1969.

The Bill should be amended to make it clear whether July 31, 1969 is supposed to be a cut-off date only as to an actual "sale" or "other disposition" made after that date, or is intended to apply to any gain recognized after that date, even if attributable to a sale or other disposition prior to August 1, 1969.

Moreover, we think the effective date language should be amended to clarify the fact that the date is a cut-off date as to all transactions which are not, strictly speaking, a sale or exchange but which necessitate the recognition of capital gain—e.g., liquidation distributions.

Comments Relating to Sections 511 and 515 of H.R. 13270

(a) *Section 1201—Need for standards regarding 1969 allocation*

Bill Section 511(c) provides that for taxable years beginning before and ending after July 25, 1969, the alternative tax shall be computed in a manner prescribed by the Secretary of the Treasury or his delegate. In the absence of some congressional standards to be applied to the transitional year, we believe that this delegation to the Secretary of the Treasury to prescribe rules is an improper delegation of authority. In acting pursuant to the aforesaid delegation, the Secretary or his delegate may be promulgating substantive rules rather than interpreting congressional language.

We recommend that the Bill be amended to provide substantive language to deal with the computation of the capital gains tax in the transitional year.

(b) *Section 402(a) and 403(a)(2)—Use of the term "benefits accrued"*

Both proposed Section 402(a)(5) pertaining to distributions from qualified trusts and proposed Section 403(a)(2)(C) pertaining to qualified annuity plans

use the phrase "benefits accrued" as of a cut-off date in connection with the determination of that portion of a distributee's account which will retain capital gain status on distribution.

We submit that the phrase "benefits accrued" is ambiguous when used for plans other than a profit-sharing plan or a money purchase pension plan. In an ordinary pension plan, a layman might think the term referred to the cash sum then held under the method of funding utilized by the particular plan, but to benefit planners and actuaries, the term normally refers to a hypothetical amount which ought to have been funded by the date in question, depending upon the method of funding, varying from a complete deposit of the total amount necessary to provide the pension in advance, to no deposit at all, but rather a mere current pay-out of pension benefits. For this reason, it is suggested that the term "benefits accrued" be clarified.

One suggested solution is to define "benefits accrued" in terms of one or more of the funding methods which contemplate level costs or payments for the entire working career of the employee, whether or not the monies have actually been deposited. The alternative solution of according the relief simply to assets on hand at the cut-off date, appears to us unfair since the result to the employee would largely depend upon the funding method selected by his employer.

Comments Relating to Section 521 of H.R. 13270

(a) *Section 167(k)—Definition of "low-cost rental housing"*

The proposed new subsection (k) to be added to Section 167 (relating to depreciation) provides for accelerated depreciation of rehabilitation expenditures in connection with "low-cost rental housinig". The definition of "low-cost rental housing" contained in Section 167(k)(3)(B) refers to dwelling units held for occupancy on a rental basis by families of "low or moderate income, as determined by the Secretary or his delegate in a manner consistent with the policies of the Housing and Urban Development Act of 1968". The Housing and Urban Development Act of 1968 and predecessor acts have used the terms "low income", "lower income" and "low or moderate income" for various special programs. The term "low or modern income" does not appear in earlier Housing and Urban Development legislation. For these reasons, it is submitted that the definition of "low-cost rental housing" proposed for purposes of the special depreciation deductions to be allowed in the case of rehabilitation expenditures is inadequate.

The term should not be so vaguely defined in the statute as to leave the Secretary of the Treasury with the responsibility of determining the policies of the Department of Housing and Urban Development. This definition should be made more precise after consulting with the staff of the Subcommittee on Housing and Urban Affairs and representatives of the Department of Housing and Urban Development.

(b) *Section 167—Need for redesignations of subsections*

Bill Section 521(a) amends Section 167 of the Code by redesignating subsection (j) as subsection (n) and by inserting after subsection (i) new subsections (j) and (k). This would leave the lettering of subsections to run from (a) through (n) without any subsections (l) or (m). Neither the Committee Report nor the Bill make reference to the fact that new subsections (l) and (m) are proposed to be added to Section 167 by Sections 451 and 705 of H.R. 13270 respectively. This may cause technical difficulties if Section 521 is retained in tact and Sections 451 and 705 (or either of them) are rejected before final passage.

This should be corrected by adding at the end of line 7, page 300 of H.R. 13270 the following: "to follow subsection (m) (added by Section 705)".

(c) *Section 167(j)(3)—Reference to present section 48(h)*

Proposed Section 167(j)(3) contains a provision for the adoption of regulations "similar to the rules provided in paragraphs (5), (9), (10) and (13) of Section 48(h)", to be applied for purposes of that paragraph which excludes property from the new depreciation rules where construction was begun or a binding contract for construction was entered into before July 25, 1969. Paragraphs (5), (9), (10) and (13) of Section 48(h) contained transition rules for plant facilities, certain disregarded transfers (principally transfers where the basis of the property carries over to the transferee), property acquired from affiliated corporations and certain replacement property, all of which applied in the case of the suspension of the investment credit.

Although the references to rules provided in paragraphs (5), (9), (10) and (13) of Section 48(h) may be effective to accomplish the purpose intended, we think it would be clearer if the reference to Section 48(h) included paragraph (4) which relates to an equipped building rule, in addition to paragraph (5) relating to the plant facility rule.

(d) Section 381 (c) (6)—Failure to carry over transferor's 150 percent declining balance depreciation method on used property

The proposed amendments to Sections 167 and 381 result in the clearly unintended result of prohibiting the carryover of depreciation methods in the case of *used* property, (a) acquired by a taxpayer prior to July 25, 1969; and (b) transferred after July 24, 1969 in a transaction falling within Section 381(a) of the Code.

This result occurs because proposed Section 381(c)(6), which allows the carryover of depreciation methods in transactions falling within Section 381(a), permits the carryover of only those depreciation methods specified in paragraphs (2), (3) and (4) of Section 167(b) and in proposed subsections (j)(1), (k) and (m) of Section 167.

1. Sections 167(b)(2), (3) and (4), which permit the use of the double declining balance method, the sum of the years' digits method and any other no more rapid method, are restricted by Section 167(c) to new property acquired after December 31, 1953; it does not apply to property purchased used and, therefore, is inapplicable to the situation to which we are referring.

2. Proposed Section 167(j)(1), read in conjunction with Section 167(j)(3), is only applicable to property acquired under specified circumstances after July 24, 1969.

3. Proposed Sections 167(k) and 167(m) have no relevance at all to the problem we are discussing.

Therefore, unless there is a specific provision in Section 381(c)(6) providing for the carryover of the 150 percent declining balance method on used property acquired prior to July 25, 1969, the transferee corporation, in a tax-fee reorganization or liquidation, will be restricted to the straight line method of depreciation, as specifically required in proposed Section 167(j)(4). We believe that the clear intention of proposed Section 381(c)(6) was to permit the carryover of *all* depreciation methods in a transaction covered by Section 381(a). The Section as presently written fails to accomplish this result because it fails to take into account the fact that up to the present time, the ability of a taxpayer to use the 150 percent declining balance method on used property was based solely on provisions in the Treasury Regulations and not on anything specifically in the Code.

Since taxpayers have consistently been allowed, prior to the proposal in Section 167(j)(4), to depreciate used property by the 150 declining balance method, heretofore there has been no need to provide for the carryover of this method in tax-free transactions; with the passage of proposed Section 167(j)(4), there will be such a need. We suggest that proposed Section 381(c)(6) be revised to specifically provide for the carryover of the 150 percent declining balance method of depreciation in the case of used property acquired before July 25, 1969 and transferred in a tax-free transaction to which Section 381(a) applies after July 24, 1969.

COMMENTS RELATING TO SECTION 541(a) OF H.R. 13270

(a) Section 1379 (a)—Special requirements for shareholder-employees

This Section prevents a trust forming part of a stock bonus or profit sharing plan from constituting a qualified trust under § 401, unless the plan of which such trust is a part provides that the shareholder-employees shall not be benefited by forfeitures attributable to contributions deductible under § 404(a)(3). On the other hand, subsection 1379(b) provides that contributions for the benefit of shareholder-employees in excess of allowable limits result in taxable income to the shareholder-employees, but do not cause disqualification of the trust to which the contributions are made. The penalty imposed by subsection (a) quoted above for forfeitures benefiting shareholder-employees (which are in the nature of additional contributions for such persons) appears to be unduly harsh and is inconsistent with the penalty for direct contributions in excess of allowable limits. Accordingly, it would appear to be not only more equitable to treat the amount of the forfeitures which are credited to the account of a shareholder-employee as an excess contribution subject to the treatment provided

by § 1379(b), but also more consistent with the pattern of other provisions being proposed.

Paragraph (a) of § 1379 should be revised to read as follows:

"With respect to the trust forming part of a stock bonus or profit sharing plan which provides contributions or benefits for employees, some or all of whom are shareholder-employees, forfeitures attributable to contributions deductible under § 404(a)(3) for any taxable year (beginning after December 31, 1969) of the employer with respect to which it is an electing small business corporation which inure to the benefit of any individual who is a shareholder-employee for such taxable year shall be considered contributions made in that year by the employer to such shareholder-employees in computing the excess contributions which are taxable to such shareholder-employees pursuant to the provisions of Section 1379(b)."

(b) Section 1379(b)(3)—Deduction for amounts not received as benefits

Proposed Section 1379(b)(3) provides that where, upon termination of his rights under a plan, an individual has not received payments equal to that amount previously included in his income as excess contributions, he will be allowed a deduction, equal to the amount previously included in income, and not recovered by payments. However, the Section does not make it clear which taxpayer is entitled to the deduction. The right to the deduction may arise long after the death of the shareholder-employee who was taxed on the excess contributions.

Accordingly, the Section should be revised to make it clear that the deduction inures to the person receiving benefits under the plan at the time the rights of such person under the plan terminated.

We suggest that the last clause of Section 1379(b)(3) be revised to read as follows:

"Then there shall be allowed as a deduction, for the taxable year in which such rights terminate, to such individual (or to his beneficiaries if such individual predeceases the taxable year in which such rights terminate), an amount equal to the excess of the amounts included in gross income under Paragraph (1) over such payments."

COMMENTS RELATING TO SECTIONS 601 AND 602 OF H.R. 13270

(a) Section 103(b)(1)—Subsidies for industrial development bonds

The election given to States and their political subdivisions to elect to issue taxable bonds can be made with respect to certain industrial development bonds which remain tax exempt under Section 103(c), such as certain small issues. It is unclear why the United States should pay any subsidy to a lending institution for such loans. Furthermore, the ultimate user of the funds would pay less interest because of the incentive factor prescribed by Section 103(b) if, in fact, the election is made.

We recommend that Section 103(b)(1) be revised to insure that no election may be made with respect to industrial development bonds which remain tax exempt.

(b) Section 103(b)(2)—Irrevocability of an election

This provision does not make it clear whether an election with respect to an issue which is withdrawn would be irrevocable if the issue is placed on the market at a later date.

We recommend that Section 103(b)(2) be revised to specify that an election with respect to any issue once made is irrevocable except with respect to any issue not actually issued.

(c) Section 103(b)(2)—Failure of Secretary to recognize a purported election

It is unclear what consequences would follow from a failure of the Secretary to recognize a purported election under this section.

We suggest that Section 103(b)(2) be revised to provide that an election is effective only upon certification by the Secretary or his delegate.

(d) Section 103(d)—Definition of arbitrage operation

The term "arbitrage operation" is not defined in the Bill, notwithstanding the fact that interest on such obligations issued after July 11, 1969 is taxable. Thus, taxpayers bear the risk of paying taxes on obligations they presently consider tax exempt but are subsequently found to be taxable. Furthermore, taxpayers run the risk of relying on the stated intention of a state with respect to newly issued obligations.

To avoid unfair consequences to a taxpayer, Section 103(d) should be revised to provide that an obligation will be considered an "arbitrage obligation" only from the date it is so designated by the Secretary or his delegate, and only interest either paid or accruing after that date will be considered taxable.

(e) *Section 602(b) (1)—Determination of fixed percentage.*

Under this Section, the Secretary or his delegate must determine and pay a fixed percentage of the interest yield on each issue of obligations to which an election under Section 103(b) applies. If the Secretary or his delegate does not determine the percentage for calendar quarters substantially before the first day of the quarter, an issuer would be uncertain as to the applicable percentage and would have insufficient planning time.

We recommend that Section 602(b)(1) be revised to provide that the Secretary or his delegate shall determine the applicable fixed percentage *before the first day of the month preceding each calendar quarter.*

(f) *Section 602(b) (1)—Issues sold in subsequent quarters*

The Bill provides that the fixed percentage determined by the Secretary or his delegate shall apply with respect to all issues of obligation made during the calendar quarter to which elections under Section 103(b) apply. What is the applicable percentage with respect to obligations actually issued or sold in a quarter subsequent to the quarter in which the initial obligation in an issue are issued or sold? How will an issuer be able to plan an issue if it cannot be completed in one quarter?

We recommend that these questions be answered by revising the last sentence of Section 602(b) (1) to read as follows:

"The fixed percentage so determined and published shall apply with respect to any obligation issued as part of an issue, the initial obligations of which are issued during such calendar quarter and to which elections under such Section 103(b) apply."

(g) *Section 602 (c)—Administraive burden of United States*

Althou[illegible] the General Explanation of the House Committee on Ways and Means specifies on page 174 that, "in no case will the United States be required to assume the administrative burden of making payment directly to the holders of the obligations", proposed Section 602(c) does not specifically so provide.

A subsection should be added to Section 602 to specifically provide that payment by the United States shall be made directly to the state or the paying agent designated by the state.

Comments Relating to Section 703 of H.R. 13270

(a) *Section 49(b) (5)—Sale and lease-back transactions*

It seems clear under the Bill that the investment credit can be passed through to a lessee if the lessor purchased the "asset" from the lessee after April 18, 1969, provided the lessee in the sale and lease-back transaction had a binding contract preceding that date. Considering the literal reading of the language contained in Section 48(d) of the existing law, it is not clear that a pass-through of credit is permitted where the lessor purchases from the lessee the binding contract, and the lessor thereafter acquires the asset from the supplier. To eliminate the possible ambiguity, language should be inserted at the conclusion of Section 49(b) (5) to the effect that "in any case in which a lessor described in this paragraph makes an election under Section 48(b), the lessee described in this paragraph shall be treated as having acquired pre-termination property."

The Bill is also not consistent in permitting taxpayers similarly situated to enter into sale and lease-back transactions following April 18, 1969 where the seller in the sale and lease-back transaction has the right to claim the investment credit. If the seller in a sale and lease-back transaction were the purchaser of the asset pursuant to a binding contract predating April 18, 1969, the purchaser in a sale and lease-back transaction would be entitled to claim the investment credit. If the seller, on the other hand, was entitled to the investment credit because it or its subsidiary was the manufacturer of the asset and was entitled to the investment credit because it met the machinery and equipment rule (Section 49(b) (4) of the Bill), the purchaser in a sale and lease-back transaction would not be entitled to claim the investment credit. That inconsistency in treatment has no justification and to correct it Section 49(b) (5) should be

revised to read as follows (including the language required to eliminate the ambiguity referred to above)—the proposed changes in language being designated by the underlinging of the appropriate words in the following quotation:

"(5) Certain Lease-Back Transaction, Etc.—where a person who is—

"(*i*) a party to a binding contract described in paragraph (1) transfers rights in such contract (or in the property to which such contract relates), *or*

"*(ii) a taxpayer referred to in paragraph (4) transfers a piece of machinery or equipment referred to in paragraph (4)*"

to another person but a party to such contract *or a taxpayer referred to in paragraph (4)* retains a right to use the property under a lease with such other person, then to the extent of the transferred rights such other person shall for purposes of paragraphs *1 or 4* succeed to the position of the transferor with respect to such binding contract and such property. In any case in which the lessor does not make an election under Section 48(b)—

"(A) the preceding sentence shall apply only if a party to the contract *or a taxpayer referred to in paragraph (4)* retains the right to use the property under a lease for a term of at least one year; and

"(B) if such use is retained, the lessor shall be deemed for the purpose of Section 47 as having made a disposition of the property at such time as the lessee loses the right to use the property.

"For purposes of subparagraph (B), if the lessee transfers the lease in a transfer described in paragraph (7), the lessee shall be considered as having the right to use the property so long as the transferee has such use. *In any case in which a lessor described in this paragraph makes an election under Section 48(b), the lessee described in this paragraph shall be treated as having acquired pre-termination property.*"

Statement by Floyd Robertson, Assistant General Director, National Association of Evangelicals

The following testimony is given on behalf of the 34,000 churches which compose our constituency.

I. Unrelated Business Income Tax

The Association has adopted the position that income from any business not directly related to and a necessary part of the function of a tax exempt organization should be taxed on the same basis as any other business income. To do otherwise not only results in the loss of taxes which are due the government but creates unfair competition and other inequities between tax exempt organizations and the rest of the business world.

II. Advertising Income

Our Association has not adopted an official position on whether advertising income should be characterized as unrelated business in the case of magazines and other periodicals published by exempt organizations. In the past the government has properly recognized the value of eleemosynary institutions and encouraged their support.

Churches have been included in this category. The publishing of magazines is usually a very important and essential part of the functioning of such institutions.

It is hoped that no changes will be made that will reflect any less interest on the part of the government in the existence and expansion of these fine charitable organizations. If it is found that the advertising income on the part of some has become a *de facto* unrelated business we would interpose no objection to having such income taxed. However, we strongly recommend that such advertising income as relates to the business of the organization continue to be tax exempt. It should be noted that most church publications are heavily subsidized and do not realize an overall profit from their advertising.

III. Standard Deduction

It appears to us that an increase in the standard deduction from the present 10 percent of adjusted gross income would be in order. We also recommend that those using the standard deduction be allowed to claim as a deductible item contributions to churches and other charitable institutions

IV. TAX TREATMENT OF CHARITABLE CONTRIBUTIONS

1. *The 3% limitation.*—The proposal to take charitable contributions out of the area of the standard deductions and treat them as a separate deductible item with its own 3% minimum amount above which deductions would be allowable will have very serious implications. This can only be interpreted as a change in government policy and have the effect of discouraging the support of eleemosynary institutions. It would appear that this will eliminate at least 90% of the contributions to such organizatons as a tax deductible item and is apt to have a detrimental effect on the voluntary support they receive. Inevitably this will require additional taxes for welfare purposes which may be far more than the additional revenue received as a result of the change. So it would appear that such a move would not only be detrimental to the public interest but economically unwise.

According to the Yearbook of American Churches the per capita giving of church members runs from less than $5.00 to about $265.00 per year. Currently published figures show that the medium income for an average family is around $9,000.00 per year. It is obvious from these figures that only a small fraction of contributions to the churches would be in excess of the 3% limitation. Even so, we do not believe that such a change would seriously affect the giving to churches. The tax deduction incentive for church giving is minimal particularly for those who give in execess of 3% of their income.

So our concern expressed above is for the charitable organizations other than the churches but more importantly it is disturbing to suppose that the government would take any action to discourage the support of the outstanding work so many of them are doing. While the churches do not need nor do they incur the favors of the government we believe as a matter of equity and justice they should always be placed in the same category as other eleemosynary institutions as far as treatment given by the government.

2. *Appreciation of contributions above costs.*—A person may now buy an item for $5.00 and later contribute that item to the Red Cross with an appreciated value of $10.00. He pays no taxes on the increase in value but receives credit for a $10.00 contribution. Looking only at the personal benefit it would appear that he has received an undue tax advantage. On the other hand the objective of allowing the tax deduction is to encourage the support of such organizations as the Red Cross which has received the full value of the contribution claimed. For this reason we believe that this type of contribution should be allowed when it is made to long established organizations which do not invite abuse of the privilege.

STATEMENT OF THE NATIONAL CONSTRUCTORS ASSOCIATION BY THOMAS J. RYAN, CHAIRMAN, TAX COMMITTEE

The National Constructors Association welcomes this opportunity to present its views with respect to H.R. 13270, the Tax Reform Bill of 1969.

The Association, known as NCA, is composed of 34 internationally known firms of engineers and constructors which design and erect large scale industrial complexes within the United States and throughout the world, including oil refineries, chemical plants, steel mills and power generating plants. Attached to this statement is an informational folder describing the Association and listing its members, officers and major committees.[1]

The NCA wishes to express its views with respect to the following Sections of the proposed Tax Reform Act of 1969.

BILL SECTION 231—MOVING EXPENSES

The NCA would like to take this opportunity to express its appreciation to Congress for the proposed modification of the allowable deductions for moving expenses as set forth in Section 217 of the Internal Revenue Code.

The extension of the deduction to certain indirect moving expenses incurred by a taxpayer gives recognition to the increased mobility of a large segment of our labor forces.

We would like to see a further expansion of the definition of moving expenses which would provide for a deduction of the expenses incurred by construction

[1] The folder referred to was made a part of the official files of the committee.

workers who, out of economic necessity, must move from construction site to construction site, either from state to state or country to country, in pursuit of work as the phases of construction jobs they are working on become completed.

We recognize that Section 162 of the Internal Revenue Code provides for the deduction of certain traveling expenses incurred by a taxpayer in the pursuit of his trade or business. However, the construction worker who, with his family, maintains his home near each job site may be denied a tax deduction for the expenses that he must incur in traveling from a completed construction site to a new staging or standby area, or some other geographical point, in quest of work. Were Congress to consider these extraordinary relocation expenses incurred by construction and other similar workers as a deduction for income tax purposes, such action would assist towards assuring a constant source of skilled construction workers. Furthermore, the alleviation of the financial burden the construction workers must incur by moving from job site to job site, through increased deductions for their moving expenses, would help to insure that such persons would not find it necessary to remain immobile, thereby potentially increasing unemployment costs in any particular area.

We recognize that Congress has already given recognition to the mobile status and consequential potential loss of tax benefits of construction workers and seasonal or migrant agricultural workers under the current provisions in the Code, through the introduction of H.R. 3695. This proposed bill would liberalize the amount of time that construction or itinerant workers must be employed in their new principal place of work in order to qualify for the moving expense deductions currently provided for in the Code.

The NCA recommends that further consideration should now be given to provide for further liberalization of the deduction for the extraordinary moving expenses incurred by construction workers and other migrant and seasonal workers. In addition, we request that the 50-mile geographic limitation factor be restored to the 20-mile limitation presently in effect.

BILL SECTION 431—FOREIGN TAX CREDIT REDUCTION IN CASE OF FOREIGN LOSSES

American business is currently in competition in the international market with increasingly aggressive foreign competitors. Such competitors are endowed with tax concessions provided by their countries for the sole purpose of fostering export trade. Many such countries have relinquished their right to impose income taxes on income earned abroad. Some countries have granted immediate tax relief to domestic companies whose foreign operating subsidiaries have sustained losses in developing foreign markets, as well as expanding the limitations of the foreign tax credit to provide extraordinary relief under special circumstances. The foregoing concessions, coupled with direct export subsidies provided to our competitors, lead us to question how much longer we can remain competitive in the export of our technology and services, as well as related plant materials and equipment produced by U.S. manufacturers and fabricators.

From the inception of its system of tax, the U.S. has chosen to tax its residents on the basis of world-wide income, with certain exceptions. Having asserted this theory, our Government wisely recognized the need to eliminate the burden of international double taxation and chose to provide U.S. taxpayers with relief from such double taxation by granting a foreign tax credit against the U.S. tax imposed upon income earned abroad. Without an equitably administered foreign tax credit mechanism, any country which asserts its jurisdiction to tax its residents (both individual and corporate) on a world-wide basis will, within a short period of time, find its international markets extremely limited.

Proposed changes in the operation of the U.S. foreign tax credit are currently being considered by this Committee to eliminate certain alleged abuses which result in the loss of U.S. tax revenues. In attempting to correct any such abuses, this Committee is respectfully requested to consider the problems encountered by U.S. residents operating internationally. The imposition of a 50 per cent corporate income tax on the earnings of a branch of an American corporation in a particular foreign country is as much an economic reality as the imposition of the same rate by the United States. Without our foreign tax credit mechanism, an equal amount of U.S. taxes would result in complete taxation of this corporation's earnings.

Section 431 of the bill attempts to negate any benefit a U.S. corporation or individual might obtain in utilizing foreign taxes when such corporation or individual has obtained the benefit of a loss incurred through foreign operations against other U.S. taxable income. This Section is particularly directed

to those resident taxpayers who employ Section 904(a)(1) of the current Internal Revenue Code, commonly referred to as the "per country limitation." This Section restricts the amount of the foreign tax credit allowable against U.S. income tax foi foreign income taxes paid to any single country to the amount of tax imposed by the U.S. on income derived from that individual country. It would be interesting if this Committee could obtain from the Treasury Department statistics on the number of U.S. corporate taxpayers who employ the "per country" method of computing foreign tax credits. It might be equally interesting to find that those corporations employing the per country method of claiming the foreign tax credit choose to conduct their operations through the medium of branch operations of U.S. corporations rather than employing foreign subsidiary operations. If this is true, such corporations immediately pay U.S. taxes on income earned in those countries where the foreign tax rate is effectively lower than the prevailing U.S. corporate tax rate and, generally, effect early repatriation of foreign earnings enhancing our balance of payments.

Further, in those foreign countries where the effective foreign tax rate is higher than the prevailing U.S. corporate tax rate, such companies have suffered additional tax burdens because of their inability to "blend" such taxes with foreign source income taxed by foreign governments at less than the effective U.S. tax rate from other foreign countries as is presently allowable under the Internal Revenue Code Section 904(a)(2), commonly referred to as the "overall limitation." Such "blending," available under this alternative method, provides foreign tax credits against U.S. income tax which is not available to those U.S. taxpayers electing (or bound) to the "per country" limitation. The NCA appeals to this Committee to take into consideration the economic effect of a foreign tax paid by a U.S. taxpayer before exacting additional U.S. tax revenues. While, admittedly, it is true that a U.S. taxpayer may obtain a benefit arising from a foreign loss in determining its U.S. tax in one year, it is equally true that such taxpayer may be obligated to pay a foreign tax in another year which obviates the tax benefit obtained on its U.S. tax return. To extract additional U.S. taxes thereafter creates an additional burden which may be the determinative factor in removing such taxpayer from the international market. To illustrate this point, we cite an example as follows:

Assume U.S. taxpayer who has chosen the "per counrty limitation" has, in 1970, a foreign loss from Country "A" of $100. Assume further that such taxpayer has U.S. income of a similar amount of $100. Accordingly, the consolidated income of the taxpayer for 1970 is zero. Taxpayer's foreign loss offsets his U.S. income. In 1971, the taxpayer's sole income is $100 from Country "A." Country "A" imposes an income tax of 50% on such income. Under the proposed amendments, the following occurs:

YEAR 1970

Consolidated U.S. income:	
Country "A" loss	$(100)
U.S. income	100
Total	0
U.S. tax	0
Country "A" tax	0

YEAR 1971

Consolidated U.S. income:	
Country "A" income	$100
U.S. income	0
Total	100
Tentative U.S. tax (before foreign tax credit at 50-percent assumed rate)	50
Country "A" tax (50-percent tax rate)	50
Proposed credit for foreign taxes:	
(a) Source income Country "A" $100 less $50 or	50
(a) U.S. taxable income	100
(c) U.S. Tax at 50 percent	50

Proposed foreign tax credit limitation (Item (*a*) $50 over item (*b*) (100) times item (*c*) $50 equal $25).

U.S. foreign tax credit	$25
U.S. tax payable	25

Now consider the economic cost to the U.S. taxpayer on such earnings:

Consolidated earnings—Year 1970	0
Consolidated earnings—Year 1971	100
Total taxes paid:	
Year 1970	0
Year 1971—Country "A"	50
United States	25
Total	75
Effective tax rate—United States and foreign on $100 earnings (percent)	75

Perhaps the most equitable solution for this U.S. taxpayer would be to choose to operate solely in foreign countries which recognize operating loss deductions substantially similar to those granted by the United States. Unfortunately, many U.S. concerns, including NCA members, cannot exercise such discretion in their foreign operations but are forced to operate wherever a particular project is located. Another alternative to such taxpayer would be to claim a U.S. deduction for foreign taxes paid in the foregoing example. Using a tax rate of 50% or higher, the U.S. tax, after considering the foreign tax paid as a deduction, would be no greater and perhaps even lower depending upon the rate of the foreign tax. For example, assume further that the U.S. taxpayer in the above example was subject to a foreign tax in Country "A" at the rate of 75% and chose in the year 1971 to deduct all foreign taxes paid as a tax expense under the Internal Revenue Code Section 164. After deduction of this expense, the taxpayer's net U.S. income would be $25 and the U.S. income tax thereon would amount to $12.50 in lieu of $25 if a credit is claimed.

The NCA requests that this Committee consider the impact on U.S. companies operating abroad if the foreign tax credit provisions of our tax law are to become more penalizing. Perhaps such consideration in maintaining the existing foreign tax credit provisions may be viewed as a subsidy. If so, why not now rather than later when a more direct subsidy would be less effective in preserving our competitive posture abroad and insuring more favorable balance of payments.

Bill Section 703—Repeal of Investment Credit

The NCA has previously testified in opposition to the repeal of the 7% investment credit. In the event that the credit is repealed, we wish to emphasize our interest in maintaining the competitive position of U.S. industry in foreign markets and, therefore, respectfully request that Congress consider providing U.S. taxpayers with sufficient investment incentives to accomplish this objective. Liberalizing tax depreciation allowances could furnish sufficient incentives for both investment in capital goods and cost reductions to meet prices offered by foreign competitors.

It must be recognized that Congress has been generous in the past in providing some relief in this area. However, even guideline depreciation, while offering temporary relief, is still related to book or financial accounting depreciation. Perhaps what is needed is a complete tax depreciation policy completely unrelated to financial accounting depreciation, similar to Capital Costs Allowances granted in the U. K. and Canada. Taxpayers should also be granted discretionary power to defer such depreciation allowance in a taxable year where an operating loss is sustained and be able to utilize such deferred allowance in profitable taxable years without having the depreciation expense "locked" into the net operating loss deduction which is limited to a specified number of taxable years.

ERIE COUNTY PLASTICS CORP.
Corry, Pa., August 20, 1969.

Subject: Tax reform.

Senator RUSSEL LONG,
Chairman of Senate Finance Committee,
Senate Office Building, Washington, D.C.

DEAR SENATOR LONG: As a business man and as a small town citizen (and investor) I have been following with concern the subject of "tax reform," both in its own right and in its current context of a counterpart of surtax extension. It is my feeling that the subject of "reform" is timely but that it is, however, unrelated to surtax extension (also needed).

I would like to record my position as follows:

(a) The most important single element to tax reform would be the addition of a provision to insure that no ultra-wealthy citizens would completely escape the payment of personal income taxes. I feel that this is both fundamentally and psychologically important.

(b) I feel very strongly against any increase in the 25% ceiling on taxation of long term capital gains. Additional revenue to the Federal Government by an increase in this ceiling would not be truly significant, whereas the highly taxed individual citizen deserves some nominal shelter to encourage his continued participation in the creation of capital.

(c) In the emotion of the present moment I strongly feel that we would be ill-advised to be stampeded into an extension of the six months "holding period" for long term capital gains; rather, in the longer term, I feel that there is a stronger case for a reduction of the six months. The great momentum of the American economy is dependent almost entirely upon the courage and the rewards for business and affluent individuals to undertake burdensome risks. To introduce a deterrent, in the form of an extension of the six months waiting period, would be contrary to our mutual interest in a sensibly compounded growth in the Gross National Product.

(d) Even though I am a shareholder in several petroleum companies I cannot in good conscience express a strong feeling against the reduction of the "27½% depletion rate." It is my feeling that a nominal reduction of this percentage would be timely from both a practical and a political standpoint.

(e) I have no very strong feeling against a reduction of the "7% investment credit" either, although this subject does lend itself to lively debating. For instance, an effective antidote for inflation would be increased competition in the market place for expendable income. A continuation of the investment credit would encourage capital expansion of industry, thereby increasing the capacity of producing goods and reducing the most of production through modernization, which in turn should combat inflation. In the context of the present pressure on "tax reform", however, I would not oppose a temporary cancellation of the investment credit.

I appreciate the opportunity to record my views on these timely matters.

Very truly yours,

P. C. ROCHE, *President.*

STATEMENT OF CHARLES E. ROCKWOOD, DEPARTMENT OF ECONOMICS, FLORIDA STATE UNIVERSITY

SUMMARY

There is a need for basic reform in Federal individual income tax rates to reduce the speed of progression in the income tax rate structure. The reform is needed because the rising level of living and the rising cost of living in this country have outdated a progressive income tax structure which, for middle income Americans, has not changed appreciably since the days of World War II.

It is suggested that individual tax rate bracket intervals be double. For single taxpayers this would mean the top rate of 70% would take effect at $200,000 instead of $100,000, as presently. Tax schedules for married taxpayers and heads of households would need to be given parallel adjustments, of course.

The cost of the reform suggested is estimated at something like $6 billion, annually. Rate schedules could be adjusted less drastically at reduced cost, but it is believed the Congressional "loophole" closing in concert with four other important reforms could provide the funds that are needed. The four other reforms suggested are:

1. Replacement of present depletion allowance on natural and mineral resources with a national severance tax of one-half of one per cent on the wholesale value of extracted natural and mineral resources.
2. Abolition of the favorable capital gains tax rate for most corporations, and modification of the rate paid by individuals to include consideration of the number of years the assets was held prior to a sale for gain.
3. Limitation of depreciation allowances on a given asset to the original cost of the asset plus the cost of improvements. The limitation to hold even when an asset is transferred to a new owner.
4. Revision of rules regarding distinctions now being made between personal and business expense items, to foster (through tax policy) some of the former, and hinder some of the latter.

THE NEED FOR BASIC REFORM IN FEDERAL INDIVIDUAL INCOME TAX RATES

An important and presently neglected part of the general problem of equity in Federal Income Tax provisions is the need for amelioration of the tax rate paid by most of America's middle income taxpayers. This is a serious oversight. It is the middle income taxpayer who is the most severely hurt by current tax rule. It is the middle income taxpayer who is helped the least by reforms proposed.

The tax burden borne by most middle income taxpayers is made especially onerous because so many high income taxpayers, by IRS statistics, end up paying an even lower rate. Indeed, as all of us know by now, some very wealthy persons enjoy years in which they pay no tax at all. This offends everyone, surely. But, basically the tax equity problem deserving of serious consideration by Congress is that of tax relief for the middle income taxpayer.

Closing special exemptions by means of which selected taxpayers, many of whom already are wealthy individuals, escape an otherwise heavy tax burden is also a desirable change in our nation's tax provisions. The change is desirable partly because everyone should bear a portion of the total tax burden, as a matter of fairness. But even more importantly the change is desirable because revenue savings obtained through loophole closing could be returned to other taxpayers, in the form of rate reduction.

There seems general agreement that our nation's poorest individuals deserve additional tax relief, and it is to be hoped that some revenue will be available for this purpose. But surely of equal importance is the need to provide tax relief for middle income Americans. The rising level of living, and the rising cost of living in this country have outdated a progressive income tax structure which for middle income Americans has not changed appreciably since the days of World War II.

It is true that tax cuts of the early 1960's provided relief for some taxpayers. But the largest beneficiaries of these changes were the very high income taxpayers. As much as 200% increase in take home pay, for income subject to the highest tax bracket, is being enjoyed by the wealthy few. Middle income taxpayers, however, have not been nearly so generously treated. For example, a single taxpayer reporting taxable income of $10,000 in 1969 will be required to pay only $231 less than a similarly situated taxpayer would have had to pay in the year 1944. For the taxpayer of 1969, this 2.31% increase in after tax income is small consolation, in the face of an increase in the Consumer Price Index of over 100% for the same 1944 to 1969 period.

Existing progressive income tax rates are antiquated in the sense that they are a product of our nation's history—and now times are changing. Basic rate structure philosophies were probably established at a time when the present extreme exploitation of tax loopholes by the wealthy was not even contemplated. The rate structure seems to reflect attitudes formed when a much lower general standard of living prevailed. They are partly a product of a belief in the economic stagnation theories that prevailed widely in the 1930's. Partly also they are a product of a desire to control wartime excess profits.

Kennedy-Johnson era reform of the tax rate structure brings the top bracket down to a more realistic level, and further reduction to a top of 50% does not seem warranted at this time. But, the top tax bracket does apply much too soon; that is, at too low a level of income. This is a permanent and undesirable feature of our tax structure. The spread between the bracket needs to be greatly enlarged.

It is suggested that the intervals between the brackets should at least be doubled. In this way the top bracket for a single taxpayer would be reached at $200,000 of taxable income instead of $100,000, as presently. Tax brackets for

other taxpayers would, of course, be adjusted accordingly. Thus, single taxpayers would be given the rate schedule now used by married persons filing jointly. Proportional changes would also be made in the tax schedules for married taxpayers and for heads of households.

The table which follows indicates that general nature of the tax reductions proposed.

TABLE I.—ILLUSTRATION OF TAX REDUCTIONS PROPOSED

	Present tax[1]	Proposed tax	Taxpayer saving
Single taxpayer reporting:			
$2,000	$310	290	20
$5,000	910	810	100
$10,000	2,190	1,820	370
$20,000	6,070	4,380	1,690
$50,000	22,590	17,060	5,530
$200,000 (or more)			14,510
Married taxpayer reporting:			
$2,000	290	280	10
$5,000	810	740	70
$10,000	1,820	1,620	200
$20,000	4,380	3,640	740
$50,000	17,060	12,040	5,020
$400,000 (or more)			29,020

[1] For simplicity the 10-percent surcharge is omitted from consideration.

The net cost of the tax bracket interval changes here proposed is large, but not impossibly so, it is believed. The revision is desperately needed, however, to restore some degree of equity to the nation's tax structure.

Apparently the Treasury Department's office of tax analysis and tax policy has not experimented with the idea of adjusting tax bracket intervals. But, estimates of 1969 taxable income by bracket intervals, supplied by that agency, were used to reach the conclusion that the current cost of doubling personal income tax intervals would be about 6 billion dollars revenue loss, annually. Of this 6 billion, about one-half, or slightly over 3 billion dollars, would be in the form of tax relief on that portion of reported taxable income which was below $6,000. In other words the change proposed does yield some benefits for lower income ranges, as indeed it does for wealthy taxpayers. Nonetheless, the primary effect of the change suggested is relief for middle income taxpayers, as has been explained.

Even beyond the one shot revision in tax bracket intervals, a further need is for a rule to be established which would insure that future inflation does not again wipe out reforms made in rate structures. A wise solution might be to tie the size of rate progression intervals to annual changes in the Consumer Price Index. Thus, if the year following tax reform were one of 5% inflation, the top bracket for a single taxpayer would be raised from $200,000 to $210,000. Again, bracket intervals for other taxpayers would need to be adjusted accordingly.

FINANCING RATE STRUCTURE REFORM

In addition to rate progression change, other tax reforms are needed to satisfy equity and revenue considerations. Equity demands that all taxpayers bear their fair share, which is not now the case. Revenue considerations demand that some taxes be increased, if the proposed tax bracket interval changes are to be implemented.

It is evident that Congress is considering seriously a large number of desirable reforms in the Federal tax strucuure. Many of these reforms, one would guess, are likely to be made into law. But, doubling the tax bracket intervals for individual taxpayers would require compensating revenue adjustments much in excess of those provided by the House bill. For this reason four additional and important tax reform changes are proposed and discussed briefly.

1. Present depletion allowances on natural and mineral resources should be replaced with a national severance tax.
2. Favorable capital gains tax rates should be abolished for most corporations, and modified for most individuals.
3. Depreciation allowances on a given asset should never be allowed to exceed the original cost of the asset.

4. Distinctions now being made between personal and business expense items need to be revised, to foster (through tax policy) some of the former, and hinder some of the latter.

1. *Depletion allowances.*—The practice of granting a depletion allowance needs to be discontinued. Depletion allowances constitute an unwarranted subsidy to some businesses and are a genuine tax loophole of signficant proportion.

What is needed is a Federal severance tax which would encourage the preservation of our nation's vital natural and mineral resources, instead of the present tax deduction which encourages prodigal use of valuable and usually irreplaceable assets.

Replacement of the depletion allowance with a national severance tax of 0.5% on the wholesale value of all extracted natural and mineral resources, for example, ought to yield additional revenue from the 0.5% severance tax of some $1.5 billion annually, plus something like $1.3 billion annually from cancellation of the depletion allowance.

2. *Long-term capital gains.*—This represents a second substantial area of concern, for if existing capital gains tax provisions are intended as an investment subsidy they discriminate unfairly among forms of investment activity. Dividend and interest income is for the most part treated as ordinary income. Capital gains are of course taxed at a special, and quite favorable rate.

If existing capital gains tax provisions are intended to encourage retained earnings by businesses they certainly are an awkward way to accomplish the task; and if this is their purpose, the policy conflicts with other rules, admittedly rarely enforced, prohibiting corporations from retaining an excessive percentage of their profits.

If, as I believe, existing capital gains tax provisions are designed to protect taxpayers from inequities that would arise under a progressive tax rate structure when income in a few years reflects the accumulations of many, the policy is improperly and unwisely liberal in some instances. It is undesirable to have capital gains taxed at a rate below that which would have been invoked if the income had been spread evenly over the years it was earned.

For this reason the corporate capital gains rate should be abolished for corporations whose annual taxable income is above the point at which the corporate surtax is applied, i.e., corporations reporting before tax profits in excess of $25,000 annually. For these concerns there isn't really any progression to their tax rate structure, and for them the existing capital gains rate represents an unjustifiable exemption.

For individual taxpayers, the capital gains rate serves an important equity function. But to be truly just, the gains rate paid by individuals should be a rate equal to that which would have applied if income from the gain had been spread evenly over the years it was earned.

A special tax table for capital gains is needed that would take into account the number of years the asset had been held by the taxpayer prior to its sale for gain. From an accounting standpoint such a change seems feasible. From an equity standpoint it is much needed.

A possible basic approach would be to have the capital gains tax bracket determined by the size of the gain divided by the number of years it took to earn the gain (i.e., the number of years the asset was held). If adopted as a basic strategy, such an approach probably ought to be combined with a minimum rate, to be used if the capital gains option is elected. A rate structure that begins at 10% is one possibility.

U.S. corporations are now claiming in excess of 10 billion dollars annually in capital gains. Since most corporate income is taxed at a rate slightly in excess of 50% and the capital gains maximum is 25% this would suggest a revenue increase of around 2 billion dollars could be expected from eliminating the corporate gains tax provision for firms whose profit exceeds $25,000.

The impact on individual and unincorporated business taxes of the capital gains tax change proposed has not been calculated. It would constitute a tax increase for nearly all wealthy taxpayers who had large capital gains to declare. For others, whether the change constituted an increase or a decrease in their total taxes would probably depend to a large extent upon the length of time the asset was held prior to sale for gain. Of course, for all individuals and unincorporated businesses the gains tax schedule proposed would still constitute a tax break; but for some taxpayers the advantages of taking the gains tax option would be less than under existing laws.

3. *Depreciation.*—Depreciation allowances should be revised so that depreciation charges would never exceed the original cost of the asset, plus the cost of any improvements. The present practice, in some instances (apartment buildings, for example) of allowing each new owner of a business to depreciate business assets anew constitutes an unwarranted subsidy and a genuine loophole of significant proportion.

When an existing business asset is sold, it should be sold together with its tax history. A new owner should then be limited, in his depreciation write-offs, to the cost of the asset to the first owner minus depreciation allowances already taken.

The additional tax revenue provided by this change while significant is not so great as that for cancellation of the depletion allowance. Still, revision of depreciation, rules along the lines indicated might yield $750 million or more annually.

4. *Distinctions between business and personal expense.*—Distinctions between business and personal expense are among the most difficult that our tax laws have to make; and, the number and complexity of tax rules in this area is a partial reflection of the magnitude of the problem. As a way out of this dilemma perhaps borderline expenditures should not be treated as fully taxable, or fully exempt. Instead some sort of mid-point in the tax rate structure might be developed that would allow borderline expenditures to be taxed at, for example, one-half the normal rate.

The idea of something less than full penalty for questionable expenditures, without going to the extreme of no penalty at all seems general in its applicability. And, the matter is especially relevant to the general question of tax equity because quite typically one of the biggest advantages that the large income recipient has over middle and low income taxpayers is the ability to exercise some discretion over the form in which he takes his income. This means that, for upper income taxpayers, the distinctions between business and personal expense tend to become blurred.

As another advantage, the plan of a mid-point in the tax rate structure represents a means by which small taxpayers might be given partly preferential treatment for some of their quasi-professional expenditures, even though theirs typically are expenditures that are not paid for by an employer. A case in point is costs of education. Education, particularly at the college level, is partly a professional expense and wise tax policy dictates that it should be at least partly deductible.

JULY 17, 1969.

Hon. CLINTON P. ANDERSON
U.S. Senate,
Washington, D.C.

MY DEAR SENATOR: I am and shall continue to be grateful for the priviledge of living in the United States of America. I also accept and willingly carry out the responsibilities that go with this priviledge. But I am also one more irate citizen because of the continued and increasing inequities in the tax structures that discriminate against the single person. This exists at every level in all types of taxation.

We pay taxes in exchange for various types of services from a variety of government agencies. The single person is less likely to need or to use such services to the extent that the services are used by the married person with a family. Yet the single person is taxed at a higher rate. Have tax committees conducted any valid research to determine why this situation is perpetuated? Has there been any effort to determine the status of the single person in our society? Why should federal and state income tax schedules be higher for the single person who already pays more as the penalty for being single? Are the tax specialists aware:

1. Of the fact that the majority of single people are women?
2. That a large percentage of single women have the full responsibility for aged and ailing parents.
3. That the single person—according to the Internal Revenue Service—cannot be "head of the household" despite the fact that she carries a mortgage on a home, pays property taxes and supports one or more relatives? My mother, age 80, draws a small pension but she fails to qualify as a dependent because: (a) the pension is a widow's civil service; (b) the pension amounts to a little over $600 per year.

4. The single person is not responsible for the "population explosion," yet our taxes make up a large portion of funds available for schools and colleges.

5. The same may be said for the support of public facilities and services such as hospitals, correctional institutions, and recreation areas.

I can find no justification for continuing the discrimination against the single person. Can't someone do *something*?

Sincerely yours,

ELLA MAY SMALL.

INTERNATIONAL LADIES' GARMENT WORKERS' UNION,
New York, N.Y., July 9, 1969.

HON. RUSSELL B. LONG,
Chairman, Senate Finance Committee,
Senate Office Building, Washington, D.C.

DEAR MR. CHAIRMAN: The International Ladies' Garment Workers' Union was very disappointed with the bill extending the surtax as it came out of the House of Representatives because it did not really contain meaningful tax reform or tax relief.

While the measure to extend the surtax, as passed by the House, did eliminate payment of taxes by the very poor, as it should, and while it called for repeal of the 7% investment credit which we favor, the loopholes which deprive the Federal Government of billions in taxes were not plugged nor did the bill carry relief for millions of low and middle-income wage earners.

We hope that the Senate Finance Committee will support the AFL-CIO position on this legislation which we believe would treat all American taxpayers equitably. It would plug the loopholes, adjust the tax payments for low and middle-income groups and would guarantee that the very rich could not evade paying their fair share of taxes as some now do.

This request for the Senate Finance Committee to amend the bill as it came out of the House to include truly meaningful reform and relief is made on behalf of more than 417,000 members of the International Ladies' Garment Workers' Union in the continental United States. We hope that it will have your full support.

I look forward to your reply stating your position on the measure now under consideration by the Committee.

Respectfully yours,

LOUIS STULBERG,
President.

STATEMENT OF WILLIS E. STONE, NATIONAL CHAIRMAN, LIBERTY AMENDMENT COMMITTEE OF THE U.S.A., LOS ANGELES, CALIF.

Thank you, Mr. Chairman, and members of the Senate Finance Committee, for affording this opportunity of presenting the viewpoint of hundreds of thousands of your fellow Americans whose voices have apparently fallen on deaf ears for many years.

As a matter of identification, I am Willis E. Stone, National Chairman of the Liberty Amendment Committee with headquarters at 6413 Franklin Avenue, Los Angeles, California. I speak for all the members, supporters and friends of the LIBERTY AMENDMENT, pending before the Congress as House Joint Resolution #23. They are organized in every state in the Union and more than 700 counties. Members of more than 7,000 other organizations have adopted resolutions of support for it, and seven states have formally petitioned the Congress to submit this question of public policy to the American people for decision. I speak with their knowledge, consent and support. I make that distinction to differentiate my testimony from that which may be given you by those who speak in the name of organizations without the knowledge, consent or support of their membership.

Many long years have passed since a vast segment of the American people last had an opportunity to express their views that true tax reform and constitutional liberty are the same things and can only be had through the literal enforcement of the Constitution of the United States. These fundamental truths have gone unheeded, and the cumulative disasters visited upon the American people are largely traceable to the fact that violations of Constitutional principles continue to accelerate at ever increasing cost to the taxpayers. The tax reform

hearings being held by this Committee were impelled by the growing clamor of aggravated and frustrated taxpayers. These hearings implied a purpose of heading off, rather than increasing the tide of taxing and spending, which are inseparable parts of the same things. The American people now find themselves in a political and economic straight-jacket of terrifying magnitude. They earnestly beseech you to actually seek true tax reform before your tax levies strangle the productive impulses of the goose that provides the plunder. I believe each of you agree there is monumental evidence to support this plea for real tax reform. As the great Al Smith so often said: "Let's look at the record."

The Statistical Abstract of the United States tells us the federal "tax and spend" spiral took a terrible toll in the 1950's. A resentful people provided the impelling motive for the tax reform hearings of 1958.

Consider the magnitude of the pressures involved. Individual tax collections by 1950 had risen to the staggering figure of $18.4 billion—almost twice the cost of government for the first hundred years of this nation. The restraints and limitations upon the use and abuse of power appeared to have been broken. The anguish and concern of a great people made it quite necessary to call the 1958 "tax reform hearings."

Unfortunately, the effects of these hearings, insofar as can be observed, were more detrimental than beneficial to the people. The tax and spend philosophy was stepped up rather than diminished—as is evident by the fact that federal individual income tax collection in 1960 reached $39.5 billion, more than doubling in that ten-year interval. This is indeed tax reform in reverse. But, we didn't know the half of it then, did we?

By 1963, the product of the 1958 "Tax Reform Hearings" should have been operative, yet individual income tax collections skyrocketed another 25 percent to $48.2 billion that year. The idea began to emerge that there has been no validity in Congressional declarations of tax reform or equity.

This opinion was further supported by the accelerating tax demands put upon the people, drying up incentives to produce, as federal individual income taxes increased nearly half again over 1963 during the next five years, reaching the fantastic figure of $68.7 billion for 1968, with a projected individual income tax collection of $90.4 billion for 1970! No wonder the spirit of rebellion is loose in the land.

Despite this accelerating tax take from a reluctant people, there appears to be no pretense of keeping spending within income. The national debt is skyrocketing steadily toward the point of national bankruptcy. Referring again to the Statistical Abstract the recorded federal debt in 1950 was $257.4 billion. It climbed to $276.3 billion by 1958. The debt went right on up to $290.8 billion in 1960—and on up to $310.8 billion in 1965—and on up to $369.7 billion in 1968.

There is no indication that this is the end of the road you gentlemen are traveling because you recently approved an increase in the so-called "tax ceiling" of $12 billion.

It is worth noting in this connection that in 1968 your tax levies managed to take more money from the American people than any nation in history ever extracted from its people yet Congress managed to spend $25.4 billion more than was taken in, adding that much to an already crushing debt. Neither is it considered a coincidence that this money was borrowed at the highest rate of interest this nation ever paid which tends to reflect a lack of public confidence in government's fiscal integrity. Confidence in your fiscal and Constitutional integrity can be reestablished by this Committee if you honestly propose taxation solely to finance the constitutionally authorized functions of government—finance them adequately—while at the same time withdrawing funds from the multitude of activities carried on by bureaucratic agencies without the slightest pretense of Constitutional authority.

There is no mystery about the agencies involved in these unauthorized functions, nor in the volume of plunder they extract from our people to sustain their interest free, rent free and tax free empires in direct and ruthless competition with tax paying enterprises. Neither is there any mystery about the corruption and waste of these specially privileged enterprises which are immune from law—local, state and federal.

The Hoover Commission's Report of 1955 revealed countless ways of instituting tax reform. We augmented that study with our own and have listed more than 700 federal agencies involved in these unauthorized activities. A copy of this list is handed to each of you herewith.* To make very sure that it is beyond dis-

*The list referred to was also made a part of the official files of the committee.

pute in this Committee or elsewhere, there is, following every agency named on the list, a number, a symbol and another number providing official reference that qualifies each agency for a place on that list.

The appearance of a named agency on that list only stipulates that in some way that agency has exceeded constitutional limitations and invaded the private areas of activitiy which were, by the design of the Constitution, prohibited to government. The fact of that intended prohibition is clearly established by the 9th Amendment which provides that: "The enumeration of the Constitution of certain rights, shall not be construed to deny or disparage others retained by the people."

The founding fathers attempted to make doubly sure of this limitation upon your powers by the terms of the 10th Amendment which provides that "The powers not delegated to the United States by the Constitution, nor prohibited by it to he States, are reserved to the States respectively, or to the people."

Despite these safeguards, however, we have this vast array of federal agencies' operating powers which were never delegated to government by the people, and exercising rights not enumerated.

The general dilemma of our time is your quest for revenue with which to maintain these illicit empires, which have already taken over forty percent of the land area and an estimated twenty percent of the industrial capacity of this nation without any Constitutional authority for doing so.

The people yearn for tax reform—true tax reform—and pray that you at long last will take steps designed to provide it by simply stopping the financing of these lands and enterprises which exist without constitutional authority. Adequate evidence exists to indicate that fully half of the federal revenue each year finds its way, through your appropriations, to the maintenance and growth of these unauthorized activities. This is an amount greater each year than the total amount of federal individual income taxes collected.

Your own reports show that, even in war, the civil functions of the federal bureaucracy demand and get greater increases in appropriations each year than the true military expenditures for national defense.

At the 1958 Tax Reform Hearings in the House of Representatives, I presented a summation of a highly objective analysis of the projected budget spending under the 1959 budget which was then before you. It was ignored, but the subsequent developments have confirmed every factor therein. I again present this summation, together with a comparable summation of the potential savings under the 1967 budget, showing a very similar pattern. Because of the ultra conservative basis of these computations it is doubtful that any overstatement will be found therein.

I am certain each of you know of these gigantic potentials for true tax reform. You may not agree in all details but you can not successfully contest the facts because they are too evident for denial.

There are, as you well know, hundreds of ludicrous but tragic examples of bureaucratic incompetence. There was the abortive political effort to raise Abaca in Central America, and the more disastrous political idea of mining low grade nickel in Cuba. There is the continuing program of compelling American farmers not to produce sugar which, as a side result, sentenced Cuban farmers to a lifetime of peonage to tyrants there. There was the ridiculous Eskimo Housing program—only slightly more ridiculous than the rest of the housing programs spawned here in Washington at the cost of countless billions of American tax dollars, and resolving nothing.

There is the thoroughly silly story of the steam-heated railroad tunnel in Alaska, and the bureaucratic effort to corner the world's tin supply which ended in disaster for us, and produced the turmoil in Bolivia that ended in a Communist take-over of that unhappy land. There is also the current mania for financing a road through Asia which the U.S. Army Engineers are building at our expense for our Communist enemies.

There is an endless variety of such amazing and unauthorized dissipation of the productive energies of the American people—your people. They want it stopped. It is the first necessity for producing true tax reform on the heroic scale that will grolify you, our nation and our people for centuries to come. It can be done by just living according to our Constitution. Vast numbers of people, all across this broad land, are gathering in support of the Liberty amendment, which is designed as the best possible instrument for restoring the Constitution to full force and effect, and compelling government to live within its organic law.

It is a tragic commentary that the people are coming to believe it necessary to forcibly apply the principles of the Liberty amendment to reapply the rule of of law upon those who represent us in government. It would be much more to the point, and infinitely more desirable in every way, if you, our leaders in government, would approach the great problem of tax reform from this traditional and truly basic viewpoint. The tremendous problems which confront you will rapidly diminish if you do this, and stop the insane spiral of spending by our bureaucratic empire builders.

What does the future hold? By the arbitrary imposition of the tax and spend philosophy which has destroyed countless nations, we can go deeper into the morass of tumult, conflict, rioting, burning, right into the agony of revolution in the eternal struggle of power and plunder. I am sure all of us want to prevent that.

Our people prayerfully hope that your Committee will find the way, in these tax reform hearings to restore the tranquillity and equity of just and equal law under the Constitution. We pray you will finance only constitutionally authorized functions of government, leaving all else to the sovereign states and the free people of this great land.

How can we reach your ears, your minds, your hearts, and inform you, our leaders, regarding the will of the American people, and inspire you to the task of repairing the sanctuary of the Constitution as the only safeguard to our lives, liberties and property. Surely, the stark, silent but immutable message of the public will be free of oppressive governmental taxing and spending has long been evident to those who will listen. We pray that you will hear these truths, and heed them, and bring about that "rebirth of freedom" for which your people yearn.

Statement of Walter N. Trenerry

STANDING

Your relator appears in his own right as a taxpayer and also as counsel for:

Certain taxpayers who have gross incomes of more than $1 million a year and:

a. Take part in new, risky, experimental business ventures.

b. Borrow money for many kinds of investments.

c. Carry on a sizeable business in oil and gas exploring, producing, and selling.

SUMMARY OF ARGUMENT

The Hobby Loss, Investment Interest, and Natural Resources sections of H.R. 13270 will keep money back from new business ventures and will lessen tax collections.

The Natural Resources sections also penalize the oil business, which other risks already threaten, and may conflict with established American foreign policy.

Part 4 of Statement of Walter N. Trenerry

Your relator, Walter N. Trenerry, of St. Paul, Minnesota, Attorney-at-Law and Member of the Minnesota Bar, respectfully states to the honorable Finance Committee of the United States Senate:

While he does not favor all additions and changes created in the Tax Reform Bill of 1969 (H.R. 13270), your relator objects only to the matters in Subtitles B and C of Title II, Subtitle A of Title III, and Subtitle A of Title V, which he mentions specifically here.

Your relator does object formally to all the following as unfair and shortsighted:

Title II. Subtitle B: Sec. 213(a) Hobby Losses (Proposed amended Sec. 270 of the Code)

Title II. Subtitle C: Sec. 221(a) Interest (Proposed new Sec. 163(d) of the Code)

Title III. Subtitle A: Sec. 302(a) Allocation of Deductions (Proposed new Sec. 277 of the Code)

Title V. Subtitle A: Sec. 501(a) Percentage Depletion (Proposed amended Sec. 613(b) of the Code)

I. IS IT WISE TO CHOP DOWN THE TREE TO GET AT THE FRUIT?

The Congress certainly knows that these sections will make their subject-matter less attractive and will keep Joe and Judy Taxpayer from putting money into them.

While this policy may give Uncle Sam a bigger tax bite from Joe and Judy this year, next year Uncle Sam's choppers will slam together on nothing when they try to bite the former taxpayers Joe and Judy supported.

In other words, giving rough handling to a tiny tiny fraction of taxpayers will cost Uncle Sam money.

Rich men who escape taxation through deductions have to pay those deductions, in cash, to someone who pays a tax on them. The total taxes paid by these someones will be much more than what the single rich man would have paid if not allowed to take the deductions.

Historically, some part of all economic growth has come from people who would not give up, but pushed on, year after year, pouring money into ventures that looked hopeless. Until now the income tax quietly encouraged them. Most of these ventures were hopeless, but some, like the Ford Motor Company, turned out well.

Now the Congress apparently wants to penalize these cheerful optimists who are willing to lose money today in their belief in a sure bonanza tomorrow.

The Congress is admittedly free to make its own tax policy and to pick the objects of taxation; but the way of tax statesmanship is not grabbing and choking to death infant taxpayers of the future.

It is no secret that credit furnishes most of American risk capital. To discourage borrowing for investment, and to discourage putting capital into anything but absolutely safe ventures, could bring premature old age and decay to an economy based on expansion and managed by men trained to push for growth.

II. SPECIFIC SHORTSIGHTED MEASURES

Your relator believes that the hobby loss, investment interest, and natural resource sections of H.R. 13270 will have a strangling effect on the economies of both today and tomorrow.

1. *Hobby Loss Limits and Presumptions* (Section 213(a) of the Bill, proposed Amended Section 270 of the Code)

This hounding for speedy results, now applying to "an activity" rather than only individuals, hits much harder than Sec. 270 of the 1954 Code. Acting under such pressure, both Joe Taxpayer and The Joe Taxpayer Corporation will necessarily cram their hugest research and development, or expansion, costs into repeated two-year spurts. Whether this will help find new products, or enlarge businesses, or raise more taxes, remains to be seen.

Through its setting in the Bill the word "hobby" gets a certain sanctification, but the word is misleading and much out of place; the section slams more than harmless men and women tinkering with amusement devices. It would hit Thomas A. Edison if in 1969 he were still working on the incandescent lamp.

For some reason Income Tax administrators have never come up with a better distinction between hobbies and business than "If you love it, it's a hobby; but if you hate it, it's business." The Joe Taxpayer who loves doing what gives him his daily bread is, in the Income Tax zoological garden, one with the chimera, the griffon, the phoenix, and the sphinx—a thing of art, but a phantom.

From 1939 to 1969 the Congress was willing to allow Joe Taxpayer, as an individual, four years of limitless business deductions and only questioned his economic wisdom if in the fifth successive year he tried to deduct more than the gross income of his venture plus $50,000.

Now, 30 years later, the Congress practically limits both Joe Taxpayer and The Joe Taxpayer Corporation to two years of limitless business deductions and one year of business deductions equaling gross income from the venture plus $25,000.

Rather than cutting the $50,000 allowed since 1939, the Congress ought to raise it to $100,000. Filling the public trough has chopped real values at least this much.

Keeping the public trough filled to politically acceptable levels, incidentally, calls for more and more new taxpayers each year.

In addition to denying relief for inflation damage, proposed new Sec. 270 relies for administration upon the marvelous 20/20 vision of hindsight. When

five years are over, Uncle Sam has the chance to look back and pick out any three of them to attack for impropriety.

Present Sec. 270(b) has vanished and was presumably murdered somewhere offstage, leaving Joe Taxpayer and The Joe Taxpayer Corporation to carry on their natural resource businesses under the perpetual menace of these loss limits.

The inevitable result will be to distort existing business practices—minerals do not conveniently allow themselves to be discovered and made commercial within fixed limits of time, any more than King Canute could make the tide go back—and to discourage new venturers from entering the field.

Finally, in a country which prides itself on freedom from compulsory self-incrimination, and glories in a presumption of innocence in criminal cases, putting the burden of proving *non-taxability* on the taxpayer is outrageous.

The Congress might as well say, "Every person subject to this act is presumed to owe at least $100,000 in tax."

When Uncle Sam proves that Joe Taxpayer or The Joe Taxpayer Corporation had business losses of $25,000 plus gross income from the venture in three out of five years, Uncle Sam can rest.

And at that point Joe Taxpayer or The Joe Taxpayer Corporation has no right to challenge the sufficiency of Uncle Sam's evidence. As things stand, the tax is owed unless the taxpayer can wiggle out.

The unhappy taxpayer is forced to engage in a long and expensive lawsuit, in which he suffers further unhappiness from knowing that he is paying the salary of Uncle Sam's lawyer as well as the fees of his own.

Simple morality calls for making Uncle Sam prove that Joe Taxpayer or The Joe Taxpayer Corporation owes a tax; and calls for giving the taxpayer a chance to test Uncle Sam's evidence at one time, *before* having to prepare and present a costly defense.

As a matter of policy apart from morality, the Congress would be better advised to define what "activity" will allow deductions, and to stop there. In the competitive and costly business world, the chance of keeping a steadily losing business going into an indefinitely deductible future is very slight. At some point even the most virulent tax-hater has to start scratching for income.

Every business has its unplanned bad years. To demand bouncing back in three years, or coming up with a commercial product in three years, is petulant; American impatience for quick results.

Does this section mean to penalize branches, divisions, or other parts of large businesses? In a conglomerate, if the razor blade divisions shows a forbidden series of losses, does it matter if the frozen food division shows profit?

A possibly unforeseen risk is that this section could put Uncle Sam's best taxpayers in trouble. If General Motors brought out three Edsels in a row, and in addition had to pay taxes out of dwindling cash, the real sufferers would be stockholders, who are also taxpayers, and persons who depend on pensions and profit-sharing trusts holding this stock. The following year Uncle Sam would suffer.

Your realtor feels it proper to allow taxpayers to deduct true business losses without limit. The iron laws of economics make unlimited income to support these deductions very unlikely; and a business manager is better able to judge "reasonable expectation of realizing a profit" than is the Internal Revenue Service.

Two projects that literally changed the world, but only after repeated trial and error—and deductions—may suggest not trying to interfere with the inventive and business rhythms of mankind.

In the 1930's everyone "knew" that men could split the atom but no one could figure out exactly how to do it. By 1939 a General Electric cyclotron made this possible in a small scale.

During 1942–45, with national survival at stake, the "Americans" (Bohr, Einstein, Fermi, Meitner, Szilard) worked at large scale atom-smashing and in 1945 saw their success at Los Alamos, Hiroshima, and Nagasaki.

Estimated experimental time: 12 years.

In the 1830's came the lonely figure of Charles Babbage, working on a mechanical computer that he could never perfect. Nearly a century later, in 1930, Vannevar Bush brought forth a mechanical differential analyzer that did work.

Tinkering with this gadget in the 1930's at M.I.T. and elsewhere led to the analog computer of 1942, used in automatic tracking and leading for the World War II anti-aircraft guns, and which in turn led to the modern electronic analog and digital computers of 1946 and after.

Estimated experimental time: 116 years.

It is safe to say that the taxes paid by those who followed in both these fields outrun by quite a bit all conceivable income tax deductions based on experiments leading to them.

2. *Investment Indebtedness Interest Limit* (Sec. 221(a) of the Bill, proposed new Section 163(d) of the Code).

Whether to continue or kill this deduction is a policy matter for the Congress. Your relator feels that this section will hurt the economy by discouraging men and women from borrowing to buy securities of new businesses or securities issued for business expansion.

When this section combines with other sections dealing with capital and capital gains, it reinforces other measures in the Bill which give a clipping to capital.

3. *Natural Resources Allowances* (Sec. 501(a) of the Bill, proposed amended Sec. 613(b) of the Code)

The Congress has seen fit to lower the percentage depletion allowance for oil and gas to 20% and to limit the use of percentage depletion to production from domestic sources.

After all the publicity there is no doubt that this represents a calculated decision and that the Congress realizes that this may result in lessened American oil and gas investment abroad. The change is sure to have an effect upon an industry long accustomed to the 27.5% rate, applied to production from any area in the world.

Without going into the technical merits and demerits of 27.5% as against 20%, or a domestic base as against a worldwide one, your relator suggests that the Congress might consider some broader policy questions which overlap questions purely of taxation.

These policy deliberations must also take into account two other sharp attacks made on natural resources businesses by H.R. 13270.

One is the limit on "hobby loss" deductions fixed in Sec. 213(a). The other is the limit on personal deductions computed in Sec. 302(a), which uses certain intangible drilling costs, and the excess of percentage over cost depletion, as limiting "tax preferences."

All three—lower percentage depletion, lower hobby loss limits, and lower personal deductions—make natural resources less attractive for investment and will discourage spending in this area.

The "hobby loss" section is particularly menacing, in that the realities of mineral exploring usually call for a long period of testing and waiting before anything turns up. Estimating the final cost is usually little better than guesswork. To have to use after-tax dollars until the payout comes is a burden that those able to bear my just as easily decide to forego.

In 1954 the Congress was so concerned about this particular issue that it inserted present Sec. 270(b) of the Code to assure Uncle Sam that needed exploration and development in the oil business would go on.

It is a matter of interest that Amerada Corporation spent at least $20,000,000 in North Dakota before making its first discovery; and it will be a matter of more pertinent interest to see when Alaskan North Slope production brings a profit.

It is particularly the oil business which brings policy questions into play. In 1969 this business is not the happy playground of rich tax-dodgers, as politicians call it, but more a beleaguered giant.

If in fact the Congress had schemed to launch an attack on Pete Petroleum in the year in which he would be most open to one, 1969 would be Y-Year.

In 1969 Uncle Sam and the world have plenty of oil; the black stuff pops up everywhere and has not risen in price since around 1950. As a result Pete has his marketing troubles without facing the other troubles threatening him.

In 1969 the oil-rich world found new riches in the Alaskan North Slope discoveries. Pete has to face the price competition of this oil now, while it is still landlocked in the frozen Arctic.

In 1969 the Athabasca tar sands in Alberta went into commercial production, and the Alberta government has just approved a second extracting and refining unit. This area has oil reserves equal to the total of the whole world's present known conventional reserves. The product comes into Pete's marketing territory and he must reckon with it.

In 1969 Pete has to face the competition of foreign government-dominated companies even in scrambling for leases in Uncle Sam's back yard. Side by side in Texas, or Louisiana, or California, or Alaska, may be Pete, Acquitaine

(French), British-American (British), Petrofina (Belgian), Deutsche Erdoel (German), or AGIP (Italian).

In 1969 the President announced that he would lower oil import quotas, opening Pete's domestic territory to the direct price competition of oil produced abroad; produced, obviously, by labor paid a good deal less than Pete has to pay his employes, and under such odd conditions of life as being subject to instant decapitation at the whim of some Sultan.

These complications and many more face Pete in trying to carry on his daily business at home. Now Pete is a large taxpayer and the employer of millions. Should Uncle Sam try to heap further burdens on him in this year of his grievances, 1969?

When Pete carries his business outside Uncle Sam's yard, it meshes with certain deep concerns of Uncle Sam.

In 1969 this globe is hardly the Peaceable Kingdom of Adam and Eve. Uncle Sam is adding to his defenses. It is in his interest to have friends, who can defend themselves and help defend him, in areas he thinks the cornerstones of foreign policy and defense.

For instance, Canada is a place that Uncle Sam has to guard, or see guarded, even if it is hostile; and the Middle East, including Libya and Saudia Arabia, is a cornerstone area in foreign policy.

These places have oil, developed by Pete's investment, not Uncle Sam's, but Pete's investment makes it possible for these places to defend themselves and so bolster Uncle Sam's defenses and foreign policy.

If Uncle Sam's interest in these places should fall, that of Uncle Ivan or Uncle Mao will bound upward.

H.R. 13270 lessens incentives for Pete to invest his money in these places and will raise incentives for oil producers in these places to join other producing and marketing (and political) systems.

Is the Congress sure that this is consistent with Uncle Sam's best interests internationally?

The Congress might remember that it saw fit to exempt Canada from the strict rules of the Foreign Direct Investment Act.

III. CONCLUSIONS

This ends your relator's statement on H.R. 13270.

The Bill can do what the Congress wants, if the Congress's dearest wish is to see all men and women who enjoy sizeable incomes pay some income tax.

It will come at a cost, including badgering charities, discouraging capital investment and basic businesses, and a new Internal Revenue Code of unbelievable complexity.

To your relator all this effort resembles building a mile-high, mile-long, 220,000-volt electric mousetrap.

The Congress admittedly has the power and duty to provide for the general welfare and to collect taxes to do it. Your relator would welcome a real income tax reform; but the Tax Reform Bill of 1969 has pilfered a name which it has not earned.

As a positive recommendation, your relator asks the Congress to restudy basic tax policy and to take the time to simplify taxes. So far, from 1913 to 1969, "reforms" in income taxation meant adding some new subject of litigation to the Act or Code.

As it stands the Internal Revenue Code needs changes of both form and substance.

In choosing simpler forms, the Congress might look at the British Inland Revenue Acts. In these a simple basic act levies the tax. Appended schedules fix the subject-matter, rate, and special treatments such as depreciation. To make changes, the Parliament has only to amend the schedules involved.

In dealing with substance, the Congress should decide whether a taxing act should try to do more than collect money. Your relator feels that it should not, even though any taxing act is bound to have an effect on every man, woman, and business subject to it.

The always-growing list of special favors handed out under the income tax has made the Internal Revenue Code the bulky puzzle it turned out to be.

A tax rebate on tea fired the American Revolution, and tax favors to oil producers fueled the movement for H.R. 13270. Outright subsidies to favored beneficiaries would be simpler, would not complicate the tax structure, and would probably be cheaper.

The Congress should then decide whether it really needs more than one kind of tax. From 1789 to 1862 the tariff supplied all of Uncle Sam's tax income.

While this will not do for an exporting country, a sales tax might be the ideal answer. It reaches everyone and everything and it brings in a lot of revenue.

While a single tax which is a sales tax may sound questionable politically, in assessing the relative worth of tax types the Congress must put aside the hypocritical moral and emotional issues that clog the simple matter of raising money.

The purpose of a tax is to raise money wanted. If it does that, it succeeds. No matter in what spirit or for what purpose applied, it is an extortion based on power to force payment, and earns no heavenly blessing because squeezed from the rich to scatter among the poor.

For this reason, if a tax brings in all the money that the Congress wants, it is immaterial to the Congress that the tax does not reach some men, women, or objects, and that some men, women, or objects go untaxed.

In reaching the specifics of the tax or taxes chosen, the Congress should decide whether it should allow any exclusions, exemptions, deductions, or rebates. Your realtor feels that it should not; this is the opening to favoritism and complex tax plans.

The data gathered by the Congress to guide its choice of tax or taxes will also supply information on how the tax will work.

A man, woman, or corporation paying a sales tax coming to 10% of gross income, or an income tax coming to 15% of gross income, may be just as well off as if paying a tax of 50% of net income left after a myriad of exclusions, exemptions, and deductions, each of which is problematical and each of which could lead to a long-drawn-out lawsuit for each year in which claimed.

In conclusion, your relator objects to H.R. 13270 because it is arbitrary, inflexible, and complex; but your relator would support genuine tax reform meant to raise revenue simply. A single tax, without exceptions, levied on a gross basis, would be the best model toward which to work.

BELOIT COLLEGE,
Beloit, Wis., August 7, 1969.

HON. RUSSELL B. LONG,
Chairman, Senate Finance Committee,
Washington, D.C.

DEAR SENATOR LONG: I am enclosing copy of a statement that I have prepared specifically for consideration by all officials of the federal government who are giving attention to the matter of tax reform at the present time.

I do so with some trepidation and embarrassment because of the magnitude of what is proposed by the statement. It may even appear to some to be irresponsible in its radical simplicity. However, I am convinced that the basic points are incontrovertible and that some person must urgently be about making them.

I would appreciate it, therefore, if you could find some time to give attention to my statement as Chairman of the Senate Finance Committee.

Respectfully yours,

MILLER UPTON, *President.*

AMERICAN TAXATION—THE NEED FOR COMPLETE OVERHAUL NOT ISOLATED REFORM

(By Miller Upton, President, Beloit College)

In my presentation to the House Ways and Means Committee on March 14, 1963, in opposition to the so-called Kennedy tax reduction on the grounds that it would inevitably lead to inflation rather than secular growth, I concluded with the following statement:

"As for our tax situation, we have reached the place where we must dispense with the use of patent medicines in the form of rate reductions and isolated amendments and resort to surgery in the form of a complete overhaul. Anything less than this will merely be temporizing and no worthwhile effect will be had on long-range economic development. Everyone who has given any serious consideration to the matter has had to admit that the present tax structure is a monstrous concoction without any governing rationale—a burdensome and ugly mass of unrelated accretions that have accumulated over time as an outgrowth of different political and emergency pressures. It can readily be shown to be inequitable, overly cumbersome, overly expensive to administer and a severe deterrent to economic vitality and growth and development.

"Although taxation is as old as human society, general reliance on the in-

come tax is relatively new. Certainly it is new in this country. We have learned much from our experience over the past fifty years which we should draw upon in developing an entirely new tax structure. The present tax law should not be considered sacrosanct simply because it is the prevailing law. We should not allow ourselves to become enslaved by a monstrous creature which has been fashioned by the combining of separate and disparate acts designed to deal with immediate needs which vary with the passage of time.

"In the final analysis, tax reform is fundamentally simple if it originates from a real desire to deal with fiscal and economic realities and does not confuse the issue with political pressure. If the government would proceed in such reform on the known fact that all taxes, however called or however collected, must be paid out of individual income, a new structure could readily be developed which would be simple, direct, equitable, and efficient.

"Such fundamental reform should also reckon with the fact that in any society there should be only one taxing authority. The situation that prevails now with communities, states, and the Federal government vying with one another for the citizen's tax dollar is one of utter confusion and leaves the individual taxpayer a pawn that is pushed around rather callously by the separate governmental authorities, each passing the buck to the other. Either the Federal government should raise its revenue by an assessment on the individual states on the basis of each state's contribution to the national income, or it should become the central taxing authority and take care of the separate needs of the states. In keeping with the Federal character of our national governmental structure the assessment approach would be by all odds the better, but we seem to be drifting rather indifferently and dangerously toward the other.

"Certainly there would result from such a major overhaul a substantial amount of temporary disruption within the economy. Some businesses and business practices have come to be tied directly to the ramifications of the existing tax law. But to preserve a bad law to protect its economic spawn would be the height of irrationality. The economic disruption resulting from a complete tax overhaul would not last long, and the great benefits that would result to our society at large would be worth far more than the price of temporary inconvenience that would have to be paid."

I submit that this strong but not exaggerated statement is even more true today than it was six years ago and will become increasingly more accurate and demanding with the passing of each year. In view of the widespread and serious consideration being given to the tax structure at the present time it would seem that there has never been a more propitious time for facing realistically the need for complete overhaul and doing something about it. The need is too critical to lose the opportunity that exists now.

The point to be reckoned with it not that there is no need for the kinds of reform being given serious consideration by the Congress at the present time. To the contrary, the need for such reform for the sake of equity and efficiency is so intense and pervasive that isolated adjustments have the effect of mere tinkering rather than fundamental reform. True equity and efficiency can be achieved under existing circumstances only by a complete overhaul that starts from scratch. In the meantime we should stay with what we have, including the existing surtax, for the whole structure is so intertwined and confused it is impossible to determine or predict what the net effect of isolated tinkering will have upon the economy and the society in terms of tax incidence, tax incentives and revenue generation.

Any such complete overhaul should proceed with full adherence to three principles in particular. These are: (1) All taxes, however named or however imposed, must ultimately be paid out of individual wealth. (2) For a given society there should only be one taxing authority. And (3) equity can be assured only if the tax system is used strictly for revenue-producing purposes and not perverted to other political and economic ends.

In addition to these basic tax principles, any substantial overhaul must reckon with the basic equity value judgment to which our society seems to be increasingly committed that taxation should be based upon ability to pay rather than benefit received. What this means in particular is that the tax burden should be related to individual current income rather than accumulated wealth in any form. If accumulated personal wealth is to be tagged for social purposes it should be done by inheritance taxation and not by the current revenue producing system.

Both equity and efficiency, in other words, calls for a single, simple progressive tax on individual income. Only in this way can the incidence of the tax be readily determined and the revenue generation be readily and reasonably anticipated.

No tax system can be defended as either efficient or equitable if its incidence is unknown. That is why even the corporation income tax should be dispensed with in favor of the single progressive individual income tax. Reason supports the proposition that most corporation taxes are passed on to the individual by way of inclusion in its product price, but precise identification is impossible. And under those conditions of elastic demand for the product which may inhibit full recovery by way of the price, the tax becomes a tax on production and not income and therefore self-defeating.

Corporation income should be taxed the same as partnership income is now taxed, that is, identified with the individual owner and taxed as his personal income. Each corporation would certify to its per-share earnings for a given year and the individual stockholder would declare this as ordinary income. Although the point is disputed, such an approach could have by-product advantages for the economy in general in that it would provide a check on an individual management's decision to retain earnings for corporate purposes, and it would free the corporate form of business organization (one of man's greatest inventions) from irrational discriminatory treatment.

On the surface, excise taxes and use taxes of various sorts would seem to be the one justifiable exception to the single tax on individual income. The incidence is clear and equity seems to be respected. But closer scrutiny brings to light the illusory nature of such thinking. Certainly the user of the toll road is not the sole beneficiary of such. Immoderation in general is a greater social evil than a particular item of consumption per se. And one man's luxury may well be another man's necessity. In fact, we are well acquainted with historical validation of the dictum that today's luxury *is* tomorrow's necessity. Excise taxes rely upon a morass of value judgments that make equity indeterminate and therefore should be no part of a straight-forward revenue-producing system.

In support of the principle that for a given society there should be only one taxing authority, it would seem only proper in our country for this to be the fact that the Federal constitution specifically grants the Federal government the right to tax directly and not rely solely on an assessment of the individual states, the dominant trend in our society over recent decades, particularly as regards taxation, has been toward centralization of governmental authority in general to the point that reliance upon a system of state assessment by the Federal government would be anachronistic. Furthermore, centralizing the taxing authority with the Federal government avoids the danger of duplicate taxation of a given individual's income by separate states and the possible development of "border taxes," such as sales taxes imposed by a state to raise revenue from the "foreign" tourist. Such reasoning constitutes a shift from the position I used to hold.

Clearly the Federal government is without authority to require the sovereign states to give us their taxing authority, but a system that would enable states and municipalities to raise their revenue needs by latching on to the Federal tax would have great appeal to these governmental units on the basis of economy, certainty and equity. Instead of participating in some inescapably involved sharing formula, each state and municipality would be authorized to establish a tax rate of its own to be added to the Federal rate and collected by the Federal government. For example, an individual citizen living in New York City might have his income subject to Federal rate, or a New York State rate and a New York City rate, all applicable to the one income figure and all collected by the U.S. Internal Revenue Service. Funds thus collected by the Federal government on behalf of the State governments would be turned over to them, and they in turn would be responsible for making the distributions to their respective local governments. Each governmental authority would receive a copy of each of its citizen's tax reports for checking and control.

Under such a system there would be no need for local property taxes. Renters and property owners would be treated equally on the basis of ability to pay. But absentee property owners would be subject to local tax rates wherever they own property as well as where they reside.

Where our taxing authorities have been most negligent in the past is in violation of the principle that the tax system should be used strictly for revenue-producing purposes and not perverted to other political and economic ends. These ends should be sought directly and not via special tax allowances. Failure to be faithful to this principle is what has produced so much of our crazy quilt pattern with built-in contradictions, discriminatory provisions and arbitrary allowances. The raising or lowering of the tax burden in general for purposes of fiscal policy is not a case in point. It does not modify the internal aspects of the law.

33-865—69—pt. 2——29

The goal of equity as represented by ability to pay can only be approached by a progressive rate schedule applied to a uniform definition of income. Clearly it is impossible to promote general equity on an individualized basis, and the governmental authority should not be placed in the compromising position of trying to do so. It is enough that the tax be equitable; to expect it to compensate for all the existing inequities in life is totally unrealistic. A Christian Scientist can make a strong case for an educational allowance in place of a medical allowance. And the excessive medical payments of a hypochondriac clearly should not be subsidized by other citizens. Nor should profligate use of credit be rewarded by the interest thereon being allowed as an income deduction.

The size of one's family, furthermore, should be looked upon as one of life's personal decisions for which one accepts responsibility, and it should not be a tax consideration. Those who choose in favor of a small family on the grounds of economic responsibility should not be penalized in favor of those who prefer large families. If family welfare is involved it should be handled directly by a special private or governmental program designed to deal with the problem on the basis of its individual nature. The very allowance for dependents in income calculation requires a definition of the term that in the final analysis must be arbitrary. And the amount to allow for dependents so defined is bound to be arbitrary in the ultimate.

Each governmental authority should determine its level of service and then raise the needed revenues in the most direct, efficient and equitable fashion possible. It can only do this if it keeps its revenue system free of contamination from diverse political economic and social objectives. (Again, fiscal policy excepted.)

Once having provided for the calculation of an individual's tax liability in this straightforward fashion there should be opportunity for a tax credit based upon the individual having voluntarily taxed himself. Two principles are involved here. One is that private initiative and philanthropy is the cornerstone of a free society. The other is that government in a free society should only undertake those services which its individual citizens are either unable or unwilling to do on their own initiative. Contributions by private citizens to finance needed social services, therefore, constitute a form of voluntary tax and should be allowed as a credit against their individual tax liabilities up to a fixed limit.

One final matter remaining for consideration is the implication of this approach to the capital gains tax. Since total individual income each year will be subject to tax whether realized in cash or not, separate taxation of appreciation could constitute double taxation and therefore an inequity. To the extent that appreciation in an individual case is in excess of the accumulated earnings retained plus any factor of monetary inflation, taxation of this additional income can be justified. The most defensible approach would be to reckon it as a discounted value of future earnings and prorate it to current income over an arbitrary period of time into the future, such as ten years.

The aim of this paper, however, is not to submit in definitive form a total tax revenue structure. Such is beyond the capability of any one individual. Rather, the purpose is to try to establish in broad outline form the basic approach that must be taken to achieve the kind of complete overhaul that is called for at the present time. As long as we continue to temporize and tinker with what is obviously an inefficient, inequitable, overly cumbersome and outmoded tax structure we will merely be compounding our difficulties, aggravating our dissensions and prolonging our self-made suffering. Simple logic insists that our society will have to come eventually to some straightforward revenue system as described herein. Why not now?

AMERICAN VETERANS COMMITTEE,
Washington, D.C., July 14, 1969.

Hon. RUSSELL B. LONG,
Chairman, Senate Finance Committee, U.S. Senate Office Building, Washington, D.C.

DEAR SENATOR LONG: I would like to call your attention to the enclosed resolution on "Tax Reform" passed by the National Convention of the American Veterans Committee last month.

Your comments will be welcome.

Sincerely,

JUNE A. WILLENZ,
Executive Director.

Resolution: Tax Reform

I

AVC in its platform has called for tax reform; that is, the abolition of favored treatment of numerous types of business transactions and of the exemptions of broad classes of income from the burden of income taxation. Tax reform is NOT, however, the imposition of a token tax on a small group of very wealthy taxpayers whom the law presently enables to avoid all taxes or the repeal of the income tax which now hits some very small net income earners. If, as the Nixon Administration proposes, only these two steps were taken, it would be in effect a refusal to bring fundamental justice to our tax system. Even within this framework the Administration proposals reduce the proposed tax bite from the income of the very rich from $420,000,000 in earlier proposals to only $80,000,000 in their own current project and narrow relief for low income taxpayers to the very lowest group which pays minimal income tax in any event, and pays taxes primarily through sales taxes which some Administration leaders seem to favor on a nationwide scale under the guise of a "value added" tax. This reshuffling of income taxes would help the very low income earners very little and would certainly not relieve seriously their poverty. To this end, welfare policies must be revamped as we propose in a separate resolution. It is our hope that Congress, sensing the mood of taxpayers, will take the bit in its mouth and enact a program which will reshape our income tax to make it a fair instrument to raise the funds needed to finance national programs.

II

The areas of favored income and transactions are today well-known in their broad outlines to lay taxpayer and tax specialist alike. In general, in these areas, tax reform means the removal of the tax favored treatment. If some situations require special formulae, these would not be in the nature of exemptions, but of defining the application of the general principles imposing the income tax to particular sets of business facts.

The major classes of income which should be made fully taxable are:

1. Interest from tax-exempt state and local bonds, including industrial development bonds.
2. Capital gains, including unrealized capital gains on assets passing on their owner's death to his heirs or as the principal of a trust upon the death of the tenant to the remaindermen.
3. Income from oil and gas properties and rights and other mineral and natural resources through application of depletion allowances.

Arrangements which should not give rise to tax-favored treatment include:

1. Stock options for corporate executives.
2. The splitting of a single business into multiple corporations to escape in part the surtax on corporate income.
3. Unlimited charitable contributions.
4. Charitable contributions of appreciated property.
5. Real estate transactions involving accelerated depreciation and other "tax-shelter" devices.
6. Interest paid on funds borrowed for certain types of bond purchases.
7. Farms operated primarily for loss deduction purposes by individuals and corporations engaged in non-farm callings or professions.

It has been estimated that the annual tax loss to the U.S. Treasury Department from the tax-favored treatment of these and other classes of income and transactions exceeds $20 billion at present tax rates. Obviously, many social programs for the relief of poverty and discrimination, for the improvement of housing and of our environment, and for the advancement of science and education could be financed and, in addition, relief be given to the lower and middle-bracket taxpayer.

III

The business activities and investments of charitable and educational and religious institutions, including private foundations, have grown to such an extent that the burden on other taxpayers of the exemptions from income tax which their income from these sources largely enjoys, is seriously called into question. We endorse proposals to subject their income to taxation at a special

lower rate which recognizes implicity the public benefit judged to flow from their activities.

We warn, however, against the misuse of the need for reform in this area, as well as in the area of self-dealing and personal benefit between foundations and their founders, to impose upon foundations restrictions on the choice of their activities which reflect political prejudices of congressional majorities and bar them from innovative social projects which could not be undertaken without foundation support for the benefit of the American people.

IV

We urge immediate repeal of the investment credit provision in order to help stem present inflationary pressures.

Statement of the American Veterans Committee (AVC) Submitted By June A. Willenz, Executive Director

This statement is submitted on behalf of the American Veterans Committee, Inc. (AVC), a group of veterans of our country's wars from World War I to the war in Vietnam. It was founded by World War II veterans to foster a more democratic and prosperous America and a peaceful world. Hence, our concern with the proposed tax bill. At our National Convention in June 1969 we expressed the hope that Congress would enact a measure to make the Federal income tax laws a fairer instrument to raise the funds needed to finance national programs. Our tax program adopted by the Convention, is included in the printed record of the Senate Finance Committee on the subject of tax reforms.

I

The bill adopted by the House of Representatives represents a step forward in increasing the tax contribution of those who heretofore have altogether escaped any tax burden or at least their proper share of the burden. We commend the House of Representatives for having taken this step and urge the Senate to concur in the House action. We wholeheartedly endorse the proposals to reduce, among other measures, oil and mineral depletion allowances and other excessive deductions allowed the oil and gas industry at present, to increase the taxation of capital gains, to reduce the tax shelter provided by certain types of real estate transactions, and to increase the taxation of financial institutions, of certain corporate activities and arrangements, and of deferred compensation.

We oppose all those Administration proposals recently presented which would reduce the impact of the tax reform proposals adopted by the House of Representatives. The net effect of the Administration proposals is to water down the by no means perfect provisions of the House bill to achieve a greater measure of tax justice. The Administration proposals are regressive proposals which should be rejected.

II

The proposed House tax bill, however, contains two highly regressive features:

(1) It sacrifices the opportunity of improving the welfare of those millions of Americans who have not been able to overcome poverty and racial prejudice, and of providing other opportunities for social and environmental betterment to tax relief for those in the middle and higher income brackets.

(2) It compounds this disregard of our social and environmental needs by straightjacketing, curtailing, and restraining privately financed tax-exempt activities directed toward the solution of the problems alluded to, when carried out by tax-exempt institutions and foundations.

III

By drastically reducing national tax receipts, the bill wholly disregards, and the Administration proposals would disregard, our major national needs and goals. Instead, it proposes to dissipate the several billion dollars of new income raised and indeed more in tax relief to individual income taxpayers, and, if the Administration proposals are accepted, also to corporations. These proposals are made at the very time when we are told daily how sums a fraction of what (ultimately) nine billion dollars of tax relief would accomplish vital success in eradicating hunger, providing a minimum income for the poor, remedy the worst

aspects of air and water pollution, revitalize low-cost housing construction, or solve many other social problems.

An yet the House has now voted to appropriate these sums, when they finally may become available, to individual American taxpayers. We approve of tax relief, however, small, for those whose total income is below the "poverty line", though we realize that such relief will do little to remedy their poverty.

But the bulk of the proposed tax relief will go to Americans mostly not in need at all, in small driblets running from less than $100.00 to several hundred dollars per year, as if this were our highest and most urgent priority! Important tax reductions, when achieved under the bill are obviously reserved to the high bracket taxpayers whose taxable income exceeds the $25,000 level. Among the various classes of taxpayers principal benefits go to the relatively small number of corporation executives, lawyers and other professionals who earn compensation in excess of $100,000 by limiting the maximum tax on their compensation to 50% and have borne a higher tax burden up to now without restraint on their activities and are well able to continue to do so. They go in addition to single persons over 35 years of age (hardly as yet the elderly) without family responsibilities who all along the line get a break far more substantial than that given to married taxpayers with children. Even percentagewise the new schedule is unreasonably erratic: for instance, the tax reduction for a family of four is 5.5% at $25,000 and for an individual over 35 without family responsibility, it is 6%. Certainly, these pecularities should be further considered and corrected.

If, on the other hand, the most recent Administration proposals are adopted, additional tax relief would go in substantial measure to large corporations at the expense of taxpayers in the lower middle income range. We see no reason why corporations are deserving of tax reduction at their expense.

But beyond all the inconsistencies within the tax reduction plan which the House bill and the Administration proposals share in one way or another and their injustice in favoring high bracket taxpayers, there remains the callous indifference to the suffering of the poor and to our urgent social needs. All the money to be raised and an estimated two billion dollars more goes to those less or least in need and goes to individuals for personal expenditure (or, possibly, to corporations for dividends and higher executive salaries) as against expenditures for public and common needs. If this part of the bill stands, Congress would not only sanction a shirking of long-accepted public responsibilities but also confess, in the face of selfish pressure and clamor, to lack of courage in acting for the best welfare of all and in championing a better life in the United States. If Congress were to follow this step by unrestricted grants from the thus reduced federal income to the States, as is now urged, we could only consider such action a further abdication of Congressional responsibility. We urge Congress to reject the first step on this road which is now before and to vote down the unneeded tax reductions proposed to it.

IV

A major goal of current economic policy is the stated purpose of eliminating inflationary pressure on prices, especially for consumer goods. The middle income taxpayers who seek, and who would be the beneficiaries of, income tax relief, are those who suffer most from current inflation. Perhaps they and those who support tax relief for them will understand, if not national priorities of social goals, at least the fact that the distribution of billions of dollars of new tax money to them, likely to be used mostly for immediate consumer expenditures, will feed inflation even more than all budget deficits together. The bill proposes to remove the investment credit because its effect is currently considered inflationary. It then feeds the flames of inflation by giving more than twice the amount thus taken out of the economy to individual taxpayers. The inconsistency of the two measures is apparent. If the inflation menace is taken seriously, massive income tax relief should be postponed for a long time.

V

Both historically and in our own day the people of the United States have relied to a large extent on private initiative to support education, the arts and sciences, health and welfare services, and all manner of scholarly research into scientific and economic or social problems. Private wealth, rising to the challenge, and the support of large numbers of smaller contributors have made many of these activities possible through the creation of operating institutions or capital funds devoted to the financing of these goals. Their great usefulness to our society has

been recognized by tax exemption of the income of these institutions and of a tax deduction for contributions made to them. In particular, many socially-minded individuals and persons interested in the advancement of the arts and sciences have in recent years created small foundations the income and capital of which are used to fund studies and experimental activities in these fields, often not suitable for larger institutions or Government-funding.

The pending tax bill now proposes to deprive the United States of many of the contributions which these institutions and funds have made, especially to the knowledge of human society. The proposed bill does not prohibit such activities outright, but by a combination of bureaucratic record-keeping requirements and substantive restrictions on the subject matter of research grants and on the activities of foundations, makes the continuance of these activities so onerous that many institutions and funds will prefer to eschew them altogether rather than to run the risk of severe penalties for what may be later held to have been minor violations of hazily-phrased statutes. We ask ourselves whether the Senate, and Congress as a whole, really desire such a result.

Does Congress really intend, for instance, in the proposed section 4945(b)(2) of the Internal Revenue Code to bar foundations from financing all but the most abstract and technical research in the field of law reform? Almost by definition such research is an "attempt to influence legislation," that is to present or counsel against proposed changes in the law.

Is this provision actually intended to prevent public museums or other cultural institutions which are or may hereafter be financed by local Government from seeking higher appropriations?

Is it really intended to prevent the executives of the Brookings Institution or of similar research institutes, from testifying before committees of Congress on economic policy and the effect of proposed legislation on the American economy or on matters within their special field of competence in other fields?

We cannot believe that Congress, in reaction to certain specific and highly visible violations of trust by foundation managers, would hamstring all but the most routine foundation activities. In our view Section 503(c)(3) of the Internal Revenue Code now imposes adequate limits on foundation programs, prevents political abuse and assures that freedom which is necessary if foundations of all kinds are to be able to continue to make their fruitful contributions to our national life. In consequence, we consider the additional restraints proposed to be imposed under the new section 4945 of the Internal Revenue Code which go beyond existing law as undesirable and urge that they be rejected.

VI

At the moment our hopes rest with the good sense of the Senate and with the ability of its forward-looking leadership to withstand pressure for petty benefit which taxpayers may seek to appropriate for themselves by threatening to defeat those standing momentarily in their way. We also trust that they will not allow the imposition of improper restraints on valuable private activities to be imposed by those who wish to ventilate their rancor against some foundations because of some of their activities.

The provisions of the proposed tax bill now threaten the accomplishment of our national goals in the areas of important social and national purposes: Elimination of poverty; improvement of our physical environment; combatting hunger; better housing and education; advancement of the arts and sciences. If new tax revenue is now uselessly frittered away, if private activities for the solution of our social problems are restrained and restricted, then we will for a long time put the accomplishment of our national goals and purposes in these areas beyond our means. We earnestly hope that a majority of the Senate and the entire Congress will oppose the waste of public funds to which we have pointed and thereafter appropriate the new revenues to the goals and purposes indicated herein and which stand high in our national agenda.

Statement of Ronald F. Weiszmann, Cincinnati, Ohio

This committee has had numerous witness present their cases as to why the particular loophole or special tax exemption, deduction, allowance, or what have you, is essential to the preservation of this country's colleges, charities, oil supply, investment, etc. The common string running through each of these groups and

the benefiting taxpayers is that they have large and powerful lobbies bending the ear of Congress to accede to their plight.

None of these groups, or is there any group that speaks for the plight of the middle income taxpayer and, consequently, he unfairly shoulders a disproportionate share of the tax load.

As one example, take the school situation where colleges assert the reduction in charitable deductions will severely curtail their funds. But on the other side of the coin is the fact that numerous local (grade and high school) school bond issues have been turned down by taxpayers because of their excessive total tax burden. Consequently, we may end up with great colleges but inadequately prepared applicants because of the severe curtailment of funds available for grade and high schools.

In addition to the need for modifying the income tax structure, it has become quite apparent that our general method of raising revenues for local schools is totally inadequate. The quality of education now obtained by a child is dependent solely on where he lives and the local school district and its relative concentration of industry for property tax. Several law suits are now winding their ways through courts contesting that this method of allocating school funds violates the equal protection clause of the U.S. Constitution.

Pursuant to the authority vested in Congress under the 14th Amendment, I strongly urge the inclusion of a provision similar to the following in the tax bills:

Pursuant to the 14th Amendment of the United States Constitution Congress has determined that it is a denial of due process and equal protection of law for different per capita amounts of money to be spent on students residing within the same state, wherein the difference in funding is based merely on the geographic location of their residence. Accordingly, we hereby enact the following law to correct this glaring inequity:

"Section 1. EQUAL EDUCATION.—It shall be unlawful for any state or any of its subdivisions to allocate and/or spend pursuant to state law, administrative decision or any means whatsoever, other than substantial equal dollar amounts on a per student basis as determined by the total number of students enrolled in the public elementary and secondary schools of that state.

"Section 2. SUBSTANTIAL EQUAL DOLLAR AMOUNTS.—This term may include a reasonable basis to allow for a disparity of cost of living between the various parts of a state but shall not in any manner be adjusted to accommodate any difference in the taxes of any local or political subdivision of the state.

"Section 3. INCENTIVE FOR PROMPT ADOPTION.—The states shall have five years to comply with these provisions and any state completing and initiating a plan acceptable to the Department of Health, Education and Welfare within one, two or three years of the enactment of this section shall receive a Federal allocation of ———— dollars per year per pupil for each year less than four years within which its plan is inaugurated."

It is quite apparent that enactment of a section similar to the foregoing will do much to eliminate the rempant and invidious denial of equal protection of the laws now perpetuated by our state property tax laws.

Another tax point to be considered is the oil depletion allowance. The papers have been flooded with numerous ads relating to the necessity of increasing the price of gasoline if the depletion allowance is reduced. The truth of the matter is that the oil depletion has constituted a taxpayer subsidy to auto users. This system relies heavily on all taxpayers supporting substantial users of autos such as corporations having large auto fleets and trucking companies. Not only does this prevent the user from realizing the real cost of auto operation, but it also causes untold millions of dollars in air pollution damage.

Not only should the depletion allowance be eliminated, but a Federal pollution tax of at least $.05 a gallon should be exacted with the resulting money going into an air pollution trust fund to conduct research to help eliminate air pollution.

WEINBERG, WARD & BEAM,
PUBLIC ACCOUNTANTS
Birmingham, Ala., September 2, 1969.

HON. RUSSELL B. LONG,
Senate Office Building,
Washington, D.C.

DEAR SIR: Attached hereto are my views as a tax practitioner on a few sections of HR 13270. I should be in favor of the whole bill; it is a sort of Social Security for preparers of tax returns.

I am not an economist. I am a public accountant (semi-retired) with 45 years of audit and tax practice. Every time the tax law is changed I help my clients take advantage of every new lawful means to hold their taxes to a minimum. I have a few wealthy ones; they get attorneys' opinions to bolster my suggestions. They shift their sails with the Congressional winds; and they are well protected. I have never had a fraud case.

My gross income ranges from $9,000.00 to $15,000.00 a year (in 1953 it reached $19,000.00). So I have no axe to grind for myself.

These are my own views; neither my partners nor any other organization have prompted me.

I am thoroughly in accord with taxing foundations, religious and other organizations who compete with taxpayers, either as entrepreneurs; stockholders, landlords or lenders.

Respectfully yours,

J. C. WEINBERG.

FUTILITY

After all the "loop-holes" are plugged by this bill (HR 13270) there will remain ways to avoid, reduce, or postpone taxes, all strictly allowable, but many at the expense of the economy or of the general public. One example: the wealthy are buying cut-over land or exhausted farms, and planting trees. Thirty years hence there will be taxable income, presumably at capital gains rates.

FUTILITY OF CORPORATE TAXES

H.R. BILL SECTION 401 AND 501

It makes almost no difference how you tax corporations; they set their prices to achieve after-tax profits. They either realize their goal or they lose money and get a carry-back refund; and finally they liquidate at a loss, or are absorbed.

Thus: a reduction in percentage depletion works out to a penny or more a gallon on gasoline at the filling station. A disallowance of multiple surtax exemptions for chain stores means an increase in the price of bread. Jones pays the freight.

H.R. BILL SECTION 512

When you disallow one-half of net long-term capital losses by individuals it *sounds* fair because you taxed only one-half the gains. But you are taxing the unfortunate for the benefit of the fortunate. Net capital losses come out of either income or of capital which might produce future income. The loser is poorer by 100% of the loss. And even then he can deduct no more than $1,000.00 in any one year.

The overall purpose of liberal tax treatment of capital gains and losses has been to encourage ventures. This bill does the opposite. Of course, if you want to reduce the taking of chances under the free enterprise system this bill will do it after a few losses by individuals. The odds are too high.

The estimated gain from this section is put at $65 million in 1079. It is a courageous man who can forecast gains ten years ahead. Our budget estimators missed a one-year forecast by $2 billions.

H.R. BILL SECTIONS 301-302-602

These sections in effect tax non-taxable interest on municipal bonds as well as imposing additional taxes on capital gains. It is a scatter-gun aimed at the wealthy, but hitting the public. It also aims, under Section 602, at making the States still more dependent on the Great White Father at Washington.

State and local governments collect local taxes to pay the interest on their bonds. When you tax such interest, no matter how you disguise it, and no matter how piously you invoke equity, you raise the interest rate. Once again the little taxpayer, who owns no bonds, bears the burden in local taxes.

Section 602 makes it worse. It proposes to put the States squarely in competition with private industry for loans. Dollar for dollar, the big corporations are the better risk. Up goes the rate!

It is proposed that the Federal Government rebate the States a predetermined and flexible percentage of the extra cost; and the prediction is that this will cost nothing because collections from presently untaxed holders of bonds will

off-set the rebate. If this be true, we will have accomplished nothing: the bond-buyers will collect additional interest and pay the increase in U.S. Taxes; the Federal Government will collect from them and pay out the money to the States; the States will offset the higher interest with U.S. Subsidy. Why disturb an already weak market in municipals for no fiscal benefit?

SECTION 802—ANTITHRIFT

This section gives with one hand and takes away with the other. A married employee with cash salary of more than $54,000.00 gets relief ranging from 3% to 20%; deferred compensation (usually at retirement) is not subject to relief. Most people spend what they earn; deferred compensation, Social Security and stock options more or less force savings on them, which is a good thing.

A tax incentive on earned income is worthless to the man who is forced to retire at 65. It is no incentive to the idle rich who would have to be trained for any job at all. I can envision a rash of token employment as "managing directors" at large salaries for such people, with consequent reductions in corporate income. Even before adoption of this bill the courts have been crowded with cases of disallowance of family salaries.

The thrifty ones will continue to strive for capital gains unless *all* incentive for such gains is taken away.

I agree that the upper brackets (on all income, wherever derived) are too high; the proof is that they are not yielding the revenue previously predicted for them.

I have confined my remarks to these few sections; there are many more that call for careful scrutiny. I venture my own prediction: the very rich will continue to thrive under any tax bill the Congress brings forth; the general public will pay the taxes for them in one way or another.

CAMPBELL, WOODS, BAGLEY, MCNEER & HERNDON,
ATTORNEYS AND COUNSELORS AT LAW,
Huntington, W. Va., September 22, 1969.

Re Tax reform bill.

Hon. RUSSELL LONG,
Chairman, Senate Finance Committee,
U.S. Senate, Washington, D.C.

DEAR SENATOR LONG: I have been engaged in the active practice of law for more than thirty years, and a great deal of my practice involves business transactions and federal taxation. Through this experience I have had an opportunity to observe the impact of federal taxes in many varied situations. For this reason I am taking the liberty of outlining several of the ideas which I have with regard to the proposed Tax Reform Bill.

Rates of tax on capital gains should be reduced as holding period increases.—The present and proposed capital gains provisions of the Internal Revenue Code tax so-called capital gains, much of which are the products of inflation, and, to this extent, they lay a capital levy. In order to recognize, and to some extent exclude, the inflation factor in realized gains, the rates of tax applicable to capital gains should decline as the holding period increases. The present and proposed taxes on capital gains of corporations and individuals—which are the same, no matter how long the holding periods involved—are grossly unfair and confiscatory. I sincerely hope that the Senate will give due recognition to the inflation factor when re-working the capital gains provisions of the Tax Reform Bill.

Progressive tax rates of incomes of individuals should be reduced as inflation increases wage, salary, and price levels.—As wages, salaries, and price levels increase as a result of inflation, taxpayers must pay a steadily-increasing share of their total higher incomes to the Government, while at the same time the combination of higher taxes and prices serves to prevent any increase in the standard of living of individual taxpayers and, in the higher brackets, serves often to reduce their standard of living. It is because of this crushing effect of the combination of price inflation and progressive income tax rates that Congress recently voted to its members, as well as to Government employees, particularly those in the higher categories, very substantial increases in salaries. If Congress gives this very practical recognition to the needs of its members and to the whole

group of federal employees, particularly those in the higher salary categories, then it should give like recognition to the needs of other taxpayers. I sincerely hope that the Senate will include in the Tax Reform Bill a statement of policy to the effect that it is the intent of the Congress that as inflation continues progressive tax rates will be reduced, to the end that, because of inflation, the Government will not take a steadily-increasing share of the income of the people of the United States and that the Bill reported by the Finance Committee will include rate reductions. It is my opinion that existing and proposed rates on incomes have passed the point of diminishing returns and that lower rates will in fact produce more money than higher rates.

Tax rates on capital gains should be reduced.—Most capital gains realized are the results of *voluntary* transactions. Taxes levied on capital gains discourage the sale of property, and the higher the rate the greater the discouragement. Such taxes reduce the availability of properties for sale. As a lawyer actively engaged in handling all kinds of property transactions, I have seen many deals fall through because the owners refused to become liable for the taxes on the capital gains that would be realized. Such refusals not only apply to land and buildings, but also to all other forms of property, including stocks and bonds. The question often asked by the proposed seller is—"How can I invest the proceeds of sale after deducting the capital gains tax as advantageously as I have already done in the property proposed to be sold?" The obvious result is to lock many taxpayers into continued ownership of assets which should be sold and thereby to increase further the prices of like articles which are in fact sold and thereby create artificial scarcities and higher price levels, which further feed the fires of inflation. Here again, I submit, higher rates on capital gains will actually reduce the money realized by the Government in taxes on capital gains and will serve to increase price levels, whereas a reduction in the existing taxes on capital gains will stimulate sales, increase the total quantity of properties available for sale, and serve to offset inflationary price tendencies by lowering price levels.

The only road to simplicity is rate reduction.—Much of the complexity of the present Internal Revenue Code is the result of effort to soften the impact of the high rates in situations where the high rates either discourage needed transactions or are required to eliminate inequities as between different groups of taxpayers or are required to achieve social or economic ends. The Internal Revenue Code has become entirely too complex. Even skilled tax lawyers cannot agree on the meaning of many of the provisions, with the result that the volume of tax litigation to determine the application of tax provisions in many complicated situations has greatly increased with the years. I submit that the efforts of the Senate Finance Committee should be, first of all, to simplify the Code rather than to increase its complexities. *The Tax Reform Bill before the Committee is probably the most complex piece of legislation ever passed by either of the two Congressional bodies.* A drastic reduction of rates with accompanying eliminations of many of the provisions allowing deductions and credits would certainly go far to provide the simplicity so long desired and also greater equity as between various groups of taxpayers. I have heard it said that a flat rate in the low 20's applicable to individuals would produce more revenue than existing progressive rates now produce and would eliminate much of the confusion and trouble which individual taxpayers have in keeping income tax records and preparing and filing correct returns.

This letter is already too long. I hope you will find the time to read it. I request that it be incorporated in the record of the hearings before the Senate Finance Committee on the Tax Reform Bill.

Respectfully yours,

LUTHER E. WOOD.

KAPLAN, LIVINGSTON, GOODWIN, BERKOWITZ & SELVIN,
Beverly Hills, Calif., October 8, 1969.

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

GENTLEMEN: I wish to make certain comments with respect to the proposed amendments to the Internal Revenue Code contained in H.R. 13270 and the explanation contained in the Report of the Committee on Ways and Means (H.

Rept. 91-413). These comments are the individual views of the undersigned and are not made on behalf of any group of taxpayers or any particular taxpayer, except as noted below.

OTHER DEFERRED COMPENSATION (SEC. 331 OF THE BILL)

The House proposed to radically change the method of taxation of deferred compensation payable under an unfunded arrangement with the employer. Under present law such income is taxable to the employee in the year received. This type of arrangement has been widely used to provide post-retirement compensation benefits to employees. It has also been used as an averaging device by certain groups of taxpayers who experience unusually large income over a relatively short period of time.

Under the House bill the employee would continue to be taxed only in the year in which the income is received but the rate of tax would be computed as if the income had been earned during the period that the services were performed.

The House proposal runs directly counter to two established economic goals which have been consistently supported by prior Congresses and which have the overwhelming support of the public.

First, a taxpayer should be allowed to average the highs and lows of his income over a period of years so that he will not be required to pay a disproportionate amount of tax in relation to his cumulative earnings. The capital gains provision and the income averaging provisions are examples of prior Congressional implementation of this principle. Second, persons retired from the work force should have an income sufficient to provide for their needs. The Social Security program and the pension and profit sharing provisions of the Internal Revenue Code are the two most prominent examples of this principle.

The deferred compensation arrangements which the House proposes to restrict are a self-help variation of income averaging and retirement benefits. A substantial number of taxpayers have been able to average their income in this way rather than under the limited benefits now provided by the Internal Revenue Code. For example, an individual with earnings of $100,000 in one year and $5,000 in each of the next four years is not eligible for averaging under present law. Yet this individual will generally be more in need of averaging than the individual who has four years in which he earns $5,000 followed by a fifth year with earnings of $100,000.

Similarly Social Security benefits are of little value to an individual with moderately high earnings in his pre-retirement years (above $20,000 for example). In fact an individual who defers income beyond age 65 has probably made a conscious choice to forfeit his Social Security benefits until his deferred payments cease or he reaches age 72. Moreover as inflation pushes prices and income higher a greater proportion of the public will be unable to retire on Social Security benefits.

An additional criticism of the House proposal is that it will be difficult to establish guidelines with respect to the definition of deferred compensation. An employment contract in which the employee agrees to perform active services for a period of years and "consulting" services for an additional period may often frustrate the statute.

SUBCHAPTER S CORPORATIONS (SEC. 541 OF THE BILL)

A Subchapter S corporation is a corporation which is not generally taxed as a corporation; instead the earnings are treated as having been distributed pro rata to the shareholders and taxed in their hands. A corporation which elects to be taxed under Subchapter S is entitled to adopt a corporate retirement plan. The House proposed to limit Subchapter S corporations to H.R. 10 retirement plans (relating to retirement plans of self-employed individuals). These plans limit contributions made for the benefit of a self-employed individual to the lesser of 10% of the individual's earned income or $2,500. There is no similar limitation under corporate type plans.

The stated reason for this change is that Subchapter S was intended to simplify the tax complexity of corporations but instead is becoming a method of avoiding the tax limitations of partnerships and proprietorships. The Committee believes that if an enterprise wants to be taxed in a manner similar to a partnership then it should be subject to the same limitations as partnerships.

The explanation given by the Ways and Means Committee appears to justify

the proposed amendment but in so doing it glosses over a major inequity in the tax laws.

The differences between corporate type retirement plans and H.R. 10 plans create the single greatest discrimination against a class of taxpayers under our tax laws. An individual who works for a large corporation is entitled to have a substantial part of his income invested without tax in a retirement plan whereas an individual who works for himself is limited to a fraction of the same benefits. This inequity was recognized in 1962 when the Self-Employed Individuals Retirement Act (H.R. 10) was adopted. The Treasury then argued that an extension of the corporate type plans to the self-employed would create a serious revenue loss. Thus H.R. 10 was intended to narrow the discrimination against the self-employed.

In light of this it is totally unreasonable to single out a further class of taxpayers, that is, shareholders of Subchapter S corporations, and limit this class of taxpayers to the second-class benefits now available to partnerships and proprietorships.

Note also that many corporations which have elected Subchapter S for purposes of "simplicity" could as easily terminate the election and be taxed as regular corporations without increasing their overall tax burden significantly. Thus a Subchapter S corporation which has $50,000 of earnings, part of which is contributed to a retirement plan and the balance of which is paid out to the shareholders as current compensation, can in many cases terminate its election under Subchapter S, make the same contribution to the retirement plan, pay out the same compensation and not be subject to a corporate tax. In this respect the undersigned is personally familiar with a large number of Subchapter S corporations that do in fact pay out substantially all of their earnings in the form of compensation.

The probable effect of the House proposal would be to make Subchapter S unattractive to a large number of taxpayers. One further observation: the House proposal is all the more unreasonable in that it singles out a class of taxpayers as if this class were "avoiding" taxes. This is no more correct than an observation that the tail wags the dog.

CHARITABLE CONTRIBUTIONS (SEC. 201 OF THE BILL)

The House proposed a series of changes with respect to the deduction of charitable contributions. First, the tax advantages under the present law for gifts of appreciated property would be substantially curtailed. Stated broadly there would be a distinction between gifts of appreciated property to private foundations as opposed to gifts to public foundations and a further distinction between gifts of tangible personal property and gifts of intangible personal property. These distinctions are illusory in many respects.

The discrimination against private charities is an indirect penalty on these charities, probably motivated by the mounting criticism of the performance of private charities and foundations. By this distinction, however, the House has attempted to correct the "effect" rather than eliminate the "cause". The better approach is to impose stricter requirements on private charities with respect to their performance. Since the House has also proposed such sanctions it should be unnecessary to further penalize them.

A further distinction is made for charitable gifts of works of art, collections of papers, and other forms of tangible personal property. Unrealized appreciation on this type of property will be subject to the House restrictions regardless of the donee. The stated reason is that "Works of art are very difficult to value and it appears likely that in some cases they may have been overvalued for purposes of determining the charitable contribution deduction." H. Rept. 91-413, page 55. It is patently unfair to discriminate against a taxpayer with an asset "difficult to value" and in favor of a taxpayer with an intangible asset which is presumed to be more susceptible of valuation, particularly since stock in a private corporation is oftentimes more difficult to value than a work of art.

Moreover the Internal Revenue Service has attempted to resolve the valuation problem by creating an art advisory panel of experts and it has promulgated guidelines with respect to the valuation of art objects. The stated reason for penalising taxpayers who make gifts of appreciated tangible personal property is therefore not overly persuasive.

The House also proposed to limit gifts of appreciated ordinary income assets. This proposal will eliminate a serious inequity in our tax laws which favors a small class of taxpayers. An artist who contributes one of this paintings to

charity in effect is contributing the value of his services and is entitled to a deduction for the value thereof. Thus, if the artist paints ten paintings a year, each of which he sells for $5,000, he would earn $50,000 on which he would be taxable. However, if he contributes two of these paintings to a qualified charity his earnings will be only $40,000 and he will be taxable on only $30,000 after allowance of a $10,000 charitable contribution deduction. Such an opportunity is not available to the masses and little can be said in support of this type of deduction.

It should also be noted that this type of deduction has been abused by a substantial number of prominent political figures who contribute their "papers" to charity at an artificially high valuation.

The House also proposed to substantially revise the laws affecting non-exempt trusts and estates. These changes appear to be the most complex and least desirable features of the entire proposal in this area and in practice are unlikely to result in an improvement over existing law.

The gift of a remainder interest in trust would be allowable as a present deduction only if the trust is a "charitable remainder annuity trust" or "charitable remainder unitrust". The reason for this amendment is that the House is concerned that the gift to charity of a remainder interest in trust may be diverted in whole or in part as a result of the type of investments made by the trust. It proposes to reduce the uncertainty involved in such gifts by introducing complex new rules and requiring artificial payout provisions in the trust.

As the House noted the possibility that the charity will not ultimately receive an amount that will "accord" with the charitable contribution deduction allowed the donor generally arises only where the corpus of the trust is invested in high income, high risk assets. A donor who is anxious to enhance the income interest in a trust at the expense of the remainder interest is not necessarily likely to favor such investments. The high risk factor can affect the value of the income interest to the same extent that it affects the value of the remainder interest, that is, by a loss of principal. On the other hand if the House is suggesting that all "high yield" assets are high risk assets, one need only note that Treasury bonds today provide yields of more than 7% to dismiss this proposition.

In my own experience I have never personally known a grantor to attempt to maximize the income interest at the expense of a charitable remainder interest nor have I ever heard a fellow tax practitioner mention such a situation. And in this respect the House has not furnished any statistics which support its position. Thus the probable effect of the House proposal will be to impose unreasonable and unnecessary restrictions upon charitable remainder trusts which do properly benefit the intended charitable beneficiares.

The Ways and Means Committee also discussed its understanding of the law affecting charitable contributions. It stated that "in some cases charitable contribution deductions have been allowed for gifts of charitable remainder interests in trust even though it is not probable that the gift will be ultimately received by the charity." H. Rept. 91–413, page 58. This statement is highly inaccurate. The gift of a charitable remainder is deductible only if the possibility that the gift will not ultimately be received by the charity is "highly improbable", *Jones* v. *U.S.*, 395 F. 2d 938 (6th Cir. 1968), or "so remote as to be negligible", *Darling* v. *U.S.*, 375 F. 2d 843 (Ct. Cl. 1967).

The Committee further stated that it understands that a charitable deduction for income tax purposes would not be allowed in the above situations if the rules under the estate tax law were applied. Therefore it proposed to apply the estate tax rules in the income tax area. The House is misinformed as to the rules under the estate tax law. Under Reg. § 20.2055–2(b) a gift to a charity which is contingent upon the happening of an uncertain event will be allowed as a deduction only if the possibility that the charitable transfer will not become effective is "so remote as to be negligible". Moreover if an estate or interest has passed to or is vested in a charity and the estate or interest would be defeated by the performance of some act or the happening of some event, the deduction will be allowed only if "the occurrence of which appeared to have been highly improbable at the time of decedent's death." These rules are similar to those applied in the income tax area.

LIMITATION ON DEDUCTION OF INTEREST (SEC. 221 OF THE BILL)

Under the present law taxpayers are allowed an unlimited deduction for interest paid on accrued during the taxable year. The House proposed to limit

the deduction of "other interest" to $25,000 plus investment income and long-term capital gains.

The reason for this amendment is that the House believes that certain taxpayers borrow substantial amounts of money in order to create a mismatching of investment income and the related expenses of earning the income. Thus the taxpayer deducts the interest expense against his ordinary income over a period of years and then in a later year he realizes a capital gain from the investment which his indebtedness enabled him to carry.

There are undoubtedly a number of taxpayers who have already incurred indebtedness in order to carry certain investments. The House has not allowed a transition period wit respect to these taxpayers. As a result these taxpayers may be forced either to sell assets to reduce their indebtedness or forfeit part of their interest deduction. This problem could be resolved either by excluding interest on an indebtedness incurred prior to 1969 from the term "other interest" or by gradually treating such interest as other interest over a period of three or four years.

Unused interest deductions will be allowed as a carryover but taxpayers who fail to derive any benefit from the carryover will not receive any further relief. In fairness a taxpayer should be allowed some benefit from these unused deductions; for example as a part of basis.

With respect to partnerships and Subchapter S corporations the House proposed to apply the limitation at both the partnership or corporation level and the partner or shareholder level. It is unfair and also unnecessary to apply the test at the partnership and corporation levels since the provision will be no less effective if the limitation is applied only at the partner and shareholder level. Under present law a partner is required to report on his personal return his distributive share of each partnership item, including if relevant his share of "other interest". Therefore a partner will not be able to avoid the statute by reason of the fact that the interest expense was incurred by a partnership. This is not true of a Subchapter S corporation but the problem is easily solved by filtering other interest down to the shareholders.

To illustrate, assume the ABC Partnership has 10 partners and during the taxable year it incurs other interest expenses of $50,000 in excess of its investment income and capital gains. Each partner would be entitled to deduct 10% of $25,000 on his individual return under the House proposal. On the other hand the XYZ Partnership has only two partners each of whom share profits and losses equally. It incurs other interest expense of $25,000 during the taxable year. Each partner will report $12,500 of interest on his personal return. The House proposal would apply to the partners of the ABC Partnership even though each of the partners would be entitled to deduct only $5,000 of interest as his distributive share whereas the limitation would not apply to the XYZ Partnership even though each of the partners would be entitled to deduct $12,500 on his personal return.

Section 221 of the House bill also contains an unfortunate discussion of the deduction of prepaid interest, discussed below.

GENERAL COMMENTS

The House Report also contains certain comments that are unrelated to the pending bill but which could affect the tax liability of certain taxpayers. In particular the Committee discussed the deduction of prepaid interest and the position taken by the Internal Revenue Service in Rev. Rul. 68-643. This ruling held that a payment of prepaid interest which materially distorts income would not be an allowable deduction to a cash basis taxpayer for the year in which paid but would be allowable only on the accrual basis. According to the Ways and Means Committee "this ruling is in accord with the treatment given other prepayments of expenses and is in accord with your Committee's concept of the law. Thus, it does not seem necessary to include a provision in the Bill to deal with this problem." H. Rept. 91-413, page 73.

This statement has all the appearances of a behind the back attempt to legislate an administrative position of the Internal Revenue Service adopted in No-

vember, 1968 to curb an alleged abuse. As a legal matter the position taken by the Internal Revenue Service is at best the minority view.

To be sure in recent years there have been abuses with respect to the deduction of prepaid interest but it is axiomatic that not every prepaid interest deduction involves either an abuse or a distortion of income. The true abuse situations can often be dealt with under existing law since the so-called "interest" may actually be a loan or may only be a sham.

The problem created by the House advisory opinion is that many taxpayers have elected to prepay interest notwithstanding Rev. Rul. 68-643. In so doing they have studied the relevant law and determined that prepaid interest is deductible in the year paid. Now these taxpayers are rebuffed by a later Congress which has issued a fiat that such interest is not deductible. In this respect the statement made by the Ways and Means Committee is likely to do more harm than good and is offensive to the principles of fair play.

Similarly on Page 66 the House commented on the exchange of a male calf for a female calf tax-free as a like kind exchange. The Committee recognized that there has been some "confusion" in this area and it expressed the view that Congress did not intend this type of exchange to be tax free. It "feels" that allowing this treatment would be an incorrect interpretation of the statute. The question is obviously not free of doubt, as clearly evidenced by the very existence of the remark.

The above remarks were obviously inserted in the the Committee Report at the urging of the Treasury, presumably to improve its position on these issues. The Internal Revenue Service will undoubtedly treat these comments as legal precedents. Indeed it will argue that Congress never intended the relevant statutes to be so used by taxpayers. It is unfortunate that the Treasury can so dominate one branch of the Congress and so effectively encroach upon its legislative powers.

EFFECTIVE DATE OF REPEAL OF THE ALTERNATIVE CAPITAL GAINS TAX

This comment is made on behalf of a client of this office. The House has proposed to repeal the alternative capital gains tax for individuals. The amendment applies to sales and other dispositions made after July 25, 1969. A client of this office made a sale of his business on July 30, 1969 pursuant to a binding contract made prior to July 25, 1969. This client had an expectation on the day that he executed the contract that his gain would be taxable at no more than a 25% tax rate. If the House proposal is adopted and the effective date is not changed, this taxpayer, and presumably others like him, will be subject to an unexpectedly high rate of tax. In this respect the House proposal will have the effect of retroactive legislation. It is requested that the Senate amend the effective date provisions to exclude a sale or other disposition made after July 25, 1969 pursuant to a binding obligation entered into prior to July 25, 1969.

The Senate has previously recognized this type of problem in connection with new legislation. For example, it granted similar relief with the suspension of the investment credit in 1966. See Section 48(h)(3), Internal Revenue Code of 1954.

CONCLUSION

The House bill is an encyclopedia of alleged tax abuses which the Treasury has been unable to deal with in recent years. The proposed solution to these abuses is a series of sweeping provisions applicable to a far greater class of taxpayers than the group of offenders. The comments made in this letter deal with proposed amendments which I believe will create more serious problems than they will solve. Other amendments proposed by the House are subject to similar type criticisms. On balance the House bill needs substantial revision if the final legislation is to be an improvement of our tax laws.

Yours very truly,

MURRAY S. WEBER.

TAX REFORM PLANS IN THE UNITED STATES[1]

(By Prof. Robert G. Wertheimer, Babson College, Babson Park, Mass.)

I. THE ISSUES

"The Computation of the Income Tax is too complicated for a Mathematician. It takes a Philosopher."—ALBERT EINSTEIN.

Talks about a "Great Tax Reform" are misleading: the United States never had reform that would realign taxes to achieve specific ends such as tax justice, broad incentives for savings, a harmonization of the taxing powers of various levels of government. Neither were plans ever submitted to change the relationship of income and other direct taxes versus indirect taxes. We should not expect major changes during this legislation either, though the extension of the surtax will require as political bargaining price some measures discussed subsequently.[2]

Great pressures have been building up to do something about the tax burden on the middle class now squeezed between inflation, rising taxes,[3] proliferating and wasteful programs (there are 600 invididual federal grant programs, for example) without an end in sight of demands either from the poorer sectors of the population or defense. The heavy reliance of the federal government on personal income taxes makes them a particular challenge in terms of equity, equality of treatment and simplicity. Over the years, excessive marginal rates which now have "leveled down" to a "mere" 77% to which state and sometimes local income taxes must be added, led to the establishment of tax shelters of every kind. Now, many people resent that they have to pay more than their fair share of the national tax bill as they see it. Taxes are too high and the average citizen complains that he gets too little for them; he feels strongly that too many wealthier people get away without paying taxes. The system, moreover, makes it difficult for the hard-working man to build up some equity while too many take advantage of relief and idle at public expense. The group most disgruntled about the tax situation consists of those who earn from $6,000 to $18,000 annually and furnish most of income tax collections and see over one-third of their gross wages and salaries swallowed up by direct and indirect taxes.[4]

II. THE TAX STRUCTURE

The American tax structure is incredibly productive and recent deficits were not the result of lagging tax yields but extraordinary needs for defense and welfare. Personal income taxes and social security payments now furnish 70% of total federal tax revenues.[5] The tax brackets have remained unchanged since World War II, making effectives tax rates much higher than during these war years in view of rising money income falling under graduated rates in an inflationary period. The Corporation Income Tax set at 52.9%, the yield of which greatly depends on the growth rates of the National Product, is the second most important revenue raiser. Indirect Taxes furnish a mere tenth of total federal revenues from taxation of tobacco, alcohol, transportation, etc.

The Federal Unified Budget accounting for all tax revenues including trust funds on an accrual basis and loans on the expenditure side, shows this projections: (actually the table is based on the latest National Income Accounts which are very similar.)

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[1] A reprint of an article being published in the Wirtchaftsdienst, Hamburg, Germany, July/August issues (written June 20, 1969).

[2] This is what is going to happen according to acting chairman of the House Ways and Means Committee, Boggs, who will send a minor reform bill to the House by the middle of August.

[3] State and local taxes are equally disturbing. In Massachusetts, substantial increases in the sales and income tax are underway to finance salary increases of state employees. Likewise, property owners will have to pay the deficit of the subway system amounting to $40 million, though fares were almost doubled last year.

[4] In 1929, total taxes on all levels absorbed 10% of the GNP. Today, this ratio exceeds 30% and continues to rise.

[5] Personal income tax rates run from 15.4% to 77% currently against a range of 20% to 91% in 1945.

[Dollar amounts in billions]

	Fiscal year ending June 30—		
	1969	1970	As percent of the total
Revenues:			
Personal income taxes [1]	$89	$94	46
Corporate income taxes [1]	39	40	20
Indirect business taxes	18	19	10
Social insurance taxes	44	49	24
Total	190	202	100
Expenditures:			
Defense including Vietnam	80	82	41
Nondefense expenditures	23	26	13
Domestic transfers on welfare, education, health	48	53	26
Net interest on the public debt and subsidies	14	14	7
Foreign aid	2	2	1
Grants-in-aid to States, etc	20	23	12
Total	187	200	100

[1] Assuming the continuation of the surtax at 10 percent.

While these earlier projections remain subject to change due to the continued inflationary climate, the Congress is pressing hard to reduce spending by 4–5 billion; [6] they give a good overall picture, indicating that some surplus in the budget will be achieved. Latest estimates for 1970 project a surplus of 6.3 billion [7] (provided that Social Security taxes will be increased as planned). There is a warning in place: the extremely tight credit conditions imposed by the Federal Reserve, to be tightened still further, could slow down business operations sufficiently to reduce the growth of the GNP to a minimum in 1970 and, in particular, lower business profits. The result would be a sharp decline in tax revenues while no spending reductions in the six so-called "uncontrollable" items, namely cost of the war, interest on the public debt, social security (medicare and veterans) benefits, farm price supports and grants to states are permissible. In consequence, a new budget deficit could come about, though there remain various ways to "trim off the fat" and to proceed with some window dressing to achieve a balance.

The tax structure has not been entirely rigid in the last quarter of a century. Some changes were introduced such as husband-wife income-splitting, an increase in the personal exemption from $500 to $600, liberalized depreciation, small dividend and investment tax credits, minor income tax rate changes and reductions or cancellation of war-connected excise rates. In the Revenue and Expenditure Control Act of 1968, the surtax of 10% on personal corporate incomes was imposed. Nevertheless, no real structural changes worth being called "a tax reform" took place during recent decades. For many years, tax collections and expenditures have been rising at faster rates than the GNP, while deficits were not the rule. The dilatory tax approach to the financing of the Viet Nam war brought on the huge 25 billion deficit in 1967/68, an unusual experience of a close-to-full employed economy involved in a war that requires less than 5% of total resources.

III. THE STATE AND LOCAL TAX STRUCTURE

In the United States, three levels of governments of which it is said that the national has the money, the local the problem (there are 80,000 municipalities, townships, school districts, etc.) and the states the legal powers, operate independently from each other without coordination or major common plans. State and local spending increased by 120% in the last decade, annual tax hikes run 7–8% and total tax collections exceed $100 billion or 15% of disposable personal incomes. Tax packages are being increased daily including general and

[6] On June 17, 1969, the Senate voted a "ceiling" on Nixon Spending limiting Federal outlays to 188 billion for fiscal 1970 or 5 billion below the Nixon projection of the budget. The House earlier had attached its own ceiling of 193 billion, so that in the House-Senate Conference a compromise will have to be found.

[7] Chairman Mills of the Ways and Means Committee is calling now for a total budget surplus of $10 billion for 1970.

special excise taxes, personal, corporate income and franchise taxes, sales, use and many other taxes. In the last eight years, states alone enacted 260 major tax increases and adopted 24 new taxes.

In addition to tax revenues, state and local governments receive increasing amounts of grants from the Federal government—23 billion for 1970—and also depend on the capital market where they borrow in excess of 10 billion annually on tax-exempt bonds. State revenues are derived to 60% from sales taxes and 20% from income taxes; localities rely to 90% on property taxes of which they collect 35 billion annually from houseowners, etc. Although the mere fact of such ownership is frequently not a true measure of wealth or tax-paying capacity.

Pressures against the taxpayer on lower levels make him particularly conscious of the tax burden, local waste and abuses and the never-ending increases in taxes. For this reason, Federal grants already furnishing 17% of local and state revenues, are considered an indispensable tool in coping with, for example, growth of educational spending from 15 to 44 billion, welfare and health spending from 7 billion to 16 billion (apart from direct Federal spending in both categories), etc.

IV. THE TAX REFORM PLAN

The demand of the Administration to extend the 10% surtax until the end of 1969 and continue with a 5% surtax until June 1970, triggered the argument about the needs of a real tax reform now. To the taxpayer, it brought home the reality that tax increases do not necessarily fight inflation (as consumer prices have been rising still faster since the surtax was imposed in 1968). He realizes that he is saddled both with rising taxes and higher prices and that only major changes in the tax system can achieve justice and equity for him. As neither Congress nor the Administration—from the Kennedy Administration on inspite of his "Tax Reform" Message of 1961—wanted to get involved with the hornets' nest of tax shelter and special tax privilege, it now has become up to the people to fight for a removal of unjust and expensive tax loopholes. The mood of the taxpayer is turning from passivity to a protesting reform-minded drive for action. Main issues are greater tax justice, the reduction of special tax privilege, a minimum tax for all applicable in particular to upper income levels and a reduction of the tax burden on low-moderate family incomes close to the poverty line.

The Secretary of the Treasury, David M. Kennedy, cautiously allowed these considerations to enter into the discussions of the surtax extension—though he insisted that the surtax is needed in any case to fight inflation. In substance, the government proposes this minimum reform plan:

1. An extension of the surtax at 10% and 5% respectively until June 1970.
2. The continuation of all excise taxes that should have been reduced now or cancelled.
3. The repeal of the 7% tax credit given business on the cost of their investment in equipment in recent years.[8]
4. To reduce or eliminate federal income taxes of 13 million taxpayers (out of 80) who now are paying $50–80 income taxes on the average per year.[9]

While several members of Congress wish to use the surtax bill as a vehicle and leverage for a more significant tax reform to tax the wealthier out of their loopholes, it is by no means certain that this will happen in this Congress. Procedures of such reforms are drawn out, bring strong opposition and powerful arguments why such special tax benefits once adopted for good reasons should be kept. The present reform proposals would simply permit the budget to operate as shown previously. The surtax already was assumed to be part of revenues in the 1969 and 1970 budget. All other modifications leading to revenue gains of 3 billion from the cancellation of the investment credit and the continuation of current

[8] This credit is given business on the cost of new investment spending on plant and equipment (since 1962 with a suspension in 1966). The ambitious investment program of business calling for 72 billion of such expenditures for 1969—or 14% over 1968—has labeled this credit as adding to inflation. According to business surveys, its cancellation will not deter business from its plans—it will, however, furnish 3 billion extra revenues annually.

[9] Two million families designated "poor" (with annual incomes below $3,500) will be removed from the tax rolls: another 11 million taxpayers earning somewhat above this line, will have their taxes reduced by an increase in the standard deduction, etc. Incidentally, it shoud not be assumed that poverty families are chiefly non-whites. The improvement of family incomes of blacks in recent years has been very significant currently, one-fifth of all black families living in central cities have annual incomes of $10,000 or over.

excise taxes, would balance themselves with losses from the elimination of taxes on lowest incomes near the poverty line and the reduction of the surtax from 10% to 5% for the first half of 1970.

When real changes go under way to deal with loopholes and special tax benefits, the following areas will become involved:

1. Interest income on state and local government bonds.
2. The oil depletion allowance.
3. Income from real estate transactions escaping taxation.
4. Deductible losses of "gentlemen" farmers.
5. Income of tax-exempt foundations.
6. Treatment of charitable contributions.
7. Tax benefits achieved through conglomerate mergers.
8. Treatment of long-term capital gains.
9. A minimum tax for everybody (that is, wealthier taxpayers).

A review of reform proposals made by such experts of diverse tax backgrounds as Senator Russell Long, Chairman, Senate Committee on Finance, and Mr. Meany, president of the AFL-CIO should permit a somewhat more detailed appraisal of the proposed treatment of the wealthier taxpayer in the future.

The Senator, in a proposed amendment to the Revenue Act of 1964, wanted to bring greater equity, fairness and simplicity to the 80 million income taxpayers. He also proposed that the very wealthy should pay a higher effective tax rate, frequently limited now, as he claimed, to the maximum tax on capital gains of 25%. Such minimum tax for the wealthy affecting 40,000 returns still would not add more than 400 million to tax revenues. Senator Russell Long wishes that the wealthy should pay at least an over-all effective rate of 30% to bring them in line with others according to their ability to pay, or pay a tax amounting to 15% of their adjusted gross incomes. It was the over-use, if not abuse, of the ability to pay concept, to quote the Senator, that opened the road to all these tax preferences in the very name of greater equity. He also agreed that interest income on state and local bonds should not go completely untaxed, likewise that income earners close to the proverty-line and others should get some relief by an increase in deductions. All these reform measures would collect 4 billion from the upper income brackets and bring similar reductions in the income tax bill of lower and lowest income brackets.

The AFL–CIO reforms went far beyond these plans, proposing the elimination of 17 billion in loopholes and special tax privileges. Accordingly, most capital gains as well as taxable property at death should be taxed as ordinary income; incentive depletion allowances should be eliminated, interest income on public bonds taxed and the tax freedom of foundations reduced. Furthermore, a minimum of 25% should be collected from all legally exempt income. Finally, taxes should be paid for real estate income presently favored by many escape devices, farm loss loopholes closed and tax exemptions for charity deductions minimized. Altogether, these measures are expected to yield 10 billion annually. At the same time, relief for the poorest taxpayers was suggested by an increase in the standard deduction leading to annual tax revenue losses of 3.2 billion. As second improvement, a reduction in the first two individual income tax brackets from 14% to 9% should be allowed, leading to another revenue loss of 3.5 billion. In balance, the result of all these changes would be a net tax revenue gain of 3 billion annually. In other words, such measures would permit the reduction of the surtax from 10% to 5%, for example, without revenue losses. In all likelihood, these proposals in their present form—even though they do not contain any significant ingredient of a true tax reform—have little chance of acceptance but might serve as a starting point of the tax debate.

V. A REALISTIC OUTLOOK AND THE LUXURY OF WISHFUL THINKING

Under the double pressure of dissatisfied taxpayers and inflation, the Congress will have to write some minor tax reforms: in addition to the four points already made (extension of the surtax at 10% and 5% respectively; continued excises; repeal of the 7% investment credit; and relief from income taxes for the poor), some loopholes on the upper limits of incomes might be partly sealed off; probably, a minimum tax for the wealthier will be imposed. Beyond these changes, little will be done. In particular, the 60–70 million taxpayers who pay 95% of all federal taxes, will be left out from any significant changes. In a most optimistic projection, the amounts involved in all reforms will fall below 10 billion annually, corresponding to 3% of the tax bill of the American people (of 300 billion). Fringes of the tax structure will be touched and modified but no

realignment of taxes in a general way should be expected. This is a realistic picture we must expect.

When we visualize what a real "GROSSE TAX REFORM" ought to accomplish, the job becomes gigantic. In the structure and administration of taxes, the overlapping and independent tax authorities at the three levels should be coordinated and their taxing powers properly allocated. A radical elimination of how permissible deductions from the gross incomes would double the tax base of personal income taxation and permit a simultaneous reduction into one-half of effective tax rates without revenue losses. Incentive taxation for economic growth, wealth formation by the smaller income earner and accumulation of savings should be fostered, not only to fight inflation but to recreate a more favorable capitalist climate. The broad public should be encouraged to build greater financial stakes for themselves instead of encouraging a purely consuming society. So far, chiefly equity in housing has been built up on a large scale but broader involvement in financial growth of the many is desirable. Our position in international trade also requires tax adjustments to improve price competitiveness in world markets:

In view of the growing significance of ADOLF WAGNER'S law of the "STEIGENDEM STAATS-HAUSHALTSGEBRAUCH", the dependence on income taxes for exploding fiscal needs is bound to come in conflict with the concept of the ability to pay. Excessive personal taxation will deaden incentives to work, productivity and creativity. Tax needs of states and localities are rising rapidly, forcing up taxes which increase inequities in line of least resistance, ultimately leading to confiscatory property taxes at the local level (which would defeat the social objective of encouraging the masses to build up equity). Social Security benefits for the aged are completely inadequate by any, including foreign standards. In one way or another, the weaker strata of the population, the old and the very young, low-earning, farming, racial and other groups need rising assistance only money can provide. The population explosion requires steadily increasing expenditures on the infrastructure and the provision of more services which, in turn, depend on publicly financed education, health facilities, etc. These exploding civic needs cannot be financed simply by the switching over of defense and Viet Nam money frequently proposed in an unrealistic and irresponsible way.

In this aggressive and hostile world where the giants of the past have become the beggars and trampled-on weaklings of today, defense still goes before opulence. Under these circumstances, neither the states and localities nor the federal government should be expected to be able to finance within their existing means the rising needs of education, health, science, space, research, economic development, conservation, welfare, foreign aid, and so on. Only the introduction of a value-added tax on the Federal level would make possible the raising of sufficient funds and permit at the same time substantial relief from the personal income tax burden. The Federal government, in turn, by an expansion of the already operating system of grants, could bring massive relief to the states and localities to enable them to reduce substantially local burdens. This could also do away with irritant and unjust tax collections of personal income and sales taxes (sometimes at three or four levels simultaneously), and reduce overtaxing, inefficiency and overlapping pressures which so embitter the public. According to Lindholm,[10] such value-added tax at a rate below that established in the member states of the Common Market, could yield $50 billion annually. Only in this way, can the needs of the American public be financed in the future to enable the masses to function in a democracy by the full maintenance and protection of all political and economic freedoms.

CELANESE,
October 1 1969.

RPA-69-372
Re Tax Reform Act of 1969.
Hon. RUSSELL B. LONG,
Chairman, Finance Committee, U.S. Senate,
Washington, D.C.

DEAR SENATOR LONG: Celanese Corporation appreciates being afforded the opportunity to comment upon the provisions of H.R. 13270—The Tax Reform Act of 1969. We will limit our comments to five sections of the Bill:

Section 452—Effect on Earnings and Profits;
Section 521—Depreciation of Real Estate;
Section 331—Deferred Compensation;

[10] R. Lindholm, "A Plea for the Value-Added Tax," *Tax Review*, May 1969.

Section 515—Total Distributions from Qualified Pension etc. Plans;
Section 802—Fifty Percent Maximum Rate on Earned Income.

Section 452. Effect on Earnings and Profits.—This Section amends Section 312 of the Code to require a corporation, which uses accelerated methods of depreciation permissible under Section 167 in computing its taxable income, to use the straight line method of depreciation in computing its earnings and profits.

In its report on H.R. 13270 the House Ways and Means Committee points out that the purpose of this provision is to terminate the practice which has been employed by some corporations—mainly public utilities companies—of using the excess of accelerated depreciation over straight line depreciation to reduce their earnings and profits to such an extent that they are able to make tax free dividend distributions to their shareholders.

We would agree with the Committee that such distributions are an improper tax benefit to shareholders which is generally unrelated to the purpose for which accelerated depreciation deductions are made available to corporations. We must point out, however, that the proposed amendment, in its present form, results in very real hardships for U.S. corporations receiving dividends from their foreign incorporated affiliates. Moreover, it is our understanding that this Section's effect in the foreign area was completely unintended.

To prohibit the use of accelerated methods of depreciation in computing the earnings and profits of a foreign affiliate will increase the amount of those earnings and profits for foreign tax credit purposes and will reduce substantially the amount of the foreign tax credit which would otherwise be available to the U.S. parent corporation under Section 902 of the Code. It will also increase substantially the minimum distributions requirements of Section 963 of the Code.

The hardship which this Section will work in the foreign area can readily be seen by comparing the situation of a U.S. corporation which operates in a foreign country through a branch with that of a U.S. corporation which operates in the same foreign country through its wholly owned but foreign incorporated affiliate. Assuming the rate of income tax, and other tax provisions in the foreign country were the same as the U.S., the branch of the U S. corporation could remit its earnings to the U.S. without incurring any additi nal U.S. tax whereas the U.S. corporation which operated abroad through the foreign incorporated affiliate would have to pay a residual U.S. tax on the dividends it received from its foreign incorporated affiliate. Clearly this is an unjustifiable result.

Since the purpose of this Section is to prevent tax-free distributions to shareholders we submit that Section 452 should be amended to make it clear that its provisions will not be applicable to the computation of earnings and profits of a foreign corporation insofar as that computation pertains to the determination of earnings and profits for purposes of Section 902 of the Code, Sub-part F, Section 1248 and other sections of the Code requiring the determination of foreign tax credits.

Section 521. Depreciation of Real Estate.—This Section amends Section 167 of the Code to eliminate the double declining balance and the sum of the years-digits methods of depreciation for real property the construction of which begins after July 25, 1969. It also amends Section 1250 of the Code to provide that gain on the sale of depreciable real property will be treated as ordinary income to the extent of the excess of accelerated depreciation taken after July 25, 1969 over straight line depreciation.

The principal reason cited for the enactment of these measures is to eliminate dealings in "tax losses" produced by depreciable real property. These "tax losses" have been generated, for the most part, by the deduction for accelerated depreciation and the deduction for interest on the mortgage indebtedness which financed the acquisition of the property. The combination of these deductions have produced a tax loss for some taxpayers and have enabled them to use that loss to shelter other income from taxation. In addition, it has been pointed out that such dealings have had a detrimental effect on the amount of mortgage money available for new home buildings; mortgage money which might otherwise have gone into new home building has been used to finance the acquisition of real property of a kind which is attractive for dealings in tax losses.

While it is recognized that there have been abuses in this area and these abuses should be corrected, the cure for the abuses contained in Section 521 goes beyond what is needed to end the abuse.

These proposed changes should not be applied to depreciable real property used for or in connection with manufacturing facilities, i.e., factories, warehouses, etc. Real property used for or in connection with manufacturing facilities is acquired

to generate additional income which will be subjected to income tax; it is not acquired to generate additional deductions which will shelter other income from income tax. Moreover, such real property investments have not had a detrimental effect on the amount of mortgage money available for new residential construction.

Thus the reasons cited for the adoption of Section 521 of the Bill have no application to real property used for or in connection with manufacturing facilities and we strongly urge that your Committee make appropriate amendments to Section 521 of H.R. 13270 so that its terms are limited only to those forms of real property investments which have led to tax abuse.

If your Committee agrees with the desirability of an amendment to Section 521 of the Bill to permit the continued application of the present accelerated rates to factories, warehouses, etc., we would further urge your Committee to consider among the kinds of buildings which continue to be eligible for the present accelerated depreciation rates, a building constructed for the purpose of housing a considerable amount of machinery and equipment. The present accelerated rates should apply where the cost of the machinery and equipment bears a certain specified ratio (say 200%) to the cost of the new building. Such a building is more closely akin in its use to a manufacturing facility than to an office building and the depreciation rates applicable to the former should be applicable to such a building.

Section 515. Total Distributions From Qualified Pension, Etc., Plans.—This Section amends Sections 402(a)(2) and 403(a)(2) of the Code to eliminate capital gains treatment on that portion of the benefits received by an employee in a lump sum distribution from a "qualified" pension, profit sharing or annuity plan which is attributable to employer contributions made during plan years beginning after 1969. The existing capital gains treatement, which has been in effect since 1942[1] would be replaced by a five-year "forward-averaging" device, which is intended to provide partial relief for the unduly large tax burden which would be incurred by the distributee if the entire lump sum distribution were taxed at ordinary income rates in the year of receipt.

This proposed re-structuring of the system under which lump sum distributions are presently taxed most unfortunate since it will work an economic hardship upon individuals whose principal post-retirement asset is likely to be the after-tax proceeds of such a distribution. Furthermore, the "averaging" technique which would be utilized in place of the simple method of imposing a single capital gains tax will present complex recordkeeping and tax computation problems for a group of largely unsophisticated individual taxpayers, which complexities are hardly in accord with the goals of tax reform and simplification.

The purpose of this proposal is to minimize the tax advantage which might accrue to a relatively high bracket taxpayer by virtue of capital gains treatment on lump-sum distributions. (See the example set forth on P. 154 of the House Ways and Means Committee Report on H.R. 13270, wherein it is assumed that a lump-sum distribution of $500,000 is received by a corporate executive, whose other post-retirement income is $35,000 per year.) However, those individuals who comprise the so-called "middle income" group of taxpayers are the ones who will suffer the most severe economic consequences. These individuals have been unable to accumulate any significant amount of savings prior to retirement and are unlikely to have any substantial income from other sources, such as investment dividends or interest, subsequent to retirement. For such people, the benefit which is derived from the receipt of a lump sum distribution from a retirement plan which is subject to capital gain tax benefits[2] may make the difference between an economically secure retirement and one which may be difficult.

The Celanese Stock Bonus and Investment Plan is a qualified plan in which all salaried employees who have completed two years of service are eligible to participate. An eligible employee may contribute as much as 5% of his normal monthly salary, and for every dollar which is contributed by the employee, Celanese contributes two dollars on his behalf. Upon his retirement, an employee is entitled to receive a benefit which is equivalent to the sum of his own and the employer's contributions plus any appreciation in value attributable to each of these contributions. This benefit may be received as a lump sum distribution, periodic payments in the form of an annuity, or a combination of both.

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[1] I.R.C. (1939) § 165(b), as added by Rev. Act 1942, § 162(a).

[2] Under both the Administration Proposals and H.R. 13270 at least 50% of capital gain income is excluded from income taxable at ordinary rates.

An analysis of certain statistical data in regard to the Celanese Stock Bonus and Investment Plan for the year 1969, presented in the following table bears out the proposition that the greatest proportion of employees who participate in the Plan are those in the low and middle salary brackets and that the bulk of the total amount of employer contributions to the plan are attributable to such employees:

Salary bracket	Eligible employees	Participating employees	Percent participating	Average company contribution	Total company contribution (col. 3 times col. 5)
(1)	(2)	(3)	(4)	(5)	(6)
Under $5,000	426	258	60.6	$394.66	$101,822.28
$5,000 to $10,000	4,239	3,567	84.1	683.63	2,438,508.21
$10,000 to $15,000	1,800	1,671	92.8	1,172.16	1,958,697.36
$15,000 to $20,000	835	784	93.9	1,673.90	1,312,337.60
$20,000 to $25,000	262	249	95.0	2,210.42	550,394.58
$25,000 to $30,000	84	81	96.4	2,777.51	224,978.31
$30,000 to $35,000	36	35	97.2	3,284.14	114,944.90
$35,000 to $40,000	19	19	100.0	3,834.73	72,859.87
$40,000 to $45,000	11	10	90.9	4,336.00	43,360.00
$45,000 to $50,000	7	7	100.0	4,892.85	34,249.95
$50,000 to $55,000	1	1	100.0	5,500.00	5,500.00
$55,000 to $60,000	6	6	100.0	5,566.66	33,399.96
Over $60,000	18	17	94.4	9,486.47	161,269.99
Total	7,744	6,705	86.6		7,052,305.01

Note: The average employer contribution for each participating employee is $1,052.

Of the total 6705 participating employees, 6529 (97%) are in salary brackets of $25,000 per year or less. In addition, $6,361,742.03 of contributions, out of a total contribution of $7,052,305.01 (90%) are made on behalf of employees in the $25,000 per year or less category. It is readily apparent that the Celanese Plan is not intended in any way as a method of providing tax-deferred compensation to a few relatively high-salaried executives; on the contrary, its principal purpose and effect is to enable employees of more modest financial circumstances to systematically accumulate a reserve which may constitute the most substantial portion of his available post-retirement assets and income.

When the "bunched income" problem presented by lump sum distributions was dealt with in 1942, it was thought that the most efficient way to solve it was by treating the distribution "as if" it were a gain from the sale or exchange of a capital asset held for more than six months. The theory behind the granting of "deemed" capital gain treatement is that the "gain" realized on the receipt of a lump sum distribution has accumulated gradually over the course of some years in very much the same manner as a capital asset appreciates in value over an extended period of time. In order to reflect the economic reality that the gain to be recognized on the sale or exchange of a capital asset is not completely attributable to the year in which the taxable event occurs, such gain is only subject to capital gain tax benefits under existing law which serves as a form of averaging device to prevent an unjust tax burden in the particular year.

The averaging technique afforded by existing capital gains benefits has the concomitant advantage of simplicity and ease of application. It is not necessary to compute the ultimate tax burden for the year in accordance with information or records which are relevant to either past or future taxable years, nor to apply formulas which are so extremely complex as to force the average taxpayer to seek professional help in the preparation of his tax return. The "five-year forward-averaging" mechanism which is proposed in the House Bill as a substitute for capital treatment of lump sum distributions is an example of such undue complexity. Under this rule, the recipient of the distribution must pay ordinary income tax equal to five times the increase in his tax liability for the distribution year which would result from adding 20% of the distribution to taxable income for such year. In recognition of the fact that a retired person's income is likely to decline, a "five-year look-back" rule is also proposed. Under this rule the recipient can claim a refund if he can show that his total tax on the distribution would have been less if only 20% of the distribution had been included in taxable income in the year of receipt and in each of the four succeed-

ing taxable years. Thus, the taxpayer is forced to maintain detailed records for the entire five-year period, and is made to suffer the loss of "money use" as a result of having to pay the larger amount of tax in the distribution year.

It is submitted that Congress should give careful re-examination to any proposal which will serve to diminish the net amount available from a retirement fund to people whose earning capacity may have all but terminated, and which will create undue complexities in compliance. The projected revenue gain which would result from the enactment of this proposal is relatively small,[3] and if the proposal in H.R. 13270 dealing with the repeal of the alternative capital gains tax computation for individuals is enacted, many lump sum distributions would be taxed at an effective rate in excess of 25% even if capital gains treatment is retained. For these reasons, Celanese is opposed to the enactment of proposed Section 515 of H.R. 13270.

Section 331. Deferred Compensation.—This Section adds Section 1354 to the Code, which would radically alter the existing method of taxing "deferred compensation" received pursuant to an unfunded, unqualified plan between employer and employee. Under present law, such payments are not taxed until the year in which they are received by the employee (usually subsequent to his retirement when his tax bracket is lower) on the basis that he did not have a present right to receive the payment in the year in which it was earned. Under proposed Section 331, the payment would continue not to be taxed until the year of receipt, but the tax would, in general, be computed as if it were received in the year in which it was "earned."

It is not disputed that there may be a need to re-examine the tax treatment of unqualified deferred compensation arrangements, but we are strongly opposed to the enactment of the present proposal on the grounds that it is ill-considered and functionally unworkable. We are in basic agreement with the Administration's position regarding proposed Section 331, as expressed to the Senate Finance Committee by the Honorable Edwin S. Cohen, Assistant Secretary of the Treasury for Tax Policy, on September 4, 1969. We concur with the Administration's objection that this legislation would greatly modify the annual accounting concept which underlies our entire tax system, and the more generalized objection that the entire area of qualified and unqualified plans be given a comprehensive study (which study has been undertaken by the Treasury) before any legislation is enacted.

We would also offer two additional specific objections to proposed Section 331. First, the tax which would be imposed under either of the two alternative formulas is a *minimum* tax. Thus, if the taxpayer's bracket in the year of actual receipt of the payment happens to be high enough to produce a greater tax liability under normal methods of computation than the tax which would be produced by the application of proposed Section 331, he would have to pay the tax as determined under normal methods. The taxpayer, therefore, does not have the option to use proposed Section 331 to his benefit, but the Internal Revenue Service has the option to use it to the taxpayer's detriment. This result seems patently inequitable.

Second, the proposed section would force a taxpayer to keep detailed records and tax returns for an indefinite period of time and the computations which would have to be made in order to determine tax liability would be so complex as to be almost impossible. Many taxpayers are participants in deferred compensation plans for a period of time which might be in excess of twenty years. Since the proposal assumes that each individual payment is earned ratably over the entire period of service and that taxable income is increased in each year by the portion of any previously received payment, the taxpayer is forced to make layer upon layer of calculations to arrive at the correct taxable income figures for past years in computing his Section 331 tax. These calculations would have to be made every year in which a payment was received. Surely "tax reform" legislation must have simplicity as one of its goals; and this proposal falls far short of achieving such a goal.

Section 802. Fifty Percent Maximum Rate on Earned Income.—This Section adds Section 1354 to the Code and places a 50% maximum tax rate upon "earned income" as that term is defined in I.R.C. Section 911(b). In general, this consists of wages and salaries. However, we would express opposition to the exceptions from the definition of "earned income" of the portion of a lump sum distribution

[3] The House Ways and Means Committee Report, p. 156, estimates that this provision will result in an annual revenue increase of $5 million in 1971 and $50 million in 1979.

from a qualified plan which constitutes ordinary income and of any deferred compensation payment. Our reasons in opposition to the enactment of the specific proposals relating to the taxation of lump sum distributions and deferred compensation payments have been expressed earlier in this Statement. If, however, those proposals are enacted, we feel that the "earned income" rate limitation should be applicable to any taxable amounts thereunder.

Payments of this type are just as much "compensation for personal services" (although received in a taxable year subsequent to the year in which they are "earned") as any other such payments which are received in the same year as they are "earned." There is no conceptual justification for making a distinction in the definition of "earned income" which turns upon the question of "when" such income is received. The character of the income should be the only controlling factor.

The mere fact that specific formulae have been proposed relating to the methods of computing the tax on lump sum distributions and deferred compensation payments should not be a reason to deprive such payments of the protection of the proposed 50% rate limitation. It is quite conceivable that the effective tax rate upon such payments may exceed 50%, even with the application of the various formulae particularly if other income is received in the same taxable year. In addition, it has previously been pointed out that proposed Section 331 dealing with deferred compensation payments imposes a *minimum* tax and, therefore, the reason for the applicability of the "earned income" limitation in this area is readily apparent.

If Congress does revise the methods of taxing lump sum distributions and deferred compensation payments, so as to exact a greater ordinary income tax on such amounts, fairness would dictate that the protection of the proposed 50% rate limitation should be afforded such payments since there is no reason to exclude them from the definition of "earned income."

It is possible that the "deferred compensation" exclusion from "earned income" in Section 802 of the House Bill would also prevent gains realized on disqualifying dispositions of stock acquired upon the exercise of qualified stock options from qualifying for the 50% tax rate limit. For the reasons previously expressed, we urge that the report of the Senate Finance Committee make it clear that such gains are within the definition of "earned income."

Respectfully submitted.

CELANESE CORP.,
By ROBERT P. ADELMAN,
Director of Taxation.

THE DIME SAVINGS BANK OF BROOKLYN,
Brooklyn, N.Y., September 24, 1969.

RUSSELL B. LONG,
Chairman, Senate Finance Committee,
U.S. Senate,
Washington, D.C.

DEAR SENATOR LONG: I am concerned about several features of the proposed Tax Reform Act of 1969 (H.R. 13270). Although tax reformation in some cases is certainly necessary, I think we have to be careful that reform prompted by the acts of a relatively small number of persons does not result in injustice to a great many.

Portions of the bill which I hope will be carefully considered by the Senate Finance Committee and in the Senate are the following:

Tax Exemption of Municipal and State Obligations.—All existing obligations were purchased in good faith and I do not think that either constitutionally or in good conscience the tax exempt status of those securities can be changed directly or indirectly. Even the threat of indirect taxation has already demoralized the market for such securities. What the Congress does about future state and municipal securities is something else: subsidies by the Federal government may seem like a substitute for tax exemption, but this would mean larger taxes to support the subsidies, and I feel that taxes are close to the maximum already.

Deferred Compensation.—This is a perfectly legitimate means of attracting executive talent. Mutual savings institutions, which do not have capital stock, are unable to offer prospective officers stock options, long term contracts or other inducements open to stock corporations. To such institutions deferred compensation is the only method of filling this gap. It may be that there should be a

limit on the amount of deferred compensation, but the limit proposed in the present bill is inadequate.

Taxes on Mutual Savings Banks.—The proposed bill eliminates the 3% method of calculating bad debt reserve and relies entirely on the 60% of net income formula. I have no major objection to this, but the bill further provides for the reduction of the 60% figure to 30% over a period of years, and I feel this reduction is too drastic.

I have been dealing with mortgage loans for nearly 45 years, and I can assure you that in periods of losses, such losses are heavy. I think it might be possible to reduce the bad debt reserve formula below the 60% figure for banks whose surplus and reserves exceed a certain figure, say 12% of assets, but I think it is essential to allow mutual savings banks to accumulate adequate reserves until surplus and reserve reach such an amount.

The Dime Savings Bank of Brooklyn has over 1.75 billion dollars invested in real estate mortgages, 98% of which cover residential properties, mostly one family dwellings. I believe that the mutual savings bank system, which has made possible financing of this magnitude for home ownership, should be given every opportunity to continue to serve the needs of the public. It can only do so through reasonable tax treatment. I might add that The Dime pays approximately $100,000,000 a year to its depositors in interest dividends; all of this money, except for a very small portion going to tax exempt institutions, is subject to income tax payments on the part of the recipients, and should be taken into account in considering the tax contribution of the bank.

Your careful consideration of the matters set forth in this leter will be much appreciated.

Yours sincerely,

GORDON S. BRAISLIN.

CHICAGO ASSOCIATION OF COMMERCE AND INDUSTRY,
Chicago, Ill., October 9, 1969.

Hon. RUSSELL B. LONG,
Chairman, Senate Finance Committee,
Senate Office Building, Washington, D.C.

DEAR SENATOR: Your consideration of this Association's position with respect to H.R. 13270, the Tax Reform Act of 1969, will be appreciated.

The Chicago Association of Commerce and Industry with a membership of 11,000, representing some 6,000 companies and firms of every size and of every category, is the Chamber of Commerce for the eight-county Chicago Metropolitan Area. This membership is a cross section of every facet of American business. As the representative of this varied and very important business community, this Association has carefully reviewed the provisions of H.R. 13270, the Tax Reform Act of 1969. The conclusions and recommendations reached as a result of this review have been adopted as official policy of the Association by its Board of Directors. They are hereby respectfully submitted to you for your consideration.

The Association opposes H.R. 13270, the Tax Reform Act of 1969, and urges that the bill not be adopted by the Senate. Opposition to the bill is based on its complexities, the compliance difficulties it creates, and the impossibility of making a thorough technical and economical analysis of its provisions in the short time such provisions have been available to the public. In an attempt to bring about tax reform, there is in fact a lack of true tax reform and the creation of new inequities. The highly desirable goal of tax simplification has not been accomplished and to the contrary, the tax system would become even more complex should this bill be enacted. While there are some features of the bill which are highly desirable, the economic effects of its enactment would be so far reaching as to be a cause for concern, if not alarm. A comprehensive review of the economic impact of enactment is especially necessary.

With respect to certain particular aspects of the bill, the Association respectfully submits the following comments.

Deferred compensation

The Association opposes provisions in the bill relative to changing the taxation of deferred compensation. These provisions would upset established business practice and would impose severe burdens on the continuing efforts of industry to attract and keep executive personnel.

Standard deduction

Action to increase the standard deduction is highly desirable. However, it is believed that the ceiling of $2,000 thereon is too low to accomplish either equity or simplification of filing for taxpayers.

Rate changes

Certain provisions regarding rates are desirable, including (1) reduction of the maximum tax rate to 65%, (2) the 50% rate limitation on earned income, and (3) the extention of head-of-household to single taxpayers over 35 and to certain other individuals. Highly progressive tax rates are detrimental to our economy and relief must be forthcoming to encourage economic growth, and to discourage tax avoidance activities induced by unrealistic rates.

Alternative tax

The Association opposes the elimination of the alternative tax on capital gains because it in effect becomes a tax on inflationary gains without any real economic benefit to the taxpayer. It is unrealistic to eliminate the alternative tax while at the same time extending the holding period to one year.

Profit-sharing plan

Many companies in the Chicago area have utilized qualified profit-sharing plans for many years as an incentive to employees, and a means whereby employees at all levels may share in profits of the enterprise. Elimination of the capital gains treatment on lump sum distributions from qualified profit-sharing plans would lead to elimination of many, if not all such plans which have long formed a part of sound employee relations. If profit-sharing is to be discouraged, it should not be through tax provisions.

Depreciation

CACI opposes the elimination of double declining-balance on depreciation of buildings. Any possible abuse from accelerated depreciation can be eliminated by recapturing as ordinary income at the time of sale depreciation claimed in excess of that permitted under the straight-line method. The provision in the bill is far too broad as may be illustrated by the fact that the double declining-balance depreciation on industrial buildings would be eliminated. Such buildings have rarely been sold at gains, nor is there a tax motivation present in the sale of factory buildings because relocation and other expenses discourage moving factory operations.

Depletion

The Association opposes the provisions of the bill regarding depletion allowances. It is believed that an across-the-board proportionate reduction of virtually all depletion rates cannot be supported on economic grounds because of variations in conditions of mining of various natural resources. It is urged that before any final action is taken on depletion allowances, a thorough review of the economics involved be made.

Banks

The Association feels that banks must create adequate bad debt reserves because of the public interest in such institutions and should not be limited to an arbitrary formula which has not in fact been applied to taxpayers generally.

Municipal bond interest

The Association opposes any change in the exemption of municipal bond interest because of the demonstrated need of municipalities for funds for public purposes. Particularly, the Association is concerned with the loss of tax exemption of bond issues to provide the local matching funds for sorely needed programs in mass transportation, and for the schools.

Limitation in tax preferences—Allocation of deductions

The Chicago Association of Commerce and Industry approves efforts to eliminate preferences which are not warranted. However, it feels that such preferences should be attacked directly, rather than in an indirect and complex manner which will make preparation of individual income tax returns almost impossible for many taxpayers. Accordingly, the Association opposes the "limit on tax preferences" and "allocation of deductions" approach, although it does not oppose eliminating particular preferences that are not warranted.

Moving expense rules

The Chicago Association of Commerce and Industry feels that the provisions relative to moving expenses is a step in the right direction, but that the ceiling of $2,500 for all moving expenses and $1,000 for house hunting and living expenses is too low. Many taxpayers at all levels are transferred within and to and from the Chicago and other metropolitan areas by their employers. In many instances, the transfers are lateral in nature without involving any promotion, and in a number of situations transfer is accepted by an employee in order to retain his job and pension rights. The Association feels that any reasonable moving expenses should be allowed subject, of course, to review by the Internal Revenue Service. However, the Association sees no justification for an arbitrary ceiling on legitimate moving expenses.

Investment credit

The Association opposes repeal of the investment credit because of the need to modernize industrial facilities in the Chicago area. In the event that the credit is repealed, however, reasonable transition rules should be provided.

Respectfully submitted.

EDWARD J. HARNEY,
Chairman, Federal Revenue and Expenditures Committee.

FINANCIAL EXECUTIVES INSTITUTE,
New York, N.Y., October 6, 1969.

Subject: Tax Reform Act of 1969, H.R.13270.

Hon. RUSSELL B. LONG,
Chairman, Senate Finance Committee,
New Senate Office Building, Washington, D.C.

SIR: The Financial Executive Institute is the recognized professional organization of financial management in the United States, Canada and Puerto Rico. Our Membership, of over 6,700 individual members who represent a broad cross-section of American business, includes the policy-making executives in the financial function of more than 3,500 companies. One primary objective of the FEI is to provide a means for the members to make joint studies and recommendations on matters of broad financial significance.

The Institute, through its Committee on Taxation, has reviewed the Tax Reform Act of 1969 (HR 13270) and welcomes the opportunity to submit its view for consideration by the Senate Finance Committee in connection with its deliberation on tax matters.

We suggest to you that many of the revisions being proposed by HR 13270 are to change or eliminate present Code provisions that were adopted to provide more equitable treatment of the involved taxpayer with those in similar situations but different tax postures. An example of this is the capital gain treatment of lump sum distributions from qualified trusts so that the 5 million plus participants would be taxed more equitably with partners and individual proprietors on similar accumulations over a long period of time.

Furthermore, many suggested provisions are further complications for the taxpayer without substantial revenue or needed reforms of abuses and we can find no simplification steps being taken. Even the increase in standard deductions held up as an example of simplification does not qualify for this purpose as the taxpayer must do his calculating both ways to see whether or not he should use the standard deductions.

In summary, our statement, which includes comments on various provisions of the Bill, recommends that the tax burden on corporations not be increased long range by this Bill; strongly urges the elimination of the sections of the Bill which deal with deferred compensation as recommended by the Treasury and those which would limit capital gains treatment of lump sum distributions from qualified pension and profit sharing plans, and, we point out the defect in excluding deferred compensation from the provisions limiting the tax rate on earned income to a maximum of 50%, a proposal we otherwise endorse; suggests changes in the area of real estate depreciation proposals specifically to exclude facilities constructed or acquired as an integral part of the manufacturing, production, distribution, or extraction of minerals from the reform proposals.

The proposed repeal of the investment tax credit will make the adoption of more liberal depreciation provisions imperative. We also, recommend revisions

in the proposed changes in the foreign tax credit provision of existing law, amendments to the proposed moving expense provisions of the Bill, and we oppose the application of the proposed new rules for determining earnings and profits to foreign corporations.

The Financial Executives Institute is concerned with those provisions of the Act which relate to corporations and those which would have an impact on investment and capital formation, therefore, our opposition to the negative aspects of the Bill extends to the proposed increases in the tax rate on capital gains for corporations to 30%, which we believe is an obvious example of the inherent bias of the Bill. The bias against corporations is obvious in that the Bill, universally publicized as the most significant tax reform measure in a quarter of a century, imposes a net 4.9 billion dollars of tax increases on corporations, and since corporations are the principal form of business in the United States and are the largest employers, the greatest consumers of services, and the most important producers of National Income, the unfair corporate tax burden contained in the Bill represents a bias against investment and capital formation.

We do not expect our statement to generate any sympathy for corporations because they are, after all, inanimate creatures; we seek no sympathy or understanding of the corporation, because, in fact, it will pay whatever tax the law requires, as long as it earns a profit. And, so long as there is good reason for the corporation's existence, it will survive. Rather, we ask the members of the Senate Finance Committee to give further consideration to the question of whether this Bill serves the best long-term interests of the nation.

Whether the label be anti-capital formation or bias against investment is unimportant; the Bill in its present form would, if enacted into law, seriously hamper the continued healthy growth of our economy by reducing investment which creates the products and payrolls needed for that growth. We also believe it will substantially contribute to inflationary pressures by causing costs and resulting price increases; and we are convinced it will seriously hamper the country in its ability to solve the very serious balance of payments problems it faces. Taxes are a cost of doing business. If taxes are increased, the effect is no different than if any other cost is increased. Business must decide how to make up for the increase. There are a number of ways this can be done, but the point is that no well-run business has uncommitted funds set aside to cover a tax increase. Faced with the many provisions of this Bill which are designed to discourage investment such as the repeal of the investment credit, restrictions on depreciation when what is needed is liberalization, an increase in the capital gains taxes, and a reduction of percentage depletion, business can not mistake the message: tax costs are going up and a premium has been placed on additional investment. For example, the repeal of the investment tax credit would increase the cost of capital investment by approximately 10%, thus, the increased taxes will be paid by a reduction in the productive investments which creates new products, more jobs and larger payrolls. Once set in motion this depressant can not be quickly reversed since productive expenditures require long term planning. So, in truth, H.R. 13270 represents a decision that the nation's economy will still need the brakes applied two, three or four years from now. Given the uncertainties of economic forecasting even six-months ahead, the Bill is an economic shot in the dark fired at impossibly long range.

This appears inconsistent with statements made by various Government officials that indicate that the current inflation will be under control in about two years. Despite the fact that economists are in general agreement that shortages in the market place, the inability to supply consumer demand, is one of the principal causes of inflation, our examination of HR 13270 indicates that those provisions of the Bill which will reduce the flow of products to the market place will be fully effective two years from now.

We are also concerned that the proposed increases in corporate taxes will aggravate the balance of payments problem. In large measure the U.S. balance of payments problems can be traced to rising costs which decrease the ability of U.S. businesses to compete in the market places of the world. One important reason for this is that we as a nation are not tax-cost competitive. The additional taxes on business contained in the Bill will further compound this problem.

The proposed Bill, HR 13270, imposes a net 4.9 billion dollars of tax increases on corporations and a net tax reduction of 7.3 billion dollars for individuals. We direct the Committee's attention to the following statements contained in

its report on the Revenue Act of 1964, page 8, subparagraph (c) to indicate the historical concern for maintaining a balance of the tax burden between corporations and individuals:

"(c) This bill (1964 Act) provides a balanced reduction between individuals and business firms. In this respect, the bill is much the same as the bill that came from the House. When fully effective, the bill will reduce individual income taxes by $9.2 billion and will reduce corporate taxes by about $2.4 billion. These figures must be evaluated along with the effective tax reduction of 1962 through the investment credit and depreciation reform, the largest share of which went to corporations. Taking the 1962 and 1964 programs together, the share of the reductions going to individuals is about two-thirds and to corporations about one-third, which is approximately the present relative shares of individuals and corporations in income tax liabilities.

"Looked at another way, the net individual income tax reduction will reduce present tax liabilities for individuals by just under 20 percent. The combined effects of this bill, depreciation reform, and last year's investment tax credit, will reduce corporate tax liabilities by something more than 19 percent."

The Secretary of the Treasury in testimony before the Committee has recommended 2% point reductions in the corporate tax rate to take effect equally in 1971 and 1972. The reductions recommended are modest and will still leave an increase in taxes on corporations of about 3.5 billion dollars. We endorse these recommendations but they do not go far enough in returning the balance of tax burden between the two major sources of revenue. The fact that these recommendations may not be very attractive steps to take politically doesn't make them any less important to the economic health of the nation.

The Financial Executives Institute urges the members of the Senate Finance Committee to consider the full use of the proposed tax increase on corporations to provide really meaningful corporate tax rate reductions, extended over the next few years. We strongly recommend that the Treasury's proposal for amendments to Code section 11 reducing the corporate rate 2% points be extended to offset in full the proposed 4.9 billion dollars of tax increase on corporations over a reasonable period of time.

With respect to the specific provision of the Tax Reform Act of 1969, we offer the following comments for your consideration.

Sec. 461—Alternative Capital Gains Rate for Corporations

While the House Committee on Ways and Means indicated in its report on H.R. 13270 that it was necessary to maintain a balance between corporations and individuals with respect to alternate capital gains calculations, there is no support for this statement in the bill. It is our view that there is no relationship between the individual and the corporation with respect to capital appreciation in that such gains when distributed to corporate stockholders are again generally subject to tax at ordinary individual rates.

We believe that the proposed increase in the corporate capital gains tax rate is unwarranted and should not be adopted.

Sec. 521—Depreciation (Code Sec. 167)

The Investment Credit was adopted in 1962 in lieu of additional relief in the form of more liberal depreciation allowance. It was also referred to as a mechanism for achieving tax rate reductions for business commensurate with those granted to individual taxpayers. The Credit has been an important provision of the tax law and one that is necessary if United States industry is to maintain a competitive international position, obtain the capacity to supply the increasing demand for products, and improve our technological position which is so important in view of world conditions. In addition, the Credit has helped prevent the balance of payments problem from becoming more serious than it is. By the very existence of the Credit, industry has been encouraged to make long range plans to continue upgrading plant and equipment. Such planning has been based on official statements, that the Credit would not be subject to tampering.

The Honorable Douglas Dillon, Secretary of the Treasury, in summarizing his statement before the Joint Committee on Internal Revenue Taxation on January 18, 1962 concluded the following:

"I consider our program of depreciation reform—including the investment credit—a central part of our economic policy. Our two most important long-range economic problems today are to stimulate growth in the domestic economy and to eliminate the deficit in our balance of payments.

* * * it is my conviction that depreciation reform, including both the administrative revision of depreciation guidelines and the investment credit, is not only the best way to bring about a higher investment level, but is absolutely necessary if we are to grow at a more rapid rate and maintain widespread international confidence in our currency."

Also, Stanley S. Surrey, Assistant Secretary of the Treasury, in his statement before the Society of Business Advisory Professions, Inc. on March 12, 1962, made the following observations:

"* * * If we are to achieve comparable tax treatment for productive equipment—a comparability that will be very meaningful in a world of increased international competition and freer trade—and if we are to move on under a tax system to the modernizing and deepening of our own capital equipment, we must provide an over-all treatment that includes some allowance or incentive in addition to realistic depreciation.

"* * * I gather that some say that the credit is, of course, effective, but why use it now when there is still slack in the economy? The fact that the investment credit was suggested at a time when we were in a recession period and the fact that it is being adopted in a period of recovery does not mean that it is to be regarded as a counter-cyclical tool. Rather, it is intended to be a permanent part of our basic law".

For these reasons, the Institute strongly believes that the Investment Credit should be retained in its present form. In the event that the Credit is suspended, reduced or repealed, however, it becomes imperative to enact more liberal depreciation provisions; and, Congress should, as part of the present bill, direct the Treasury Department to complete its present depreciation studies and submit specific legislative proposals to be effecitve for taxable years beginning after December 31, 1969. Such measures will encourage modernization of American industrial plants which would mitigate inflationary pressures and make U.S. industry more competitive with Foreign Industry, thereby contributing to the reduction of the payments problems.

If the Investment Credit is repealed, certain of the transitional provisions now proposed should be revised. The definition of pretermination property should be extended to include economic commitments not represented by binding contract. In addition, the provision for phasing-out the Credit, which would deny credit earned by those taxpayers with extended delivery dates are grossly inequitable and should be deleted from the bill.

Section 521(a) of the bill would deny the benefits of the double declining balance or the sum of the years-digits methods to new depreciable real property (other than residential housing) and would limit depreciation on such used property to the straight-line method.

These provisions are so broad in scope that they would include depreciable real estate constructed or acquired for use even as an integral part of manufacturing, production, distribution, or extraction. Such property is not related in any way to the reasons for the proposed change in real estate depreciation, as those reasons are set forth in the Report of the House Committee on Ways and Means. The trading in losses and the opportunities for tax avoidance which the committee's action is designed to eliminate are areas of primary benefit and interest to the real estate operator. A taxpayer who has constructed or acquired a building, such as a factory, office, store or warehouse, for his own use in the active conduct of his own trade or business, and not for speculative investment should not be deprived of the use of accelerated depreciation. The Report of the Senate Finance Committee, discussing section 167(b) of the Internal Revenue Code of 1954, is still pertinent today with respect to such facilities; the Report stated: "For all segments of the American economy, liberalized depreciation policies should assist modernization and expansion of industrial capacity, with resulting economic growth, increased production, and a higher standard of living."

Although depreciation guidelines which shortened the lives of depreciable property were promulgated in 1962, at approximately the same time the investment credit became effective, the more liberal depreciation was not made available to buildings due to the fact that there was no provision in the Code which treated depreciation recaptured on the sale of buildings as ordinary income. The Revenue Act of 1962 made this change for all other classes of depreciable property, and it would seem to us, that the simplest way to handle any tax abuse that Congress is now concerned with would be to apply the same depreciation recapture rules to buildings that now apply to personal property. Under these

circumstances, depreciation claimed after the effective date of the legislation which is recaptured on a subsequent sale would be treated as ordinary income for tax purposes. This rule, however, should be coupled with a more liberal depreciation guideline for buildings and the elimination of the reserve ratio test.

Secs. 431, 432—Foreign Tax Credit (Code Sec. 904)

H.R. 13270 as passed by the House places restrictions on the application of the Foreign Tax Credit. We oppose in principle any proposals that have the effect of compartmentalizing the computation of the Foreign Tax Credit. These provisions, although aimed primarily at the natural resource industries, go much farther than just solving the problems outlined in the committee report. Any reduction in the Foreign Tax Credit computation while the present O. F. D. I. repatriation provisions are in effect should be rejected. Since the Foreign Tax Credit provisions first became a part of our income tax structure they have been a necessary and vital factor in enabling American business to compete with industry abroad. This is more important today than ever before. To the extent that a United States taxpayer has paid taxes to a foreign government, the computation of his Foreign Tax Credit should continue to equalize his overall tax burden in comparison with his foreign competitor.

We recommend a liberalization of the deemed-paid Foreign Tax Credit provision of Section 902 of the Internal Revenue Code. Under present law the deemed credit provisions are limited to two tiers of foreign corporations with a minimum ownership requirement of 10 percent in the first tier and 50 percent in the second tier. With the increasing trend requiring control of foreign business operations by foreign nationals the present two tier and percentage limitations are unduly restrictive. This is particularly true since the information reporting sections involving foreign operations and ownership (Sections 6038 and 6046) were amended in 1962. There are no longer any administrative reasons for maintaining the present percentages.

It is recommended that Section 902 be amended so that the deemed Foreign Tax Credit is allowed regardless of the number of tiers as long as the interest of the U.S. corporate shareholder (direct and indirect) is at least 5 percent overall.

Sec. 452—Effect on Earnings and Profits of Accelerated Depreciation (Code Sec. 902 and Subpart F)

Reference is made to Section 452 of H.R. 13270 affecting the computation of earnings and profits. We call attention to these provisions as they apply to the deemed-credit computations under Section 902 of the Internal Revenue Code as well as to computation under sub-part F.

In many cases it is literally impossible for a 10 percent or more U.S. shareholder of a foreign corporation to secure the necessary information to restate the earnings and profits of a foreign corporation on U.S. basis. In some cases this result is a direct result of the provisions of foreign law. We recommend that the earnings and profits of foreign corporations, duly certified by independent accountants be accepted for purposes of computing taxable income and for purposes of computing the Foreign Tax Credit under the various provisions of the Internal Revenue Code. Proper safeguards could be developed in the case of sales or exchanges of the securities of foreign corporations or in case of liquidations involving foreign corporations. An alternative solution to the problems posed by this provision would be to apply the proposed new rules *only* when the shareholder (taxpayer) contends that a dividend distribution is excludable from his taxable income as a return of capital.

Sec. 515—Lump Sum Distributions From Qualified Pension and Profit Sharing Plans (Code Sec. 402, 403)

The House Bill proposes to discontinue capital gains treatment as to future employer contributions which are a part of a lump sum distribution from a qualified pension or profit sharing plan. The proposed change should be rejected for several reasons:

(1) In order for a distribtuion to qualify for present capital gains treatment, qualified pension and profit sharing plans must cover a broad classification of employees and must not discriminate in favor of the highly paid or supervisory employees. Accordingly, the majority of those covered are taxpayers of modest to moderate means. However, the reasons given for this change cite taxpayers with gross incomes of $50,000 per year and above as the principal beneficiaries of the present tax treatment and we believe the Committee should know that more

than five million employees now covered by qualified plans will be affected by these provisions.

(2) Many companies have adopted qualified deferred profit sharing plans or qualified savings plans as substitutes for—or supplements to—monthly annuity or pension plans to provide financial security after retirement, and over the years they have become an important factor in the total benefits programs offered to employees. Tampering with established tax laws covering the retirement planning of so many people to whom old age security is of such vital concern should be undertaken only as a last resort and only after a showing that there is abuse in the present rule. This is so even if the tampering is designed to leave such persons substantially untouched in the final economic results, because the tax laws are now so complicated that many persons may react unwisely in the face of additional changes.

(3) The provisions of the House Bill will replace the relatively simple rule, that the excess of a lump sum distribution over an employee's own contributions is taxed as a long-term capital gain.

The existing rule is not only simple but also does substantial justice. Certainly no one would advocate that the distribution of an amount accumulated over the years of the employee's participation in the plan should be taxed to him in one year as ordinary income. The tax burden under such an approach would obviously erode the amount available for retirement benefits. Accordingly, the problem is to devise a method of taxing such a distribution which will carry out the objectives for which the Plan was established in the first place. We submit that the taxing of lump-sum distributions as capital gain may not be perfect but it does provide a reasonable system of distribution at a fair rate without unduly diminishing the amount of the benefit.

In this connection it must be kept in mind that the Bill would also amend the present rules regarding taxing capital gains by removing the alternative tax of 25%. Accordingly, lump-sum distributions will bear a greater amount of tax even with the retention of the present provision of Section 402(a)(2).

(4) The proposal contained in the Bill will complicate the computation of the tax on distributions and impose compliance burdens on the employee and employer which will outweigh any technical advantage which might otherwise be gained. In place of the existing relatively simple rule of taxing a distribution of employer contributions on a separation from service as a capital gain, it will be necessary to perform several computations as follows:

(a) The amount of the distribution which is attributable to employer contributions after December 31, 1969 must be determined. This amount is not always readily identifiable. In some cases a specific amount of the employee's contribution may be allocated to the individual but in other cases the employer's contributions are determined on the basis of an aggregate plan cost and specific amounts are not allocated to the individual. The determination of that portion of a contribution which represents employer contributions after 1969 on behalf of any individual can only be made after elaborate computations which add to the administrative costs of the Plan. It should be noted that under the Bill the employee has the burden of establishing the amount of post 1969 employer contributions.

(b) Assuming the post 1969 employer contributions can be readily identified, a tax must be computed thereon using the special income averaging method provided in the Bill. The tax thus computed must be paid in the year of distribution, but the results of this computation must be re-examined five taxable years later and the tax recomputed. If the recomputed tax is lower than the original tax, then the taxpayer may seek a refund. Accordingly, the employee's tax liability is not settled for at least five years—and no doubt a longer period by the time a refund is made. Furthermore, this result is more likely to occur among individuals who do not have large amounts of income during retirement years.

(c) When employer securities are included in a lump sum distribution the net unrealized appreciation in such securities must be eliminated before the tax is computed. Admittedly this is true under present law but is already a complicating factor which would only be compounded by the proposed changes.

We submit that the procedural complications which will be added to the tax chores of the millions of employees participating in these tax qualified plans make the tax reform cure worse than the disease. Indeed, we believe that in its present form these provisions could lead to a cure for the alleged abuses cited only at the expense of the continued health of these plans. Although the implications are that

33-865 O—69—pt. 2——31

changing the rules only prospectively will work no hardship on employees covered by the numerous plans which have grown up over the years, this is not the case. Apart from the procedural complications and confusion just discussed, there will be serious economic effects on many participants as well. In fact, participants in the least successful plans will be hardest hit. Consider, for example, an employee who progresses from a starting salary of $8,000 per year to a final salary of, say $30,000, after thirty years of service. If he leaves employer contributions in the plan until retirement, they may be taxed at a higher level after waiting thirty years to receive the contribution than they would have been if he had taken distribution on an earlier "vesting" date as many plans provide. Now, if the company stock paid substantial dividends over this period, this tax premium might be considered a worthwhile price to pay for deferring tax on these dividends, but if not, then he would have been better off to take the contributions earlier, pay the tax and reinvest the after-tax proceeds. Another situation which would adversely affect participants in less successful plans will arise where there is little unrealized appreciation in the stock and, therefore, the distribution is not only smaller than had been hoped for but the proportion immediately taxable at ordinary rates is higher.

(5) The present tax treatment was one of the factors considered when these plans were originally formulated. In other words, plans are set up with the idea that continued participation by an employee over his working career will not only encourage thrift and increase employee stock ownership in the company, but will produce financial results (after-tax) within a certain range when finally distributed on retirement or other separation from employment. The capital gain treatment figured prominently in calculating these expected results and was therefore a factor in designing the plans. While the five year averaging provision in the Bill is designed to ameliorate the changed treatment, it will have uneven effects as between individuals when compared with the present treatment. The employee will be required to gamble as to the level of future ordinary tax rates whereas under present rules he can at least be assured that whatever rates may be he will pay tax at a maximum of one-half such rates when he receives his distribution.

In summary, these new provisions will greatly complicate the tax computations of millions of taxpayers who already find they lack the sophistication to understand even the present provision of the Code, they will introduce even more uncertainty into their financial planning, and they will undercut the basis of the economic design of many plans. All of this is being done in the name of tax reform aimed at a tax avoidance device involving alleged abuse in only a relatively few situations and partial correction of this alleged abuse would be achieved in the Bill through removal of the alternative tax on capital gains. We therefore urge the Committee to seek other means of correction which do not threaten the continued growth of broad-based plans upon which millions of employees now rely.

Sec. 331—Deferred Compensation (Code Sec. 1354)

As with other provisions of HR 13270, it is easy to conclude from a study of section 331 of the Bill dealing with non-qualified deferred compensation arrangements that one basic objective of tax reform; simplification, has been poorly served. For what can only be described as minimal effects on tax revenue (no measurable effect is forecast until 1972 and a maximum effect of only $25 million per year by 1979) the new rules would so complicate tax return preparation and record keeping as to render a very important method of compensating management employees largely ineffective. Not only are these rules complicated as far as compliance is concerned, as witness the two alternative methods of calculating the so-called minimum tax, but they violate long established tax principles that cash basis tax payers compute and pay their taxes for the year income is received and at rates effective for that year. Imagine, if you will the record keeeping, computation, administrative, and enforcement problems which will be created when thousands of employees with long careers under deferred plans, even those who are sophisticaated in tax law, are confronted by the labyrinth of these rules. We urge that the provisions of this section and the reasons advanced in support of them be carefully reexamined and we firmly believe that such reconsideration will show that there is insufficient justification for including them as part of tax reform legislation.

Fundamental to an understanding of why there is no need to change present law with respect to deferred compensation is an understanding of what it is and what legitimate business purposes it serves. First and foremost, however, it must

be made clear that no income escapes tax under such plans. The recipient of deferred compensation must include the payments in his gross income for the years in which they are received and must pay tax thereon at ordinary income tax rates. Furthermore, the employer's tax deduction coincides with the time of actual payment. Thus the taxation of these payments under present law is in accord with the desirable tax objective of balancing deduction with the receipt of income. Deferral of income to later years when income was expected to be lower was a definite factor but it is less useful now because tax rate schedules have been compressed and many persons find that taxable pensions, investment, and other income, combined with deferred compensation, result in little really significant change in tax brackets after retirement. And finally, under Section 802 of the House Bill, deferred compensation would be excluded from "earned income" which would be eligible for the 50% maximum tax rate limitation and it therefore could well be taxed at higher levels than if it were paid in the year earned. All this would seem to raise a question: why, if the tax advantanges have already been reduced and seem to be headed for further reduction, do these plans continue to be popular? The answer would seem to be, and is, that there are other important non-tax reasons for them.

From an employers' standpoint, attracting and retaining highly talented individuals, retaining a portion of an employee's earnings for use in the business, and providing continuing motivation through deferred payments in shares of company stock are all factors in the use of deferred compensation, and all make good business sense quite apart from any tax considerations. From the employee's view, a position with a small, growing company not yet able to meet high salary competition of larger firms can be made attractive by a deferral plan which will not endanger the present cash position of the company. As a corollary, deferred plans with "earn-out" periods of several years following the year of an award are factors which an executive considering a move to another company always has in mind. Many employees consider the spreading out of a part of currently earned income a vital part of their financial planning; even though tax rate difference may be small, it helps to level income over the combined working career-retirement period. This is particularly true where the tax qualified-pension plan of the employer is designed to prohibit participation of the part of compensation above certain levels in order to meet non-discrimination requirements and pensions are therefore inadequate to maintain a standard of living after retirement reasonably similar to the pre-retirement level.

As further evidence of the horrendous problems these provisions would create, we note that Assistant Treasury Secretary Cohens statement before this Committee during the earlier part of September contains an admission that his experts have not been able to satisfactorily define the term "deferred compensation." Even if this problem were overcome he noted they are also concerned about how they could realistically comply with the requirement that they develop regulations to determine the year in which deferred income is "deemed" to have been earned.

We conclude with one further thought; it is not impossible to imagine that federal revenues could be *reduced* by these proposals rather than increased. Since immediate compensation will qualify under the House Bill for the 50% maximum tax rate on earned income included in the House Bill, the average rate on income which might otherwise be deferred will be somewhere below 59%. To the extent that deferred compensation plans are abandoned and effective corporate tax rates exceed this average, current deductions by the companies for such payments could reduce company taxes by more than the increase in individual taxes. It would not be the first time such anomalous results flowed from ill-advised efforts to enact reform where reform is not needed.

Sec. 231—Moving Expenses (Code Sec. 217)

The recognition in the House Bill of the realities facing employees who must move their place of residence in response to transfers by employers or to accept new employment goes part way toward eliminating sometimes crushing financial burdens which are added to the ordinary disruptions of family life occasioned by those moves. While Section 231 of the House Bill is sound in principle, it is deficient in several respects. Real estate commissions, which are a percentage of the sale price of the residence, have risen in absolute terms with the rising values of real estate. This means that the $2,500 limitation imposed on the three new categories of expenses eligible for deduction is just not large enough to cover these larger commissions, plus pre-moving house hunting trips, and temporary living expenses at the new location where even a modest residence is involved.

The thirty day time limitation on deductibility for living expenses at the new location is inadequate and unnecessary if a dollar limit is in effect. We do not understand why the effective date is for taxable years beginning after December 31, 1969. This relief measure has been proposed in Bills introduced several times in the past and is long overdue. We urge that the effective date be changed to taxable years beginning after December 31, 1968.

There are many cases where a transfer of employment location within large urban areas, with their established commuter patterns and routes, would be practically impossible if the employees could not also move their places of residence. Increasing the distance requirement from 20 to 50 miles is unjustified and we strongly support the Treasury Department statement asking for restoration of the 20 mile test for new employees. We also believe that where the employee moves at the convenience of the employer any mileage test is inappropriate and urge that this be recognized in the Bill.

The requirement that moving costs that will be deductible by the employee be included in gross income even though deductible will cause problems for many taxpayers filing returns under state and local income tax laws. This provision will add to taxpayer confusion with no apparent benefit. We therefore suggest that these costs be excluded from W-2 reporting requirements, the same as the exclusion from withholding requirements provided by Sec. 340[illegible]) (15) of the Code.

The House Bill requires that all reimbursements of [illegible]oyees for moving expenses be included in gross income and the Committee Report states they are thus to be considered wages for withholding purposes. Section 3401(a)(15) of the Internal Revenue Code specifically exempts such reimbursements from withholding if at the time of payment it is reasonable to believe that a corresponding deduction under Section 217 be allowable. Since 3401(a)(15) would remain in the law, this provision of the House Bill assures that employers, employees and Revenue Agents will be subject to great doubt and confusion. There is no justification for withholding on amounts which are reasonably expected to be deductible and this provision should be amended to make it clear that Section 3401(a)(15) will continue to control in such situations.

Sec. 802—Maximum Tax on Earned Income (New Code Sec. 1348

While we generally applaud this section which imposes a maximum tax rate limit of 50% on earned income, we believe there are defects which must be corrected to make it equitable Perhaps through oversight, the definition of earned income does not specifically refer to periodic pension and annuity payments. On the other hand, deferred income payments are specifically excluded from the definition (b)(1), although referred to as earned income in other sections of the Bill. In both cases, however, the amounts received are earned during the period of active employment and are therefore clearly within the concept of earned income contained in the bill and as generally understood when contrasted with investment and other forms of passive income—which would continue to be subject to the higher tax rates We therefore urge that any payment that an employee receives from his employer or under employer plans which is taxable as ordinary income be treated as earned income for the earned income rate limitation provision.

We wish to express our appreciation for this opportunity to present comments for the consideration of the Senate Finance Committee during its deliberations on federal tax proposals and respectfully request that our complete statement be include in the record of the Committee's hearing on the Tax Reform Act of 1969.

Respectfully yours,

E. A. VAUGHN,
Chairman, Committee on Taxation.

AMERICAN PUBLIC GAS ASSOCIATION,
Washington, D.C., October 7, 1969.

HON. RUSSELL B. LONG,
Chairman, Senate Committee on Finance,
New Senate Office Building,
Washington, D.C.

DEAR SENATOR LONG: The American Public Gas Association, the national association of publicly owned gas distribution systems, held its Eighth Annual Convention at Gatlinburg, Tennessee, September 15–17, 1969. At that time, the mem-

bers unanimously adopted 5 resolutions on various issues involved in the Tax Reform Act of 1969 (H.R. 13270) now before your Committee of vital interest to the members of the association. We are enclosing herein copies of these resolutions.

We respectfully request that these resolutions be made a part of the printed Senate Hearings relating to the Tax Reform Act of 1969.

We appreciate very much this opportunity to present our views to you and the Committee.

Respectfully submitted.

ROBERT H. KING, *President.*

RESOLUTION NO. 4—THE TAX EXEMPT STATUS OF STATE AND LOCAL BONDS

Whereas, the interest from State, municipal and other public agency bonds has historically been exempt from Federal taxation under our dual system of government; and

Whereas, a Federal income tax on the obligations of States and their political subdivisions, or upon the interest they pay on these obligations, would be inconsistent with and contrary to the dual system of government contemplated by our Constitution; and

Whereas, the House of Represenatives of the United State Congress has passed H.R. 13270, 91st Congress, 1st Session (also known as the Tax Reform Act of 1969) which bill would offer a Federal subsidy to State and local bond issues in exchange for their interest's being subject to Federal income taxation; and

Whereas, H.R 13270 will have, and already has had, a seriously adverse impact on, and caused great uncertainty in the market for State and local obligations; and

Whereas, such a Federal subsidy would undermine the financial independence and integrity of State and local governments in carrying out their governmental responsibility of providing their citizens with essential public services including natural gas and would drive them to rely instead upon Federal assistance; and

Whereas, the issuance of tax exempt bonds bearing the lowest possible interest rate is essential for municipal and other publicly-owned gas utilities to have a means of financing needed facilities for the transmission and distribution of water, natural gas and electricity; and

Whereas, the limited tax preference provisions of H.R. 13270 provides a sufficient deterrent to tax abuse by holders of tax exempt State and local bonds: Now, therefore, be it

Resolved, That the American Public Gas Association:

1. Reaffirms its opposition to any legislation which would abridge the tax exempt status of bonds issued by State or local government to finance public services including natural gas; and

2. Opposes any legislation which would offer Federal subsidy as a substitution for the long-standing Constitutional and legislative tax exemption of interest on State and local bonds presently incorporated in Section 103 of the Internal Revenue Code of 1954.

RESOLUTION NO. 5—TREATMENT OF LIBERALIZED DEPRECIATION AND ACCELERATED AMORTIZATION FOR RATEMAKING PURPOSES

Whereas, the "flow-through" principle for the treatment of liberalized depreciation under Section 167 and accelerated amortization under Section 168 or the Internal Revenue Code of 1954 results in substantial savings to the rate payers who thereby pay only for the actual Federal taxes incurred by regulated natural gas companies as a part of their cost of service; and

Whereas, to the contrary, the "normalization" principle for the treatment of these matters results in the ratepayers paying for hypothetical "phantom" taxes which the regulated natural gas companies do not in fact pay to the Government and may never pay; and

Whereas, the Federal Power Commission has decided that the flow-through principle is the proper method for treating liberalized depreciation under Section 167 of the Internal Revenue Code, and has further decided that companies using liberalized depreciation may not change their depreciation method to avoid flowing through the resulting tax savings to the consumer, which decisions have been affirmed by a number of courts on appeals; and

Whereas, H.R. 13270, 91st Congress, 1st Session ("Tax Reform Act of 1969"), if enacted, would in effect "freeze utility companies in the type of depreciation and amortiaztion which they are now using by requiring (1) that if straight line depreciation is presently used, then no faster depreciation is to be permitted as to that property, (2) that if accelerated depreciation with normalization is presently used, the taxpayers must either switch to straight line or continue to normalize, and (3) that if accelerated depreciation with flow-through is presently used, the taxpayer must continue to do so unless the appropriate regulatory agency permits a change as to that property; and

Whereas, the effect of these provisions of H.R. 13270 would be to inhibit the expanded use of accelerated depreciation (and flow-through of the savings resulting therefrom for ratemaking purposes, thereby arbitrarily discriminating against consumers in those areas of the country serviced by pipeline companies which have not as yet switched to accelerated depreciation: Now, therefore, be it

Resolved, That the American Public Gas Association opposes those provisions of H.R. 13270 which would change the present law relating to the use of accelerated depreciation and amortization by utility companies.

Resolution No. 6—Oil and Gas Depletion Allowance and Intangible Drilling Expenses

Whereas, the 27½% depletion allowance for oil and gas production has long been a greater benefit and incentive than is necessary for producers of oil and gas; and

Whereas, this allowance has in many instances permitted oil and gas companies to avoid bearing their fair share of our nation's tax burden; and

Whereas, the present tax provisions relating to intangible drilling expenses which permit an immediate write-off of the costs of drilling new wells provide sufficient incentive for such drilling; and

Whereas, H.R. 13270, 91st Congress, 1st Session ("Tax Reform Act of 1969"), if enacted, would cut the present 27½% depletion allowance on domestically produced oil and gas to 20% and would repeal entirely the 27½% depletion allowance for overseas production of oil and gas; and

Whereas, the provisions of H.R. 13270 would not affect the deductions permitted for intangible drilling expansion; and

Whereas, the effect of the above provisions of H.R. 13270 would be to reallocate the Federal income tax burden in a substantially more equitable manner than now exists and, through the maintenance of the present provisions relating to the deduction of intangible drilling costs, could result in a significant increase in the exploration for and development of domestic supplies of oil and gas through an incentive to increase the level of domestic drilling operation, which would result in substantial savings to consumers in the prices they would pay for oil and gas; and

Whereas, any changes in both the depletion allowance and the deduction for intangible drilling expenses might deter the development of new supplies of oil and gas and thereby result in an increase in the cost of oil and gas to the consumer: Now, therefore be it

Resolved, That the American Public Gas Association supports those provisions of H.R. 13270 which reduce the present 27½% depletion allowance on domestically produced oil and gas to 20% and which repeal entirely the depletion allowance for foreign production of oil and gas, but opposes any attempt to restrict the provisions of Section 263(c) of the Internal Revenue Code of 1954 regarding allowance of intangible drilling expenses for oil and gas wells.

Resolution No. 7—Repeal of the Investment Tax Credit

Whereas, H.R. 13270, 91st Congress, 1st Session ("Tax Reform Act of 1969") would, if enacted, provide that the termination of the investment credit would not affect gas pipeline construction not yet begun but for which an application had been filed with the Federal Power Commission prior to April 19, 1969; and

Whereas, since 1964, the benefits derived by pipeline companies from the 7% investment tax credit have not been "flowed through" to the consumer to lower the rates he pays for gas, so that the consumers in effect, have been paying as though there were no investment tax credit; and

Whereas, this exception to the termination provisions (known also as the "pipeline sweetener") constitutes unwarranted special treatment for gas pipeline companies at the expense of the public: Now, therefore, be it

Resolved, That the American Public Gas Association opposes anything short of uniform, across-the-board treatment of all businesses with respect to the termination of the investment tax credit.

RESOLUTION NO. 8—REDUCTION OF FOREIGN TAX CREDIT FOR OVERSEAS OIL AND GAS OPERATIONS

Whereas, it is desirable to encourage exploration for and development of domestic supplies of oil and natural gas; and

Whereas, it is in the interest of the nation and the consuming public to achieve a greater economy in the production of oil and natural gas through a proximity of the sources of these products to those who buy and consume them; and

Whereas, present tax law relating to foreign tax credits for overseas oil and gas operations encourages overseas production at the expense of domestic development; and

Whereas, present law has allowed some oil and gas companies to derive double tax benefits and to disguise royalty payments to foreign governments as "foreign taxes"; and

Whereas, provisions of H.R. 13270, 91st Congress, 1st Session ("Tax Reform Act of 1969") would, if enacted, correct this situation and encourage greater development of domestic oil and gas resources by reducing the foreign tax credits available for overseas oil and gas operations: Now, therefore, be it

Resolved, That the American Public Gas Association supports the provisions of H.R. 13270 relating to reduction of the foreign tax credits available to overseas oil and gas operations.

NATIONAL FEDERATION OF INDEPENDENT UNIONS,
Washington, D.C., October 6, 1969.

Re Tax Refort Act of 1969, H.R. 12370.

Hon. RUSSELL B. LONG,
Chairman, Senate Finance Committee,
U.S. Senate, Washington, D.C.

DEAR MR. LONG: My name is Don Mahon. As Secretary of the National Federation of Independent Unions, and President of the National Brotherhood of Packinghouse and Dairy Workers, I wish to present the following statement for consideration in behalf of the members of our Organizations and their families. They are primarily among the taxpayers most seriously affected by the Act now under consideration by your Committee.

This will confirm our desire to pay our fair share of the taxes necessary to sustain and protect our government and this country. However, we feel that the present system is discriminatory and inequitable as interpreted and administered.

The following changes, to be made effective through the Tax Reform Act of 1969, would help eliminate some unfair practices now in affect.

1. Let the surtax die on January 1, 1970.
2. Eliminate the 7% tax deduction allowed Corporations to buy new equipment and the real estate exemptions of accumulated depreciations.
3. Eliminate the huge exemptions granted to foundations.
4. Impose a tax of consequence on all income regardless of the source so as to cope with the capital gains and similar situations.
5. Do away with the oil depletion allowance of 27½%.
6. Increase exemptions from the present miniscule figure of $600.00 to not less than $1200.00.
7. In cases where profit sharing plans are in effect, in lieu of pension plans for the benefit of employees in their years of retirement, provide that capital gains in such funds be treated in a manner similar to insurance and other pension plan funds.
8. That a broader definition of deductible job related costs to employees, as well as work related travel expenses, be included. (This provision should liberalize the present definition of moving to include categories of indirect deductible expenses such as costs of transportation, meals and lodging for the taxpayer and members of his household, to be deductible if the taxpayer has obtained employment in the new area before the trip begins.)

Temporary living expenses at new principal job locations. (Costs of meals and lodging incurred by the employee and members of his household for the first thirty days after obtaining employment would be deductible.)

Costs of selling old residence; buying new residence; or terminating lease. (Attorney fees, escrow fees, appraisal fees, title costs, "points" or loan placement charges (but not interest), reasonably necessary to affect the purchase of a new residence would be deductible.

Also, expense of commuting between home and place of employment as a deduction from gross income.

Serious consideration and positive action by your Committee, on these reforms in behalf of millions of Americans who are similarly situated, is hereby requested and appreciated.

Respectfully submitted.

DON MAHON,
National Executive Secretary.

STATEMENT

OF

LOUIS O. KELSO AND NORMAN G. KURLAND

ON

FEDERAL TAX POLICY TO CREATE FULL EMPLOYMENT

BY BROADENING THE OWNERSHIP OF PRODUCTIVE CAPITAL

I. INTRODUCTORY REMARKS AND SUMMARY

II. THE UNEXPLORED PROBLEM OF OUR TAX POLICY: HOW OUR TAX POLICIES FRUSTRATE BROADER CAPITAL OWNERSHIP.

A. How Corporate Tax Laws Encourage the Continuing Concentration of Wealth.

B. How Corporation Taxes Have Weakened our "Private Property" System.

C. How Other Tax Laws Accentuate the Concentrated Ownership of Capital.

D. A Slightly Different View of the Taxpayer Revolt.

E. Tax Policy and the Loopholes.

F. Tax Policy and Inflation.

G. Tax Policy and Economic Growth.

H. Tax Policy and Unemployment.

I. Tax Policy and Skyrocketing Welfare Costs.

III. THE SECOND INCOME PLAN TRUST: A HIGH-POWERED QUALIFIED DEFERRED COMPENSATION TRUST FOR CONVERTING EMPLOYEES INTO OWNERS OF NEWLY FINANCED CAPITAL

A. Description of Second Income Plan Financing and the Operation of Second Income Plan Trusts for Corporate Employees.

B. Some Examples of the Use of Second Income Plan Trusts and Related Financing Techniques to Broaden Capital Ownership.

C. Comparison of Financial Effect on Stockholder Equity of Employee Second Income Plan Trust Financing of Corporate Growth with Straight Loan Financing.

IV. THE SECOND INCOME PLAN: A COMPREHENSIVE STRATEGY FOR BROADENING OUR TAXPAYER BASE BY ENABLING ALL FAMILIES TO OWN CAPITAL.

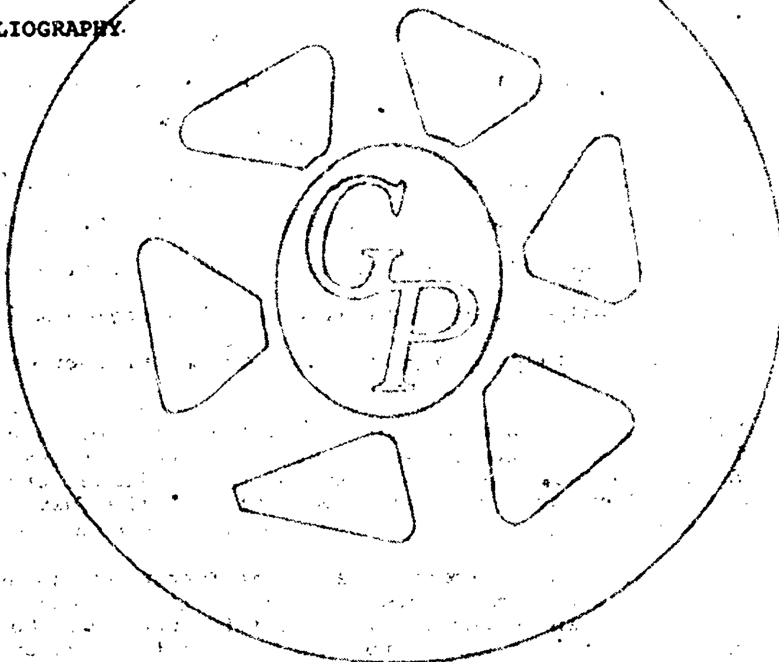
A. A Graphic Presentation of the Second Income Plan.

B. Questions Most Often Asked About the Second Income Plan.

C. Some of the Implications for National Economic Policy for Recognizing that Double-Entry Bookkeeping is the Logic of a Market Economy.

V. RECOMMENDED TAX REFORMS

VI. BIBLIOGRAPHY



My name is Norman Kurland.* I represent the Institute for the Study of Economic Systems, an educational and research organization that seeks within the strengths and dynamics of a private property, free enterprise system the new and creative solutions to the problems of our economy. My presentation today was developed in collaboration with Louis O. Kelso,** noted economist and senior partner of a widely respected San Francisco law firm specializing in corporation, tax, and finance law.

We would like to address ourselves to issues thus far ignored in the current deliberations on tax reform. Our main focus is on aspects of our tax policies which perpetuate and encourage concentrated capital ownership. Our analysis, we feel, will amply demonstrate that tax policy designed to restore health to our economy and promote economic justice has, in fact, inhibited economic vitality and has denied most Americans equal opportunities to participate in the production of wealth

*Mr. Kurland is a member of the District of Columbia bar and directs the Institute for the Study of Economic Systems. He was former Director of Planning of the Citizens' Crusade Against Poverty. He studied economics at the University of Chicago.

**Mr. Kelso is an economist and senior partner in the San Francisco law firm of Kelso, Cotton, Seligman, and Ray which specializes in corporation, tax and finance law. He is author of The Capitalist Manifesto, The New Capitalists, and Two-Factor Theory: The Economics of Reality, and numerous articles on economic theory and new techniques of financing broader capital ownership.

as owners of capital.

Our national fiscal policies today have missed the target on this important issue:

> How can we motivate all employable persons to expand to the fullest our economy's output of useful goods and services, synchronizing that expanded productive power with expanded purchasing power among people who need and desire to consume that new wealth?

In brief, today's economic problems cannot be solved without a recognition of these basic facts:

* Capital instruments in America's largest corporations produce the overwhelming bulk of our wealth.

* Capital ownership is highly desirable for people fortunate enough to acquire a capital estate.

* Capital ownership is highly concentrated and is becoming even more so.

* Current tax policy, because it encourages the use of conventional techniques for financing new capital formation, denies access to capital ownership to 95 percent of the American people.

* American industry has the physical capacity (i.e. the managerial and technical know-how, the physical capital, the trainable manpower and the resources) to expand its output of useful goods and services many times its present rate, if it had customers with sufficient buying power.

As we will attempt to demonstrate (see section II) the inability of most Americans to legitimate their incomes through capital ownership is the root cause for today's most pressing economic problems:

* Rising government costs.

* Dangerous inflationary trends.

* Inadequate economic expansion.

* Underutilized manpower and resource wastes.

* Unhealthy and increasing dependency of major corporations, local communities, and millions of citizens on Federal spending in order to survive economically.

* The continuing failure of the private sector of our economy -- the major U.S. corporations and our labor organizations -- to solve our economic problems with minimal government intervention.

* Our inability to broaden our taxpayer base.

* The ominous taxpayers' revolt.

We propose two basic and interrelated strategies for broadening the base of capital ownership -- without eroding or redistributing the private property of existing owners -- so that every household in America could begin to acquire legitimately a reasonably-sized capital estate as a supplementary source of its purchasing power. We propose that Congress enact tax reforms (see section V) which would:

(1) Encourage the expanded use of Second Income Plan Trusts, an approved variation of a qualified deferred compensation stock bonus trust, by the major U.S. corporations so that corporate employees could acquire significant capital estates as corporations financed their capital expansion programs.*

(2) Launch the Second Income Plan, a comprehensive strategy for achieving general affluence and broadening the taxpayer base by enabling all families to own capital.**

*See section III of this testimony and chapter 16 of Two-Factor Theory: The Economics of Reality by Louis O. Kelso and Patricia Hetter.

**See section IV of this testimony; also by Mr. Kelso, see: The New Capitalists (co-author, Mortimer Adler, Random House, 1961); chapter 17 of Two-Factor Theory: The Economics of Reality (co-author, Patricia Hetter, Random House, Vintage paperback, 1968) and "Eliminating the Purchasing Power Gap through Two-Factor Theory and the Second Income Plan" (co-author, Patricia Hetter), Income Maintenance Programs, Hearings . . ., Joint Economic Committee, 90th Congress, 2d Session, Vol. II, pp. 633-652, 1968. The Appendix of Two-Factor Theory contains the "Full Production Act," the model for Federal legislation to plan and implement the Second Income Plan as national policy.

This approach would:

* Build a "second economy" within 25 to 30 years that would be 7 to 10 times larger than the present economy, which is physically incapable of supporting general affluence.

* Create, within 2 years from start-up time, tens of millions of new and useful jobs in private industry to build the physical capital structure (e.g. the buildings, power plants, transportation systems, anti-pollution systems, computers, etc.) needed for a rapidly expanding "second economy."

* Broaden capital ownership among tens of millions of workers without reducing their take-home pay, fringe benefits, or savings.

* Link workers to a supplementary source of income beyond that derived from wages or salaries.

* Broaden capital ownership among the remaining 95 percent of capital-less Americans. (Conservatively, we estimate that, after a 5-year start-up period, one million families every year could leave the welfare rolls, each producing a legitimate income of $4,000 per year through its productive capital. After a second 5-year period, five million familes per year could acquire similar estates. Within 15 years, every American household would produce significant incomes through their newly acquired capital estates.)

* Generate a significant new and legitimate source of mass purchasing power not dependent on government intervention or redistribution but tied directly to newly added productive power in the economy.

* Widen the personal income tax base as the new owners produced their "second incomes" through their capital estates, enabling all Americans to share in support of necessary governmental activities.

* Encourage corporations to pay out 100 percent of net profits to shareholders and to finance their corporate expansion through techniques that lead to broader ownership.

* Enable industry to finance new capital on pre-tax net earnings.

* Gradually eliminate the need for corporation taxes.

* Reduce government costs by enabling the private sector to recapture from government the primary thrust for expanding our economy, thereby gradually reducing government's roles to its traditional functions as "umpire," "gap filler," peace keeper, and controller of our monetary machinery.

* Reduce resource and manpower waste resulting from welfare and from jobs artificially "created" with taxpayer dollars and create rewarding job opportunities for those in industry and in the military who will become "surplus" when the Vietnam conflict terminates.

* Create new and more rewarding roles for labor unions as the demand for employees (and therefore labor's potential constituency) increases under the expanding "second economy". (Labor's bargaining demands would broaden from their exclusive focus now on higher incomes from toil, to economic security and "second incomes from capital.)

* Lift the psychological and economic restraints to expanded use of our new technologies and automation. (Workers who share in the profits produced by a new machine welcome having it make their work easier or replace their toil entirely.)

* Begin to end the historic struggle between the haves and have-nots through a unique "private property" strategy that would turn have-nots into haves without taking from those who own today's capital.

* Gradually eliminate the root causes of our uncontrollable inflation:

  -- Increasing labor costs alongside decreasing labor productivity. (Capital, not labor, has become more productive.)

  -- High interest rates

  -- Non-productive government spending

  -- Unrestrained consumer credit

  -- Other causes which produce artificial purchasing power without simultaneously generating a corresponding increase in the output of wealth.

It should be noted that Second Income Plan financing would reduce corporation taxes flowing from future capital expansion. However, it would not affect Federal revenues currently derived from corporation taxes. The existing capital structure would continue to produce the same net earnings which, unless altered, would be subject to present corporation tax rates. Our proposals are geared exclusively to the future earnings produced by newly added capital. It is this new capital that our economic system so sorely needs to increase our national productive power, to raise our national standard-of-living, and to generate higher incomes for the millions of Americans with unsatisfied needs and wants. Hence, any future "losses" in corporate tax revenues would be far outweighed by revenue gains in the form of higher personal income taxes and lowered government costs.

Our specific recommendations for tax reform are outlined in section V of this presentation.

II. THE UNEXPLORED PROBLEM OF OUR TAX SYSTEM: HOW OUR TAX POLICIES FRUSTRATE BROADER CAPITAL OWNERSHIP.

A. How Corporate Tax Laws Encourage the Continuing Concentration of Wealth.

The fact that about 26 million persons in the United States own at least one share of stock, despite Wall Street's claim to the contrary, does not make them "capitalists." (A reasonable definition of this term would limit its coverage to those receiving at least half of their consummable incomes from income-producing property.) Less than one percent of American households really qualify to use this label. Most of the remaining shareholders could scarcely afford a meal in a decent restaurant if

they depended on their dividend income.

Capital has always produced the highest standard-of-living for those fortunate to own enough of it. But virtually all capital ownership in the American economy is concentrated in 5 out of every 100 families. Having ignored for too long the importance of broader capital ownership, our society has effectively and systematically barred the remaining 95 percent of families from the privilege of becoming capitalists.

One of the major institutional barriers to broader capital ownership, strangely enough, is the corporation tax, a tax solely on owners of capital. The effective rate of Federal and state corporation taxes on major corporations amounts today to about 56 percent.

On first blush this "double tax" on the earnings of capital would appear to be one of the many ways our society has developed for redistributing income from affluent Americans to increase the incomes of non-owners. But, in fact, this enormous "leak" in the income stream produced by capital only serves to perpetuate the traditional pattern of corporate finance, the primary cause of concentrated ownership. By selectively closing this leak and applying more modern techniques of financing new corporate growth, as we will explain, all Americans could become owners and produce significant incomes from capital in our expanding economy.

Our capital instruments -- not labor -- produce most of our society's wealth. Each year corporate managers -- who, interestingly enough, are basically capital-less themselves -- add new productive capital valued in the tens of billions of dollars.

This process increases our productive capacity by relentlessly shifting the burden of producing our wealth from human beings to more efficient new capital instruments. In 1969 alone, over $70 billion worth of buildings, machines, computers, power plants, oil refineries, aircraft, and thousands of other forms of capital will be added to last year's capital structure. But hardly any new owners will be created in the process. Almost all new capital will be financed out of past savings. Less than half of one percent of new capital formation during the eleven years 1955-1965 came from issuing new stocks to the public; 99.5 percent was generated internally.

Yet new capital in our major corporations is subject to "birth control." It is a standard rule-of-thumb among corporate managers that new capital will not be brought into existence in well-managed corporations unless it will rapidly pay for itself -- generally in less than 5 years -- from the future earnings that it will produce for the corporation. But under conventional corporate financing practices capital pays for itself exclusively for the benefit of present owners.

As has been successfully demonstrated in practice (for the benefit of thousands of new owners) since capital in major corporations is inherently financeable, anyone could become an owner of a significant capital estate if he could buy it on credit, let it pay for itself, and thereafter enjoy the income it produces. (See section III.B. below.)

But new owners cannot be created unless we close various

leaks in the income stream produced by newly formed capital. The pre-tax net income produced by capital added in our 4,000 top corporations consistently averages 20 cents to 25 cents on every dollar invested. Most of that income is drained away by corporation taxes (about 56 percent) and earnings withheld by corporate managers for future investment, leaving the average shareholder with a dividend return of 4 to 5 percent. Such a low return may, of course, satisfy already affluent shareholders, who would, for various tax reasons, prefer taking their investment incomes in the form of "capital gains." But such low dividends would not even cover the interest on a capital acquisition loan for potential new owners under today's inflated interest rates.

As we will discuss later, newly discovered financing techniques have overcome these barriers to broader ownership. Some illustrated below (section III.B.) are working now for the benefit of a significant number of corporate employees who could not otherwise gain a "second income" from capital. With minor tax improvements, these techniques would become more widely used as the major vehicle for restoring health to the private sector of our economy, thereby creating millions of legitimate new jobs in industry and widening our tax base. With other minor supplements to our tax policy, even persons not employed by corporations -- including the aged, the disabled, others on welfare, civil servants, and even legislators -- could become owners of a diversified portfolio of newly issued qualified shares and thus begin to produce for themselves significant independent incomes from our expanding economy.

B. How Corporation Taxes Have Weakened Our "Private Property" System.

The institution of "private property" -- whose origin in our own legal system can be traced to roots in Roman law -- amounts to no less than the right to all the wealth that one's property produces. This institution, of course, applies equally to one's right to the wealth produced by his own body and mind (labor) as well as by the non-human extensions of his body (his capital instruments). No one today seriously questions the right to wealth produced by one's labor. Ignored is the fact that the corporation tax (a tax solely on owners of capital), is a direct erosion by more than half of the "private property" of these owners.

Some may react by saying, "So what if the rich are soaked twice? At least the poor will benefit from the redistributed earnings." But are the poor really benefiting from corporation taxes? Are the rich really losing their share of the wealth of our economy? Are the forces of concentration working faster than the forces of redistribution? Is our weakening of the institution of "private property" socially and politically desirable? Is there a better alternative?

We would contend that the poor and others among the 95 percent of American households who are capital-less are seriously harmed by today's erosion of "private property" in capital because it virtually disqualifies them from ever acquiring a "piece of the real action," a private property stake in the industrial assets of the Nation.

On the other hand, the really affluent few, who by the very definition of "affluence" already receive more income than they can possibly consume, lose very little of substance by a "double tax" on their earnings. Under conventional financing techniques the same owners will automatically own all the new capital (and therefore all the new productive power) that comes into being this year, next year, and every year thereafter as we move further into the age of cybernation.

Today's corporation tax -- because it drains off indiscriminately over half of capital's earnings -- is a major factor keeping propertyless Americans economically disenfranchised from our "private property" system.

With no access to capital, most Americans must depend exclusively on toil (which often must be subsidized) and welfare as the sole sources of their subsistence.

It is little wonder then that alienation from our system has become more pervasive, particularly among the poor and our youth. It should not be surprising under the circumstances that so many young and poor people have limited respect for or understanding of the importance of "private property." Most of them, as things stand today, will never have an opportunity to acquire a genuine stake -- a vested interest -- in the property that produces most of our wealth. Does our earlier history suggest some new directions?

Thomas Jefferson envisioned a democratic American society where every family could become economically independent by owning property. The Founding Fathers generally understood

that "power naturally and inevitably follows property" and that the institution of "private property" was a primary shelter for an individual's civil liberties. They recognized that as an institutional check on the inevitable abuses that stem from concentrated power, "private property" had the same potential in the economic world that the "ballot" had in the political arena. Each placed ultimate power and responsibility directly in the hands of each citizen, where he could delegate it upwards and hold his representatives accountable for its exercise.

Under the Homestead Act, Jefferson's vision was realized. Formerly propertyless people responded with great enthusiasm to their new opportunity to free themselves economically by becoming owners of land. This historically unique "private property" approach unleashed enormously high levels of agricultural productivity, in turn releasing millions from work on farms to enter industry. Thus, this dramatic program -- possibly the most important enacted by any government in history -- served as the main springboard for this nation's rapid rise to leadership in the industrial revolution and to world prominence.

When the land frontier ran out, unfortunately, we failed to convert Jefferson's sound ideas to an economic strategy relevant to an industrial era. Industrial capital -- an even more significant form of capital than land -- remained narrowly owned. Our major corporations continued to build a "new frontier" of industrial capital -- unlike land, of almost limitless dimensions -- that continues to expand each year at a rate now rapidly approaching $100 billion worth of new structures, machines, and other forms

of productive capital.

Physically, we have the know-how, technology, resources, and trainable manpower to build enough capital instruments to produce in abundance for all. Institutionally, however, we have not yet reconciled ourselves to that industrial frontier.

C. How Other Tax Laws Accentuate the Concentrated Ownership of Capital.

The favorable personal income tax treatment of "capital gains" (limited to a ceiling of 25 percent) compared to dividend income (up to a 77 percent tax rate) for those in the top tax brackets is the widely acknowledged source of most of the complexity and inequities in our present tax system. What is not generally recognized is that it is one of the most significant structural causes of concentrated ownership. The tax preferences given to capital gains virtually "forces" the wealthy to leave their dividends in the form of retained corporate earnings, which is the main source of investment funds for capital expansion. New capital formation could just as easily -- and more logically -- be financed to broaden the base of capital ownership.

Accelerated depreciation, investment credits, and depletion allowances also tend to concentrate ownership of capital by making it easier for existing owners to acquire ownership of newly formed capital.

The tax-deductibility of gifts to general-purpose foundations -- by disconnecting ownership from people -- has a similar concentrating effect.

D. A Slightly Different View of the Taxpayer Revolt.

Under our national economic policies for the past 35 years, best expressed in the Employment Act of 1946, we have struggled to generate mass purchasing power exclusively through "full employment", backed up by income redistribution, both of which are largely dependent on taxpayer support and to a lesser extent on the manipulation of our monetary machinery. We have no national policy to broaden capital ownership -- despite the fact that capital produces the overwhelming bulk of the goods and services we consume.

Millions of families each year find themselves joining the group of highly insecure Americans who depend for their subsistence on the taxpayers, who are themselves on the most part economically insecure and debt-ridden. Included in that taxpayer-dependent group are not only the growing number of restless people on welfare and on already swollen government payrolls, but the millions of workers in private corporations which would collapse overnight but for government contracts.

Taxpayers are generally willing to support governmental activities where they can realize direct personal or social benefits. But they are generally unwilling to support artificially contrived or unproductive employment or mere doles for others, except when they consider their very survival is at stake, such as in war or under conditions of mass hysteria like war.

Taxpayers will pay for Federal aid to education under the

rubric of "national defense" (e.g., the National Defense Education Act; R.O.T.C. scholarships; Aid to Federally Impacted Areas) but will resist paying the cost of programs expressly designed to help those at the bottom of the economic ladder (e.g., Title I of the Elementary and Secondary Education Act; the Economic Opportunity Act.)

Taxpayers will pay for "law and order" before they will pay for institutionalized charity imposed by fiat. In fact, trying to institutionalize "charity" (derived from "caritas," the Latin word for "love") is as consistent with human nature as any attempt to institutionalize creativity.

Under normal conditions, an undisguised dole is guaranteed to "keep the poor in their place," always limited to the amount that, from a standpoint of political feasibility, could be taken, under force of law, from some and given to others.

Even a program disguised as a "family allowance" or "children's allowance" -- cleverly structured so that every family would receive one -- will not go unnoticed by the taxpayers who will bear the burden not only of their own "gifts" from government but also for those going to millions of non-taxpaying poor families.

On the other hand, because the material expectations of the increasingly organized poor will unavoidably continue to escalate, programs providing doles will necessarily heighten and perpetuate the already perilous confrontation between the most powerless segment of our society -- the poor -- and their most unpredictable and powerful opponent, the average American taxpayer.

If we had no other alternative for answering the problem

of the purchasing power gap in a society capable of producing general affluence, there would indeed be cause for great despair. But with minor revisions of our tax laws and more rational economic goals, we could easily solve that problem.

E. Tax Policy and the Loopholes.

Too much attention given to tax loopholes diverts us from the pressing need for more basic tax reform.

Most fair-minded observers would agree to the closing of loopholes which allow the very wealthy to escape some or all of their fair share of supporting government; e.g., capital gains taxes, accelerated depreciation, investment credits, depletion allowances, and the like. But the very existence of these legal "escape hatches" points out the importance of "private property" in terms of individual security and power. These loopholes reflect the tremendous counter-reaction of the wealthy to minimize any erosion of their property rights.

The closing of tax loopholes, it should be further noted, would hardly lessen the increasing burden imposed by our present economic policies on the middle-class taxpayer, who under any circumstances must pay the bulk of our taxes. The system might become somewhat fairer than at present, yet still collapse from overload.

F. Tax Policy and Inflation.

More rational tax policy -- one which would help bring about

widespread capital ownership of newly added productive capital without violating property rights of existing owners -- would begin to reduce inflationary pressures.

Despite our technological advantages, inflation is forcing American goods out of competition on the world markets and is inducing the flow of American capital abroad.

As most people realize, inflation stems from adding dollars of consumer power without a corresponding increase in the volume of goods. Inflation is one of the best barometers of defective economic and tax policies. (See section IV. C. entitled "Some of the Implications for National Economic Policy for Recognizing that Double-Entry Bookkeeping is the Logic of a Market Economy.")

Clearly, the most significant inflationary effect can be traced to rising wage and salary demands, the only route left open by our "full employment" policy for most people to gain a "legitimate" income, thus ignoring the almost unlimited frontier of productive capital as an alternate means for legitimizing their incomes.

Labor costs are not subject to competition in our system; while labor's contribution to production continues to decline because of automation and shorter work-weeks, American labor costs continue to rise. This result is understandable when workers are institutionally denied ownership shares in the profits produced by the new productive capital that is replacing them.

Another "cost-push" factor behind inflation is the rising cost of government, much of which is caused by the need under

present economic policies for the government to artificially generate mass purchasing power through spending programs. Under more rational policies, the corporate sector itself could generate that purchasing power directly through more innovative financing techniques which would enable capital-less households to gain "second incomes" through the ownership of newly added productive capital.

We can find a major "demand-pull" force on our sky-rocketing cost-of-living by studying the misuse of our sophisticated credit machinery: we provide credit for further capital acquisition exclusively for existing owners; capital-less Americans are limited to credit for consumer purchases.

Artificial purchasing power is created by consumer credit, which, unlike credit for capital expansion, adds no new productive power to the system. Americans also give away their future purchasing power by paying 22 cents on every after-tax dollar they earn to cover private debt service. A home buyer must earn enough for three homes under today's interest rates to buy one, widening his purchasing power gap by two homes.

On the other hand, credit for capital expansion makes sense. Capital pays for itself when added by our major corporations.

Although there is no symmetry under our present policies between productive power and consumption power, this imbalance could easily be remedied under the Second Income Plan, as is explained in section IV. C.

G. Tax Policy and Economic Growth.

New productive power in our society is basically a product of the new physical capital that is added by our private corporations, the most efficient and productive users of capital in history. Physically, our major corporations could expand (as they have done during all-out wars) by rates far in excess of our present rates, if there were markets, i.e., purchasing power, to buy what the corporations could produce. (During war, the government provides a ready market, although what is produced for war obviously satisfies no one's material needs.)

Today, changes in the tax laws (i.e., eliminating the 7 percent investment credit) are being considered to reduce further our national economic (i.e., capital) growth. This policy might be understandable when ownership is concentrated and when the system has very inefficient, humanly distasteful, and inflation-creating ways for redistributing the necessary purchasing power to take the newly added goods off the market.

A government policy to slow down the production of useful goods and services, however, is obviously absurd when non-inflationary alternatives exist to synchronize the expansion of corporate productive power with the growth of mass purchasing power. (See section IV. C. below and "Eliminating the Purchasing Power Gap Through Two-Factor Theory and the Second Income Plan," by Louis O. Kelso and Patricia Hetter, INCOME MAINTENANCE PROGRAMS, Joint Economic Committee, 90th Congress, Second Session, Volume II, pp. 633-652 (1968)).

Some Second Income Plan techniques are available under present laws and are being used successfully by a few large corporations (see section III.B . for some operating corporate models.)

H. Tax Policy and Unemployment.

Unemployment today is basically the product of our defective economic strategies. During all-out wars when the military budget provides an almost unlimited market for its output, American industry has shown that it can rapidly expand to its full physical capacity to produce, and will "beat the bushes" finding people to be hired and trained on-the-job. From 1940 to 1945, the American economy grew by over 100 percent, 20 percent a year, even with 16 million persons taken from the labor force for military duty. Although over 11 million were unemployed prior to 1940, during the war unemployment was unheard of.

Because we are institutionally unable to synchronize our power to consume with our potential power to produce, growth of our Gross National Product today is limited to about 4.5 percent, with tens of millions of persons unemployed or engaged in non-productive work and wholly subsidized activities for which there is no market demand. (See IV. C.)

If the recommendations proposed here were implemented, we would predict a gradual increase to overall peace-time growth rates of 15 percent annually, building the vast capital structure needed to physically produce general affluence. Such a monumental

task would generate 25 to 30 years of intensive and legitimate "full employment." Because every employable person would, in effect, be building his own capital estate, this approach would attract millions of people into industry who are now unemployed, underemployed, or engaged in non-productive work in industry and government.

I. Tax Policy and Skyrocketing Welfare Costs.

According to the Annual Report of the President's Council of Economic Advisors, the United States is spending $60 billion for income maintenance. Yet even according to "official" poverty criteria over 26 million persons and 5.3 million families are classified as "poor." Over 6 million persons are on the rolls of the Aid-to-Dependent Children Program alone. And the rolls are expanding at an alarming rate.

For example, a New York State welfare study published in 1961 predicted that by 1970 about 700,000 persons would be on the state's welfare rolls, costing taxpayers slightly more than $500 million. In New York City alone in January 1969, the annual cost of welfare topped $1.4 billion for about one million recipients. With 4 percent of the U.S. population, New York City accounts for 11 percent of the Nation's welfare recipients. And 50,000 persons are added to the city's welfare population each month.

Furthermore, the National Welfare Rights Organization has mounted a nation-wide campaign among the poor to "break the welfare

bank" and force adoption of some form of guaranteed annual income. The cost to the taxpayers of such a program is, of course, impossible to estimate accurately.

On the other hand, as we will demonstrate, the expanded use of Second Income Plan techniques would remove millions from the welfare rolls and place them on the tax rolls as productive participants in an expanding American economy. (See sections I., IV. A. and IV. B.)

III. THE SECOND INCOME PLAN TRUST: A HIGH-POWERED QUALIFIED DEFERRED-COMPENSATION TRUST FOR CONVERTING EMPLOYEES INTO OWNERS OF NEWLY FINANCED CAPITAL.

A. Description of Second Income Plan Financing and the Operation of Second Income Plan Trusts for Corporate Employees.

Second Income Plan credit mechanisms are, without qualification, the most innovative and efficient financing "tools" available for new capital formation. Existing owners, new owners, and lending sources now using these techniques find them mutually attractive and economically beneficial. Because their main function is to broaden capital ownership in major corporations, they represent a major weapon for restoring health to the economy.

Arnold Schuchter, author of the recent book WHITE POWER, BLACK FREEDOM (Beacon Press 1969) and a top economic and community development consultant with Arthur D. Little, Inc., probably the world's most prestigious and experienced management and technical consulting firm, has stated:

> "Together with a number of key professionals in economics and other disciplines at Arthur D. Little, I am persuaded that Second Income Plan financing techniques offer unique potentials for

economic development programs in existing and new communities benefiting both lower income whites and blacks, as well as participating corporations and financial institutions."

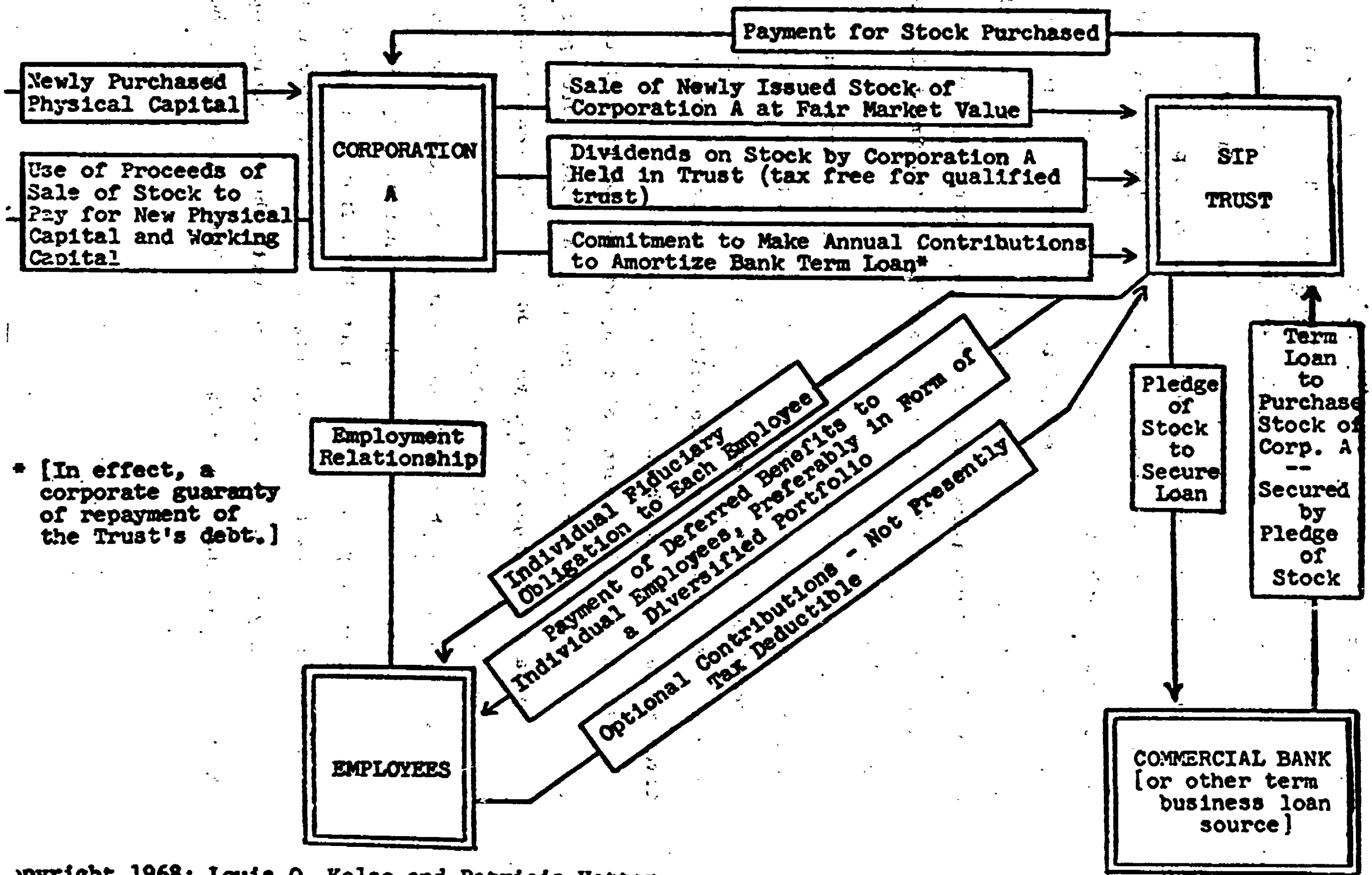
Mr. Schuchter is only one of many in the corporate world who are beginning to recognize the value of the Second Income Plan financing approach.

One of the main tools of the Second Income Plan is the Employee Second Income Trust, which is a U.S. Treasury-qualified adaptation of the standard deferred compensation trust (i.e., employee pension, profit-sharing and stock-bonus plans). The Employee SIP Trust (see diagram next page) is, however, vastly more advantageous for all parties concerned -- especially for corporate employees -- than any of the traditional pension, profit-sharing or stock bonus plans.

Second Income Plan techniques are explained more fully in the many writings of their architect, San Francisco finance and corporation lawyer and economist Louis O. Kelso. See especially THE NEW CAPITALISTS (Random House 1961), co-authored by the philosopher Mortimer Adler and TWO-FACTOR THEORY: THE ECONOMICS OF REALITY (Random House, Vintage paperback 1968) and "Uprooting World Poverty: A Job for Business," BUSINESS HORIZONS, Fall 1964, the latter writings co-authored by Patricia Hetter.

The most distinguishing technical feature of the SIP financing approach is that it permits new capital formation to be financed on credit repayable with future pre-tax earnings of the affected corporations. It thus surmounts a corporation's normal dependency on its past savings (i.e., retained earnings)

DIAGRAM I
SECOND INCOME PLAN FINANCING
[How to Promote Corporate Growth by Making Your Employees Capital Owners]



Copyright 1968: Louis O. Kelso and Patricia Hetter.

for expanding its capital assets. It is also the only technique now available to business for treating principal on a loan for newly added capital as a tax-deductible expense (interest is, of course, already tax-deductible). And, most significantly, this technique uniquely enables formerly propertyless persons to legitimately acquire an ownership stake and a "second income" from capital, without diminishing their savings or income from other sources. The net effect of this approach is to reduce government costs, slow down inflationary pressures, broaden the taxpayer base, and allow industry to expand more rapidly.

The main objects of Second Income Plan (SIP) Trust financing are as follows:

(1) To enable the employees of any well-managed and profitable corporation to acquire a part of the equity interest in the corporation (as much as 100% if desired) and to pay for the stock out of pre-tax corporate dollars, without diminishing their takehome pay or fringe benefits in any manner.

(2) To provide a means of repaying that portion of the financing required for acquiring new capital assets with pre-tax corporate earnings, rather than out of after-tax corporate net income as is normally required.

(3) To establish stockholder control of the company in the management of the company which would normally appoint the trustees of the employee Second Income Plan Trust, who in turn would vote the stock held by the Trust. This would provide long-term stability of management, together with the motivation on the part of management to manage well. (Voting power on stock

held by the Trust, if desired, can be passed on to non-management employee participants.)

(4) To make that part of the financing raised through the employee Trust attractive to the lendor by making it repayable out of pre-tax corporate dollars, enabling the company to use tax savings to finance any capital expansion program in a manner beneficial to all employees.

(5) To enable the employees to acquire their interest in the stock of the company at its initial offering price, and without any tax burden on the employees until they either retire or leave the employment of the company.

The steps in a typical financing plan might run somewhat as follows:

A. An employee Second Income Plan Trust ("SIP Trust") would be established by the company, and it would be qualified under the Internal Revenue Code as a stock-bonus trust. All employees of the company and of such subsidiaries as it may wish to include, subject to eligibility rules to be determined by management and incorporated in the Trust and Plan, would become participants in the Trust, the interest of each being proportionate to his relative income from time to time from the company.

B. The company, as the sponsor for the SIP Trust, would commit itself to contribute to the Trust each year up to 15% (the maximum deductible contribution for Federal corporate income tax purposes) of the overall payroll of employees -- generally all employees -- who participate in the SIP Trust. One of the distinguishing features of the stock-bonus trust is that the

sponsor corporation may commit itself to make the contribution each year, whether or not the corporation's earnings in that particular year are adequate to cover 15% of the covered payroll. Thus, the commitment becomes a general obligation of the corporation itself, payable in pre-tax corporate income dollars.

C. The employees of the company, as participants in the SIP Trust, could be required to sign a close-holding agreement among themselves, pursuant to which, under specified circumstances, after their retirement from active service with the company, they could be required to sell their stock to the SIP Trust. This provision might be of interest if it is desired on a long-range basis to keep the stock ownership in active employees of the company and to do this by buying the stock from retired corporate employees who desire to dispose of the stock, or from their estates, as determined in advance at the time of the drafting of the agreement. Such a close-holding agreement would normally contain a formula for the purchase of the stock that would give the retired employee or his estate the benefit of receiving the fair market value of the stock, as determined under a formula, at the time of the sale to the SIP Trust.

D. The loan by a lendor to the employee SIP Trust could, if desired, be secured by a first or second mortgage on the properties of the company. This would be done by using a mortgage to secure the company's guarantee to the lendor that it would make the contributions to the Trust necessary to enable the Trust to amortize its loan financing.

E. It should be kept in mind that employee Second Income

Trust financing could be combined with the sale of stock to the public if it were desired that the company bring about as broad participation of the public in the activities of the company as possible. (Present tax laws, however, do not allow members of the general public to pay for their stocks with pre-tax corporate dollars.)

F. The term of the loan to the employee Second Income Trust, and the terms of any other financing, would have to be tailored to the projected earnings of the company. In addition, in the case of the SIP Trust, the loan terms would have to be tailored to the ability of the company to handle its debt service out of 15% of the overall payroll of participating employees, in order to stay within the Treasury's limits on the amount of tax deduction that may be taken each year. If, for example, the payroll were $1,000,000 a year, the loan terms should be tailored so that the SIP Trust's note could be serviced (principal and interest) out of contributions of $150,000 per year.

The following are some of the characteristics of this arrangement:

1. The value of the stock of the company sold to the SIP Trust is fixed at the initial offering period to avoid any contest with the Treasury Department over such value in the future.

2. The SIP Trust should be designed so that as installments of its note are amortized, proportionate fractions of the stock would be allocated to the accounts of the employees in the Trust. These allocations are normally in proportion to the respective employees' incomes (through salaries, bonuses, etc.) from the

company. As stock is paid for and allocated to the accounts of the employees, any dividends declared on the stock should pass, with the minimum deferral period (presently three years) through the Trust into the employees' pockets. The object of this is to get a second income from dividends into the employees' pockets at the earliest possible time, while accumulating a capital estate for them in the tax-sheltered trust.

3. Employees are completely free from tax until they withdraw their accounts from the Trust at their normal retirement date, or upon leaving the employment of the company. Most SIP Trusts have a ten-year vesting schedule under which stock in an employee's account may not vest for the first two or three years, with 20% or 30% vesting at the end of the second or third year, and 10% vesting each year thereafter. The effect of this is to cause a forfeiture in the employee's account if he leaves the service of the corporation prior to the full expiration of the vesting period. Of course, instantaneous vesting is legally approved if desired.

4. Since the contributions of the company to the SIP Trust are deductible for state and Federal income tax purposes, the equity of the employees is built up on pre-tax corporate income. Another way of looking at this process, the purchase price for the shares acquired by the employees will be paid partly from <u>future</u> tax savings (roughly 56 percent at present state and Federal rates) and partly from remaining <u>future</u> corporate earnings derived from the productiveness of the <u>new</u> capital assets. The net effect is that as their incomes rise through both dividends and their wages or salaries, employees will in turn become more

significant taxpayers to the Government.

5. Employees should be motivated in due course to minimize wage and salary demands, since such restraint would maximize the income of the company available for contribution to the SIP Trust and for dividends.

6. Normally, the management committee for the SIP Trust is appointed either by the management or the board of directors of the sponsoring company. Thus, the stock acquired by the SIP Trust is under the fairly secure control of management for the indefinite future.

7. As the stock purchase price if paid off, the employee SIP Trust can be continued in operation to build equity capital estates in diversified securities for the benefit of company employees, again using pre-tax corporate income dollars.

8. Similarly, the SIP Trust can be used to purchase newly issued stock by the company, thus providing it with funds for working capital or corporate expansion financed out of pre-tax corporate dollars.

B. Some Examples of the Use of Second Income Plan Trusts and Related Financing Techniques to Broaden Capital Ownership*

1. Second Income Plan Trusts to Turn Employees into Owners of Mature, Well-Managed Corporations

a. The First California Company.

The First California Company, one of California's top brokerago and investment banking firms, traces its ancestry back to days when it was the investment banking

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* Extracted from a publication by Norman G. Kurland

arm of Bank of America. In 1964, its then owners, the Pepsi-Cola United Bottlers, Inc., suddenly sold the company to a samll, little known Los Angeles securities firm. The officers and employees, concerned about the future under new owners, wanted to buy the company for themselves.

Had they attempted to use conventional financing techniques, it would have been impossible to borrow enough funds from normal private lending sources. By using a Second Income Plan Employees' Trust (a variation of the standard deferred compensation trust) as a financing vehicle, the employees purchased and now own the business.

The plan involved the arranging of bank financing running directly to the SIP Employees' Trust in an amount sufficient--when added to the small amount of savings the employees had to invest--to pay the price in cash. The employees used that cash to purchase the company's stock outright. Using the tax leverage of deductible contributions by the company to the trust, the trust was able to pay off the bank loans within four years. The company's business performance, which had historically been sound, markedly improved when the officers and employees began working for themselves. Today, the firm has about 45 offices strategically located up and down the West Coast and in Nevada and Hawaii.

b. Peninsula Newspapers, Inc.

The Peninsula Newspapers, Inc. is an employee-owned organization comprising The Palo Alto Times, The Redwood City Tribune, and The Burlingame Advance Star and Green Sheet, all published on the San Francisco Peninsula. It is one of the largest and most profitable chains of California newspapers.

In 1954, its owners wanted to sell 72 percent of the company's stock, preferably to its employees. Using a SIP Employees' Trust, the employees obtained credit to purchase the stock and paid off the loans entirely through the company's tax-deductible contributions to the trust. Since the employees made no contributions under this arrangement, their take-home pay and personal savings were not diminished in any way.

The value of the SIP Trust was $4.7 million in 1966, over 18 times its size in 1956, when the plan was approved by the U. S. Treasury Department. In 1966, the membership of the SIP Trust stood at 446.

The Peninsula Newspapers, Inc. plan holds the further distinction of being the first SIP Trust to involve

employees who were members of trade unions. In fact, since six different unions were involved, all subject to separate collective bargaining agreements, the arrangement required multiple trusts, all identical in the nature of the benefits they provide.

With corporate profits accruing to the benefit of its employees, this highly successful newspaper chain has succeeded in preserving its integrity and freedom from outside pressures, while promoting high morale and a significant measure of economic security for its employees and their beneficiaries.

2. Second Income Plan Trusts to Turn Employees of a New Business into Owners**

a. The Albina Corporation.

The Albina Corporation describes itself as "the only Black-owned, Black run and managed manufacturing company in the United States." It was the first enterprise launched under the War on Poverty program which used a Second Income Plan Employees' Trust to demonstrate the importance of broad capital ownership for overcoming poverty, in this case, for residents of the Portland, Oregon black ghetto.

In 1967, Linus J. Niedermeyer, a successful Portland businessman, became impressed with the Watts Manufacturing Company of Los Angeles, a "ghetto subsidiary" of the Aerojet Corporation, and met with leaders of the black community to discuss the possibility of a similar subsidiary in the Portland ghetto. It was agreed by all parties that, to be more meaningful, the business should be owned and operated by residents of the community. A $195,000 manpower training grant was provided by the Department of Labor and a 27,000-square foot plant--a former bowling alley that went bankrupt--was acquired through a Small Business Administration loan. The Office of Economic Opportunity provided a $186,000 grant for consultant fees and for initial operating expenses and a $100,000 guarantee for a loan from a private bank to be financed through a SIP Employees' Trust. The corporation scouted the country for top black managers, found some, and by mid-September had hired 40 persons to produce metal, wood, and fiberglass products for larger industrial establishments and government agencies.

** The Employee SIP Trust will only begin to benefit a sizeable segment of our labor force and thus produce a significant national economic impact when it is adopted by more of our large, mature, and well-managed corporations, preferably, the 4,000 or so top U.S. corporations. This financing technique, should not be considered a panacea for risky new small businesses or struggling, poorly managed businesses, whose failure rates are today so high--mainly because of technical reasons--that their continued existence is a blessing to no one, their owners, workers and consumers alike.

The Albina Corporation has agreed to contribute annually into the trust for the benefit of each of its employees 15 percent of his total compensation. The trust is also responsible for providing all employees education in capital ownership.

It is obviously still too soon to judge the success of this enterprise. Its plans, however, call for the employment of 150 persons and a payroll of $3-3.5 million by the end of its first year of operation. The Albina Corporation's highly advantageous financing plan and its pioneering of the concept of broad capital ownership among the poor vastly increases its likelihood of success compared to other ventures calling for "economic development" in black communities.

b. Congaree Iron and Steel Company.

The Congaree Iron and Stell Company of Congaree, South Carolina, received a $1 million working capital grant from the Ford Foundation under the Foundation's new program to invest part of its portfolio in business ventures with "a high social yield." According to Boudinot P. Atterbury, an attorney, experienced investment specialist and coordinator of the new program, lawyers for the corporation modelled its financing plan directly from the techniques described in TWO-FACTOR THEORY: THE ECONOMICS OF REALITY.

As described in the Ford Foundation's press release of September 29, 1968 which announced the launching of its Program-Related Investments program, the Congaree Company, in receiving the foundation loan,

> "has agreed to establish for the benefit of its employees a trust fund to hold a siseable stake in the present ownership and future profits of the company.
>
> "Congaree was founded ten years ago. Beginning operations in an open cotton field with a handful of employees, it has grown rapidly to the point that it now has annual sales of about $7 million and 350 employees. The company manufactures steel joists (a speciality product manufactured to fill custom orders) for the construction industry. Congaree is located in a rural area of central South Carolina that is marked by serious poverty and unemployment. The company is the only significant employer in its immediate area. It hires unskilled workers and trains them in the various skills the company requires. The management of the company has always pursued an equal opportunity policy in

hiring and promoting its employees; twelve of the firm's Negro employees have supervisory positions.

"The Foundation's loan will provide Congaree a needed infusion of working capital. At the same time, Congaree will help establish for the benefit of its employees a trust fund to which it will transfer 10 per cent of its outstanding common stock immediately, and in favor of which it will contribute 15 per cent of annual profits before taxes in the future. The trust fund will invest its assets for the benefit of Congaree employees, and may elect to purchase additional common stock of Congaree or to invest the funds in other ways. W. Frank Threatt, who founded and developed the company, envisioned it not only as a private profit-making business but also as a community development venture, providing economic opportunity to displaced farmers and farm workers, mostly Negroes in the Congaree area, without the need to migrate to Northern urban centers. The Foundation sees the venture as an experiment in the development of means of increasing Negro participation in the profits and ownership of American business, especially in the ownership of companies in which they work."

3. Second Income Financing to Turn Consumers into Owners

a. Valley Nitrogen Producers, Inc.

Few envisioned the incredible growth and success of this young farmer-owned cooperative when it was organized in 1957 to manufacture and distribute fertilizer for its members and, on occasion, to national and international markets.

In 1959, Valley Nitrogen Producers opened its headquarters plant complex at Helm in the heart of California's San Joaquin Valley, some 40 miles southwest of Fresno. From that point on, the enterprise has continued to expand. In 1967, a $20 million complex was added at El Centro, in southern California's Imperial Valley. Today, the company employs about 500 people, has $55 million worth of plant facilities in operation, and produces more than half the agricultural chemicals sold in California.

But the dramatic story of Valley Nitrogen Products cannot be understood apart from the legal and financial structure which enabled it to come into being and survive in the face of vigorous opposition from five companies,

including Standard Oil of California, Shell Oil Company, Union Oil Company and others, who dominated the chemical fertilizer business in California for some 20 years previously. After VNP entered the field, the major producers dropped the price of the basic nitrogenous fertilizer--anhydrous ammonia--from the $200 per ton area in 1958 to $66 per ton (F.O.B. plant) and have held the price in the $66 to $74 per ton range ever since. Thus, Valley Nitrogen has saved somewhere around $160 million to California farmers, whether they are shareholders or not.

Valley Nitrogen was structured as a cooperative organized like a corporation which, each year, pays out all of its net earnings to its shareholders, in this case farmers who are also customers for its products. Since the corporation pays out its earnings (after debt service) each year to its shareholders, who are also its customers, it avoids the double taxation faced by most corporate enterprises. This structure allowed Valley Nitrogen to finance its present capital plant, pay off about $25 million in debt, enabled about 70 percent of its shareholders to pay for their stock out of dividends, and, with this year's patronage refund, raised the incomes of its shareholders by nearly $25 million in dividends.

4. Some Other Second Income Plan Projects Under Consideration

a. A "new City" on the West Coast and in one of the Southern states.

b. Financing of a fleet of new airbuses by one of the nation's largest airlines.

c. An international hotel-motel chain interested in building hotels in the black ghettoes.

d. A major national grocery chain for financing its new facilities.

e. The purchase of a privately owned local transit system by its employees and passengers, using a combination of the Employee SIP Trust and the Valley Nitrogen model.

f. A comprehensive industrial, commercial, and agricultural development program in one or more of the developing economies of Latin America, Africa, and Southeast Asia.

g. Comprehensive industrial and commercial development programs in Eastern Kentucky, Central Harlem, Washington, D.C., and Roxbury, Massachusetts.

C. <u>Comparison of Financial Effect on Stockholder Equity of Employee Second Income Plan Trust Financing of Corporate Growth with Straight Loan Financing.</u>

No attempt will be made here either to repeat or to enlarge upon the case made in TWO-FACTOR THEORY: THE ECONOMICS OF REALITY (Louis O. Kelso and Patricia Hetter, Vintage Books [paperback] 1968) for the advantages of employee Second Income Plan Trust financing in terms of employee motivation, sound corporate strategy, economic theory, national economic policy, or international economic development. Rather, it is proposed here to consider only the financial effect on the equity of existing stockholders of using employee Second Income Plan Trust financing rather than direct corporate loans or internally generated income to finance corporate growth. One of the most common mistakes made in initially appraising Second Income Plan financing is to assume that it resembles in theory the conventional deferred compensation trust, and that its potency as a means of accelerating corporate growth (as well as broadening corporate equity ownership and motivating employees) can be measured by the customary tests applied by analysts to other financing techniques. Neither of these conclusions is sound, for reasons pointed out herein.

Since the usual types of qualified employee deferred compensation trusts involve contributions made for the benefit of employees <u>after all competitive wage and fringe benefits of other employers have been matched</u>, the theory is

that such additional contributions will induce employees to make productive efforts over and above the usual call of duty. This simply is not so, for several reasons. The first is that the employee is hired and paid the competitive wage to render his highest and best efforts. If he fails to do so, or if he intends to withhold such best efforts, he is improperly employed in the first place. Secondly, all but managerial employees under Federal Wage and Hour Laws are required to be paid time and a half (and under some union contracts, even double or triple time) for time spent in addition to the normal work week. Finally, the Internal Revenue Code is designed to prevent a qualified deferred compensation trust being used in such way as to specially reward those employees who render unusually diligent service, and any attempt to so structure a plan as to achieve that result would cause disqualification of the plan. Consequently, the traditional deferred compensation trust is simply another of the many redistributive devices of one-factor economics calculated to transfer a portion of the wealth produced by capital to the non-owners of capital, that is, the employees. In actual fact, benefits under the usual deferred compensation plan are, as the name implies, merely additional compensation in a slightly different form, paid in ways which do instill stability of employment because of the provision for forfeiture in the event the employee leaves his job before his benefits are fully vested. Employee Second Income Plan

(SIP) financing is different both in concept, and in its financial implications.

So far as the concept is concerned, SIP financing is a method by which the employee is enabled to buy equity stock and pay for it out of the wealth produced by capital as the wealthy man is generally able to do. Second Income Plan financing benefits the corporation, as described later in this section , as well as the employees. SIP financing has all of the virtues claimed for conventional deferred compensation trust arrangements (pension plans, profit-sharing plans, and stock bonus trusts) as well as the unique advantages of both financially benefiting the corporation without economic dilution of the equity of existing stockholders, and the possibility of enormously accelerating the acquisition of equity ownership by employees. SIP financing has the further ultimate advantage that, by enabling employees legitimately to buy and pay for capital ownership without impairing their wages, salaries, or fringe benefits, they can eventually receive increased incomes without increased wages, which in turn means increased profitability for their company and the possibility of being able, because of lower labor costs, to undersell competitors.

The main purpose of this section, however, is to consider the implications of the SIP financing procedure which, while resulting in the issuance of stock to the

33-865 O - 69 - pt. 2--34

employee trust, expenses capital investment, and so lowers tax-reported or apparent income. This is compared to ordinary direct debt financing of corporate growth, which, in effect, capitalizes the investment (purchases it in after-tax dollars) and requires the corporation to pay corporate income taxes that would not be paid under SIP financing arrangements. Straight debt financing thus takes working funds out of the corporation that would otherwise be retained and presumably used productively for the proportional benefit of all stockholders. In other fact situations where management is presented with a comparable choice, it usually prefers the expense route over the non-expense route because in such instances the apparent reduction in earnings is in fact an increase in tax savings and an increase in equity dollars retained and at work in the corporation. An example of such optional alternative is accelerated depreciation authorized by the tax laws.

It is easy to see how this misinterpretation can come about. The standard rule of thumb for estimating the value of corporate equity is the price-earnings ratio of the stock (PE Ratio). The simple fact is that where financing is achieved in pre-tax dollars, a ratio that compares market price of an equity with its after-tax earnings does not measure the vital advantage of converting tax dollars into productive investment. This is why analysts frequently explain -- and so justify a higher

market price for -- a particular stock which "would have had" a higher PE Ratio if it were not for depletion, investment credit, accelerated depreciation, or the like.

When a corporation uses Employee Second Income Plan financing, it both pays off the debt (in pre-tax dollars) and issues equity on which it must expect to maintain the same dividend payments in the future as on its other outstanding stock. Normally, however, such added dividend cost is offset within a year or two after the financing is completed as the result of corporate income earned on working capital retained in the form of equity that would otherwise be paid in corporate income taxes. Consider the following example:

Comparison of Financial Effect of Employee Second Income Plan Financing of Corporate Growth With Straight Loan Financing Under Specified Factual Assumptions

Assume:

(1) - $1,000,000 financing.

(2) - Effective combined Federal, Federal Surtax, and state corporate income tax bracket of 56%.

(3) - Loan interest rate to corporation of 6%.

(4) - Maximum dividend by corporation on its stock outstanding of 3% of current market price (the price at which the corporation sells its stock to its Employee Second Income Plan Trust).

(5) - A five-year amortization plan under which the corporation pays $200,000 per year on principal through contributions to its SIP Trust and pays interest annually by similar contributions on the outstanding balance.

(6) - That the market price of the stock and the dividend rate remain stable throughout the financing period.

(7) - That the corporation earns at least 20% annually, before corporate income taxes, on invested equity capital, this being less than the average of the 4,000 or so corporations reviewed each year in its study of corporate profits by the First National City Bank in its April monthly economic letter.

(8) - That the corporate dividend on $1,000,000 of stock of $30,000 (see Assumption (4)) will be used by the SIP Trust to pay part of its debt and that the corporation will accordingly adjust its annual contributions by contributing $30,000 per year less to the SIP Trust so long as the dividends are paid.

The diagram on page 24, taken from TWO-FACTOR THEORY: THE ECONOMICS OF REALITY, p. 87, illustrates the structure of Employee Second Income Plan Trust financing for ready comparison with simple or straight debt financing which involves merely a loan and some form of repayment instrument such as a note or debenture or the lease equivalent thereof.

The two alternative methods of financing corporate growth may then be compared as follows: *

Debt Financing

Step	Description	Amount
Step A-1:	Cost of new capital formation in after-tax dollars	$1,000,000
Step A-2:	Cost of new capital formation in pre-tax dollars	2,272,272
Step A-3:	Amount of pre-tax dollars lost in taxes	1,272,272
Step A-4:	Annual loss that would not have been incurred in after-tax net income each year after debt financing wholly paid off if pre-tax dollars had been retained and used as equity investment. (On the basis of Assumption (7), this would be 20% of the after-tax saving [44% of $1,272,272], or $112,000 annually.)	112,000

Employee Second Income Trust Financing

Step	Description	Amount
Step B-1:	Cost of new capital formation in after-tax dollars	$1,000,000
Step B-2:	Cost of new capital formation in pre-tax dollars	1,000,000
Step B-3:	Amount of pre-tax dollars lost in taxes	-0-
Step B-4:	Annual dividend on stock sold to the Employee SIP Trust (see Assumptions (4) and (5)) $30,000	

* NOTE: The interest cost is not included in the comparison, since presumably the lendor will charge the same rate of interest on a loan whether it is made to the corporation, or with the corporation's guaranty, to the Employee Second Income Plan Trust. This, however, may not be realistic when banks and other lendors become fully acquainted with this new type of financing, since a significantly lower rate of interest should logically apply to a loan repayable in pre-tax dollars. Perhaps at least a 2% differential would be reasonable.

Step B-5:	Annual reduction in debt service as result of dividend available to SIP Trust for use in paying its debt, thus resulting in reduced contribution by the corporation to its SIP Trust so long as debt is outstanding	30,000	
Step B-6:	Net cost of corporate dividend until debt of SIP Trust is repaid		-0-
Step B-7:	Annual after-tax income advantage from SIP Financing each year after debt fully retired (see Step A-4)		112,000
Step B-8:	Average annual after-tax income advantage from SIP financing during debt service period (one-half previous figure)		$ 56,000
Step B-9:	Aggregate pre-tax income earned during debt service period as result of use of Employee SIP financing rather than straight debt financing (5 x $56,000)		280,000
Step B-10:	Tax saving, during the five-year financing period, after payment of corporate income taxes thereon, resulting from use of Employee SIP financing rather than straight debt financing (see Step A-3)		559,798
Step B-11:	Total after-tax advantage during the five-year financing period to equity holders resulting from use of SIP financing (result of Step B-9 added to result of Step B-10)		839,798

Thus, the equity dilution at completion of the five-year financing period would be $160,000 ($1,000,000-$839,798, rounded) which would be erased within two years thereafter since the annual after-tax income advantage of the SIP financing is $112,000, reduced only by the annual dividend of $30,000. This results in an added annual net increment to equity of $82,000 indefinitely. This, in addition to all the intangible (but nevertheless vital) corporate and

social advantages of making equity partners of employees, laying the foundation for lower-than-market wage and salary scales in the future, strengthening management's stock control, etc. favors Employee Second Income Plan financing over financing out of internally generated funds. Furthermore, it should not be forgotten that both the $559,798 saved in the above example from corporate taxes and added to the corporate equity and the corporate earnings on that saving of $279,899 after-tax accumulated during the financing period will continue to work for all stockholders as invested equity indefinitely after the SIP Trust debt has been fully amortized.

It would seem that the only instance in which the actual cost of corporate capital is less than through Second Income Plan Trust financing is straight sale of equity to the public in a market regarded as favorable to stockholders, a method so little used that it currently accounts for only about one-half of one percent of new capital formation. However, such sale by this once common method, i.e. to wealthy individuals who can afford to buy securities, constitutes, like most conventional financing, an assault on the double-entry bookkeeping logic of the economy because it does not facilitate getting capital ownership, and thus Second Incomes into the hands of consumers with unsatisfied needs and wants, thus raising their power to buy the goods and services produced with the expanded corporate capacity.

Finally, several comments on financial and economic policy may be appropriate here. Sound banking, it would seem, would require a lower interest rate on Second Income Plan financing loans, repayable in pre-tax dollars, than on conventional loans repayable in after-tax dollars. It could be argued that under present tax laws, the reduction should be at least 50%, but it would probably be more realistic to anticipate a reduction of one-third, or say two points in the example used above. Such a reduction would further shorten the period required to eliminate the temporary equity reduction. Similarly, the brief period of equity dilution of existing shareholders would be further shortened or eliminated entirely if the corporation, like a large proportion of the largest firms, earns more than 20% on invested equity. In the example used above, for each 5% increase over 20% in the annual return on invested equity, the corporation would add $28,000 annually to invested equity as the result of using Employee Second Income Plan Trust financing rather than straight debt financing so long as the greater rate of return on invested equity continued.

The importance of reforming our national economy along lines indicated by two-factor theory, and adopting, at long last, a policy of systematically expanding the productive plant of the economy and creating millions of new holders of viable capital estates would seem to more than justify increased tax deductions to corporations

that finance their expansion through Employee Second Income Plan loans. For example, a modification of the internal revenue code to authorize a deduction of 150% of contributions by corporations to deferred compensation trusts to repay such Second Income Plan financing would both accelerate corporate growth and the acquisition of viable capital estates by corporate employees. It would both contribute to reduction of potential future governmental welfare expense and to the building of the personal tax base for tomorrow's economy. It would also convert a small temporary economic dilution of the equity of existing shareholders into an immediate equity enrichment.

IV. THE SECOND INCOME PLAN: A COMPREHENSIVE STRATEGY FOR BROADENING OUR TAXPAYER BASE BY ENABLING ALL FAMILIES TO OWN CAPITAL.

A. A Graphic Presentation of the Second Income Plan.

The Second Income Plan is a comprehensive strategy, a set of practical measures and a complete legislative design (see Appendix of Two-Factor Theory: The Economics of Reality) for achieving widespread capital ownership.

Underlying the Second Income Plan are the analytical tools of Two-Factor economic theory and Mr. Kelso's advanced "pure credit" techniques of finance for emancipating economic growth from the limitations of conventional financing techniques (based exclusively on past savings.) (See The New Capitalists, co-authored with Mortimer Adler, Random House, 1961.) Henry Moulton of the Brookings Institution was the first to recognize that new capital formation does not have to be financed exclusively from past savings. (The Formation of Capital, Brookings Institution, 1935, p. 107.) Mr. Kelso extended these ideas by developing credit mechanisms which would create new capital owners simultaneous with new capital formation. He also adapted from the loan guarantee and monetary machinery developed for Federal housing programs (for expanding the supply and ownership base of private housing, a consumer item, for veterans and others without savings.)

Those interested in a thorough understanding of these ideas and techniques should read Mr. Kelso's three books and other materials listed in the Bibliography on Two-Factor Economics which is attached.

The following is a simplified graphic sketch of the Second Income Plan extracted from a 1966 publication by Louis O. Kelso Walter A. Lawrence:

THE SECOND INCOME PLAN

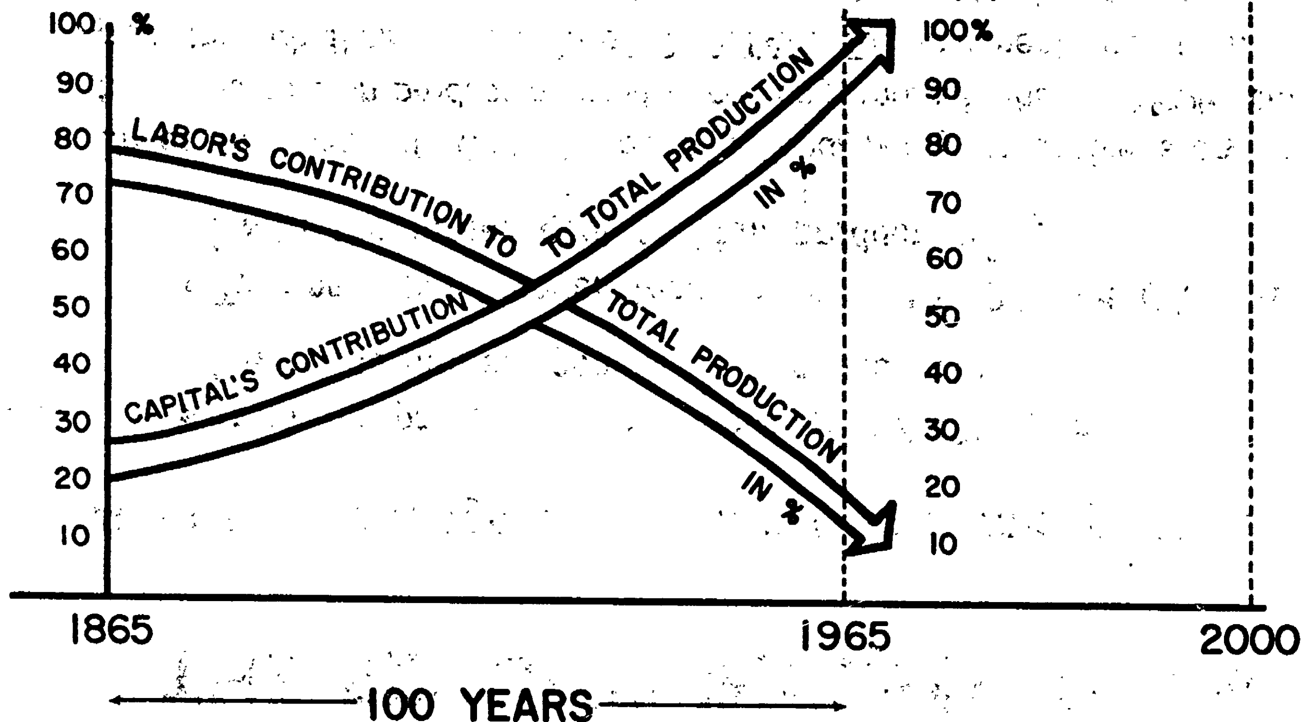
A plan to change our national economic policy .....

- From its present narrow focus on LABOR alone
  (with the limited goal of "full employment")
- To a new and broader focus on both LABOR and CAPITAL
  (with the larger goal of "full production")

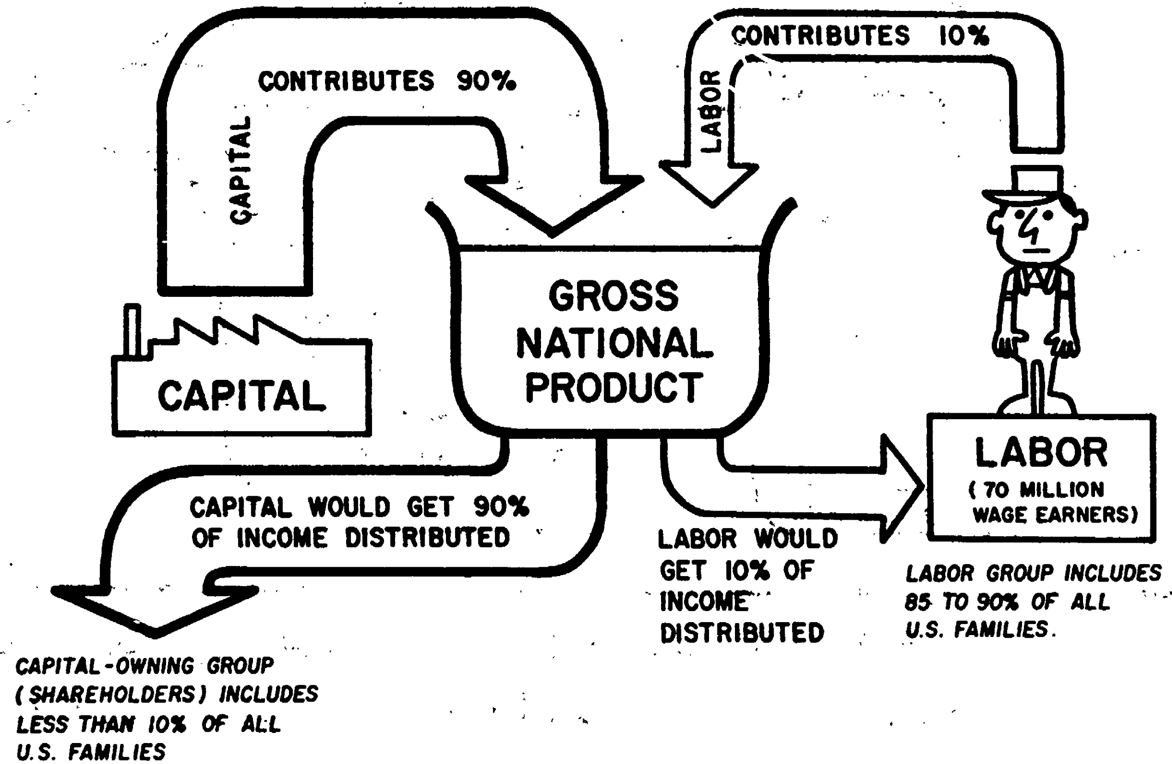
Under this plan, it would be basic national policy to enable every family to participate in producing wealth, not only through their LABOR but also through their ownership of CAPITAL. To implement this, both government and business would seek ways to extend the ownership of capital to all families, so that ultimately they could have two incomes:

- A FIRST INCOME from wages paid for LABOR
- A SECOND INCOME from dividends paid on CAPITAL (stocks).

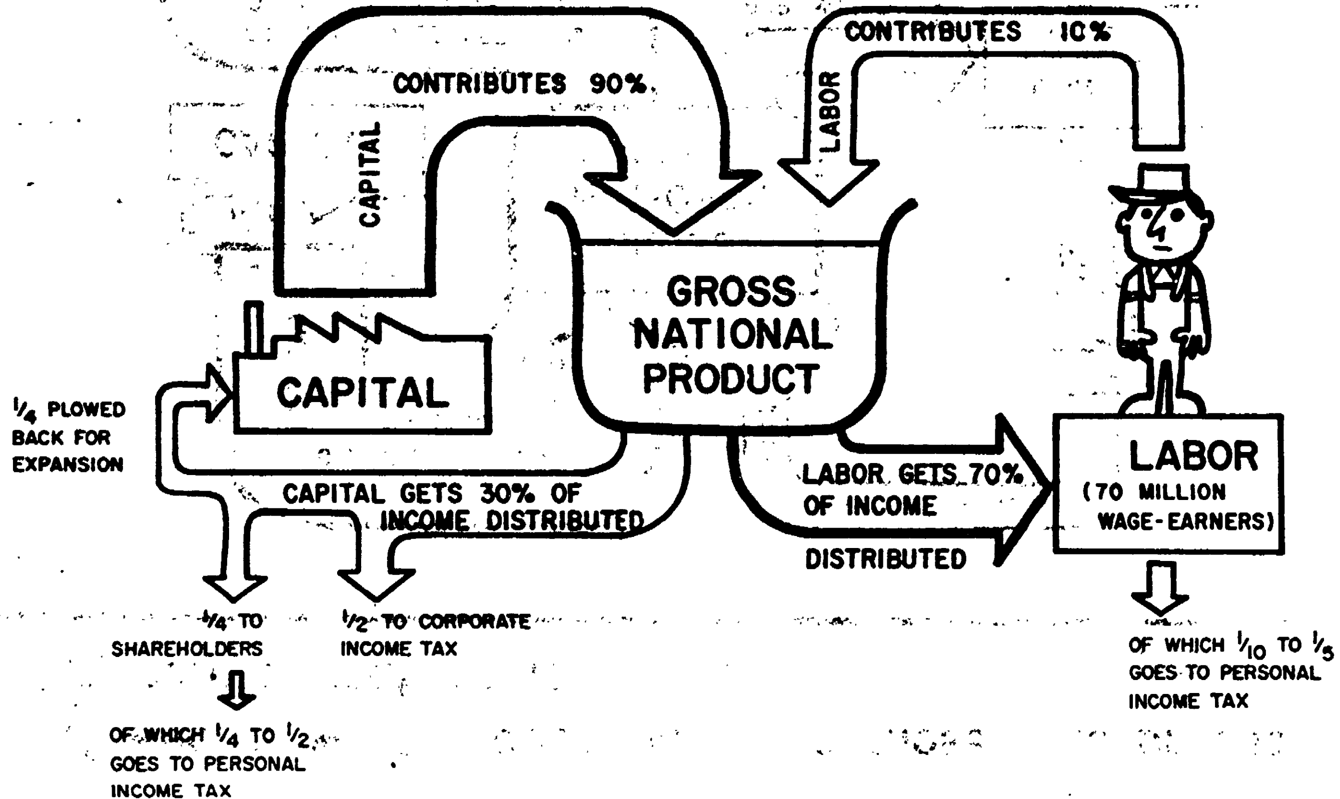
In the past century, capital has gradually taken over from labor :



If wealth went proportionally to those who produce it, here's what would happen:



Wealth doesn't go proportionally to those who produce it. Here's what really happens:



ONE-FACTOR ECONOMIC CONCEPTS
and
TWO-FACTOR ECONOMIC CONCEPTS:

The income maintenance hangup is, and has always been, the attempt to make one-factor economic concepts work in a two-factor real world. Let me now -- in half a minute -- explain two-factor theory:

It is the idea that each of the two factors produces wealth in exactly the same sense:

This idea is contrary to explicit socialist dogma.

It is also contrary to U.S. economic policy: the Employment Act of 1946 and the Economic Opportunity Act of 1964.

Both political parties espouse one-factor economic policy.

The various studies on economic goals that have been made in the U.S. since the T.N.E.C. studies of 1938-42 uniformly conclude that our proper economic goal is full employment, so they are contrary to two-factor theory.

Two-factor theory is contrary to Keynesian doctrine.

While physical capital does not pass unnoticed in the western economies, we assert that its function is to enhance the "productivity of labor."

This, of course, is contrary to reality and to two-factor theory.

If two-factor theory is sound, and if double-entry bookkeeping is the logic of a market economy, then the only way to eliminate

poverty, and to bring about a condition of general affluence, is to make it possible for every family and every individual to <u>produce</u> general affluence.

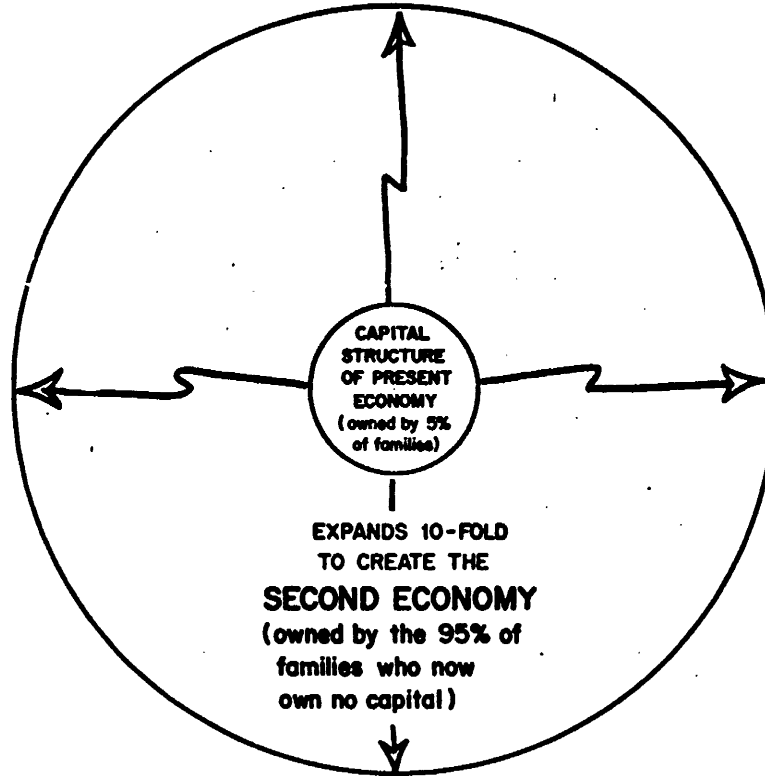
> To make a greater <u>productive</u> <u>input</u> into the economy.
>
> But if most productive input is by capital, the non-human factor, this means virtually every individual and family must be enabled to become the private owners of productive capital.
>
> To buy, pay for, and own viable holdings of productive capital.

The tools of the Second Income Plan -- financing techniques and modifications of tax laws and corporate practices -- are designed to build productive power into households and individuals now insufficiently productive so that they may be enabled to produce an affluent share of income. This method has yet to be employed as national policy in any economy. It is a method designed to protect existing private property, highly concentrated though it may be, and to build a Second Economy owned in reasonable-sized holdings by the great majority of households who own no productive capital in the existing economy. <u>This is the corrective method of the Second Income Plan</u>.

> The object of the program which we are urging industry and business to undertake can best be illustrated like this:
>
> Let the small circle below represent the capital structure of the present economy of the United States, and let the larger circle surrounding it represent a second economy, to be built over an estimated 25-year period through expansion several times over of the present economy:

33-885 O - 69 - pt. 2--35

Objective of the Second Income Plan



The principal tool of the Second Income Plan is one that can be used by business corporations under present state and Federal laws. It consists of a radically new and different use of the familiar qualified deferred compensation stock bonus plan in such way that it can both finance corporate growth and build equity ownership into employees without diminishing their takehome pay. It is beneficial to the corporation, its existing shareholders, the employees, and the economy. Its use is outlined below.

In THE NEW CAPITALISTS (Kelso and Adler, Random House, 1961) and in TWO-FACTOR THEORY: THE ECONOMICS OF REALITY (Kelso and Hetter, Random House and Vintage Press, 1968), we have shown that with modest legislative changes, equity ownership that can be built into corporate employees now under existing law could be built into non-corporate employees such as civil servants, teachers, judges, legislators, professionals, artists, invalids, widows with children, the aged, etc.

Income Maintenance

AND THE BUSINESS CORPORATION STRATEGY:

Roughly 80% of the goods and services produced in the non-agricultural, non-governmental sector are produced by corporations.

> This automatically means, under double-entry bookkeeping, that 80% of the purchasing power generated by the private economy (outside agriculture) arises in corporations.

Present strategy employed by business corporations consists of maximizing production and sales, minimizing costs, and being a law-abiding corporate citizen.

> Thus, while 80% -- approximately -- of the income (outside agriculture) generated by the private economy arises in corporations, there is no recognition that one concern of sound corporate strategy should be to make certain that income is channeled to people with unsatisfied economic needs and wants, and not to those whose needs and wants, however lavish, are already provided for.

> The chief productive factor in the modern corporation is the non-human factor of production: capital.

> > All modern techniques of corporate finance are designed to assure that the ownership of virtually all newly formed capital flows into the hands of the top 5% of wealth-holders who today own all the corporate capital.

What closes the purchasing power gap created by defective corporate strategy?

Answer: Government and consumer credit.

Government welfare distributions.

Redistribution of income from capital owners to non-capital-owners and from highly paid workers to the unemployed by graduated income taxes, personal and corporate; graduated estate taxes and graduated gift taxes; social security taxes, unemployment compensation taxes, property taxes, etc.

Government employment, particularly in public works, military overkill production, space waste, etc.

Governmental enfranchising of labor unions to use coercion in the marketplace to effect redistribution, by demanding progressively higher pay in return for progressively diminished quantity and quality of labor.

Governmental subsidies of agriculture, shipbuilding, military stockpiling, export of foreign aid, etc.

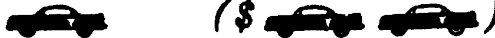
etc. *etc.*

Consumer credit closes the purchasing power gap today and makes it radically larger tomorrow.

A consumer may buy a home with a modest downpayment today

and pay for three homes over the rest of his lifetime.

The purchasing power gap is similarly, although less drastically widened by all other forms of consumer credit.



A CORPORATE STRATEGY FOR INCOME MAINTENANCE BASED ON The Second Income Plan:

What can *BUSINESS* do to solve the income maintenance problem?

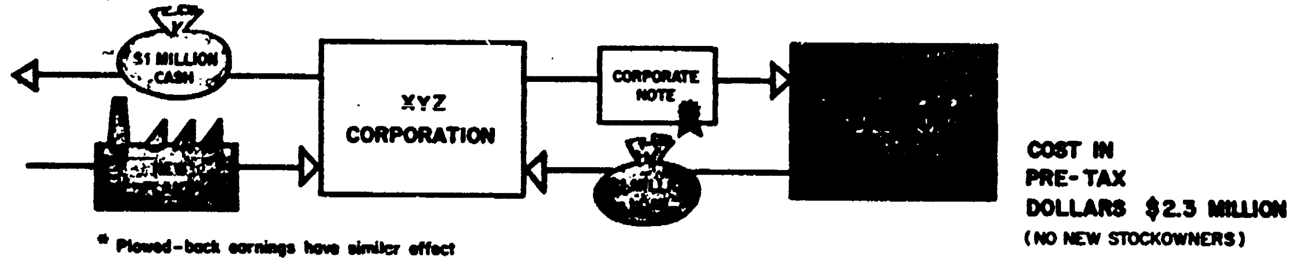
The answer is to employ as widely as possible

Employee Second Income Trusts.

The following illustrates how these operate:

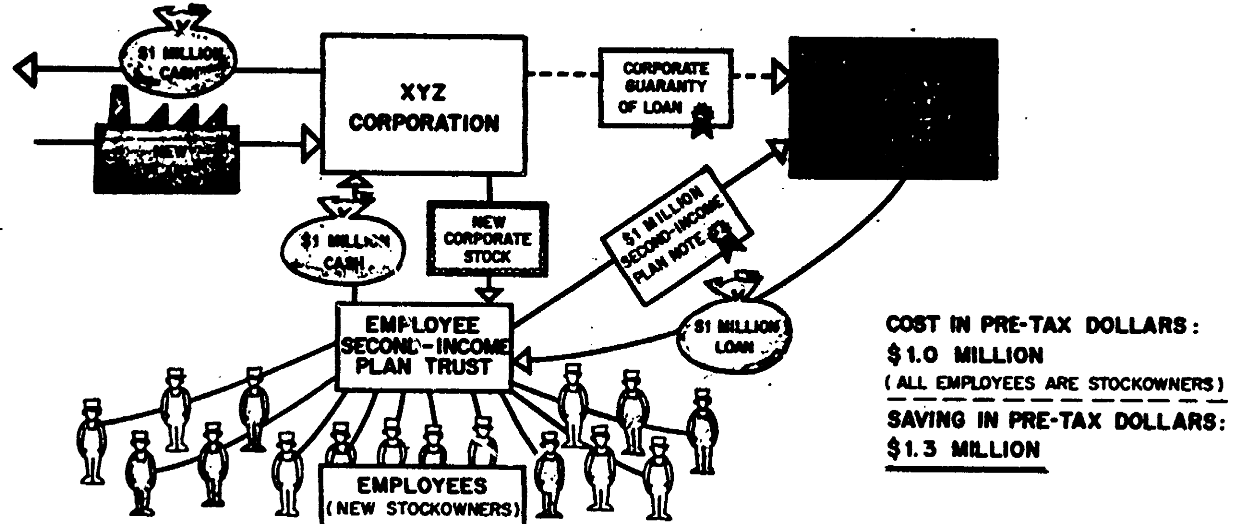
2 ways to finance corporate productive capital (new plant)

1. CONVENTIONAL DEBT FINANCING:*



* Plowed-back earnings have similar effect

2. EMPLOYEE SECOND-INCOME-PLAN FINANCING:



The main highlights of the operation of these trusts is as follows:

An employee deferred compensation trust is established, or if one is already in existence, it can be remodeled to suit Second Income Trust financing purposes.

Loan financing from conventional loan sources -- insurance companies, banks, etc. -- is arranged so that loans are made directly to the deferred compensation trust.

The trust takes the loan proceeds and invests it in the sponsoring corporation's stock.

The corporation sells and issues its stock, at the full current market value, to the trust.

The trust gives its note to the lendor and may pledge the stock to secure it.

The sponsoring corporation guarantees that it will pay off the note to the lendor in annual installments through the trust, rather than directly to the lendor as it would if the corporation itself were the borrower.

The Internal Revenue Service, within the limits prescribed by the Code, will treat the corporation's loan repayments as "contributions" to the employee trust, because under this arrangement, the employees, including corporate management, become the owners of the stock as the debt is repaid, without any reduction in their takehome pay or fringe benefits.

WHAT CAN GOVERNMENT DO TO SOLVE THE INCOME MAINTENANCE PROBLEM THROUGH The Second Income Plan?

The Second Income Plan can be accomplished in 2 steps:

Step 1: An Act of Congress to:

- Repeal the "Employment Act of 1946"
  (with its narrow focus on LABOR alone.)
- Enact the "Full Production Act of 196_"
  (with its broader focus on both LABOR and CAPITAL)

This would establish the national policy.

Step 2: A series of "Ways and Means" by both government and business to encourage the widespread ownership of CAPITAL. This would implement the national policy.

A partial list of proposed "Ways and Means" to implement the Second Income Plan.

- Change death taxes to induce the wealthy to spread out their wealth.
- Encourage corporations to set up more employee stock-ownership trusts.
- Devise ways for closely-held family corporations to sell out to employees.
- Finance urban-renewal projects so that the displaced families can own shares in the new buildings.
- Finance government water-and-power projects (like TVA) so that the families who live there can become owners.
- Finance anti-trust divestiture of corporate assets so that thousands of families can become owners.
- Finance sale of government-owned corporations (like General Analine) so that thousands of families can become owners.
- Finance industrial development in impoverished areas (like Appalachia) so that the families who live there can become owners.
- Set up the "financed capitalist" program whereby families can borrow on insured loans (like FHA) to buy stock which pays for itself out of dividends.

The Second Income Plan is broad enough to bring together both Conservatives and Liberals in common cause.

- It is <u>CONSERVATIVE</u> in that it preserves and extends private property, halts socialism, cuts taxes, and reduces the role of big government.

- It is <u>Liberal</u> in that it really does more for the common people than all the welfare legislation passed by government in the last 30 years.

Like the original Homestead Act which helped families own productive capital in the form of **LAND**,

this plan helps families own productive capital in the form of **INDUSTRIAL STOCK** .

Like FHA loan insurance which helped families own their own HOMES,

this plan uses similar loan insurance to help families own their own portfolio of STOCK, which pays for itself, with its own dividends - then pays them a Second Income, forever.

How the head of a low-income family acquires stock:

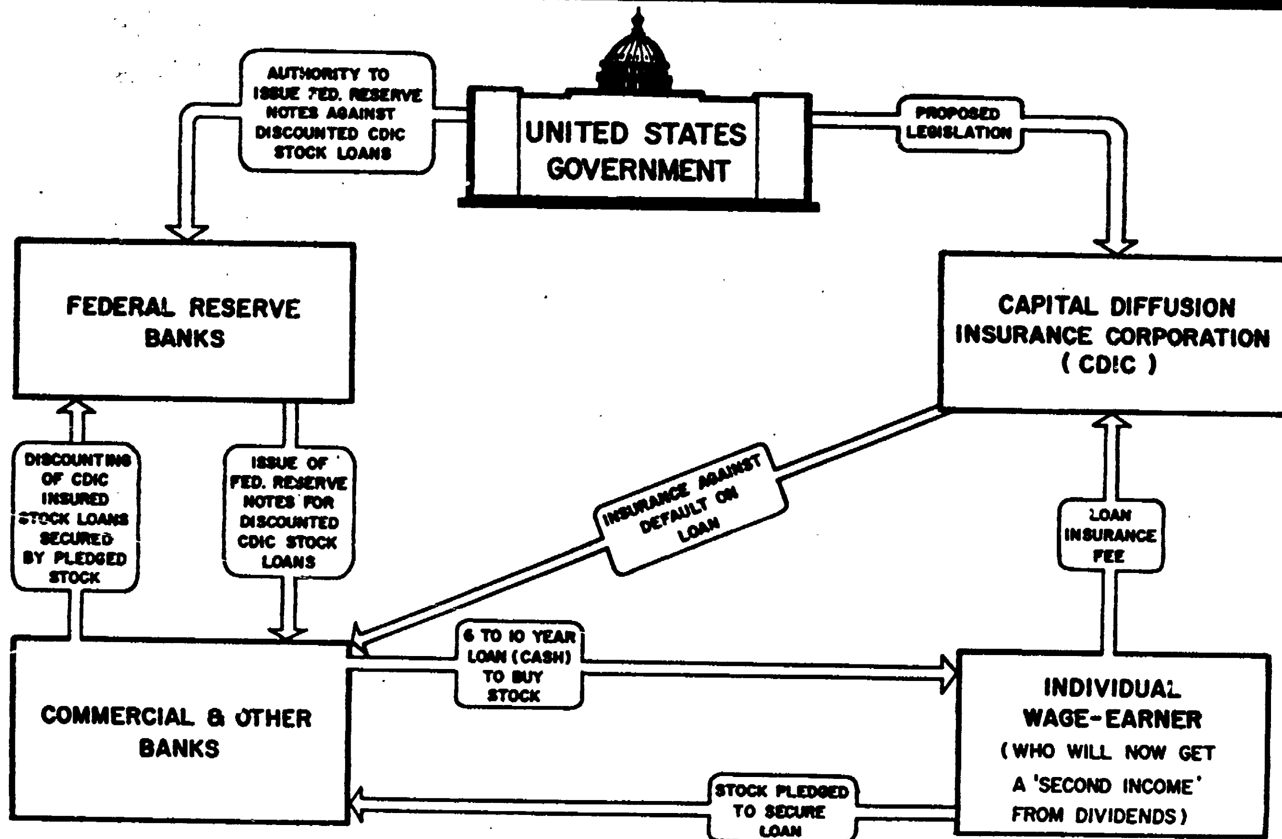
- Source of stock is newly created capital by U.S. corporations. (current expansion rate, about $60 billion/yr., enough to allocate $4000 worth/yr. to each of 15 million low-income families).

- Head of low-income family goes to bank, borrows $4000 each year for 5 years (government-insured loans, no risk to bank or to borrower). Makes small down-payment ($200). Buys stock (diversified portfolio), $4000/yr. for 5 yrs. = $20,000 worth.

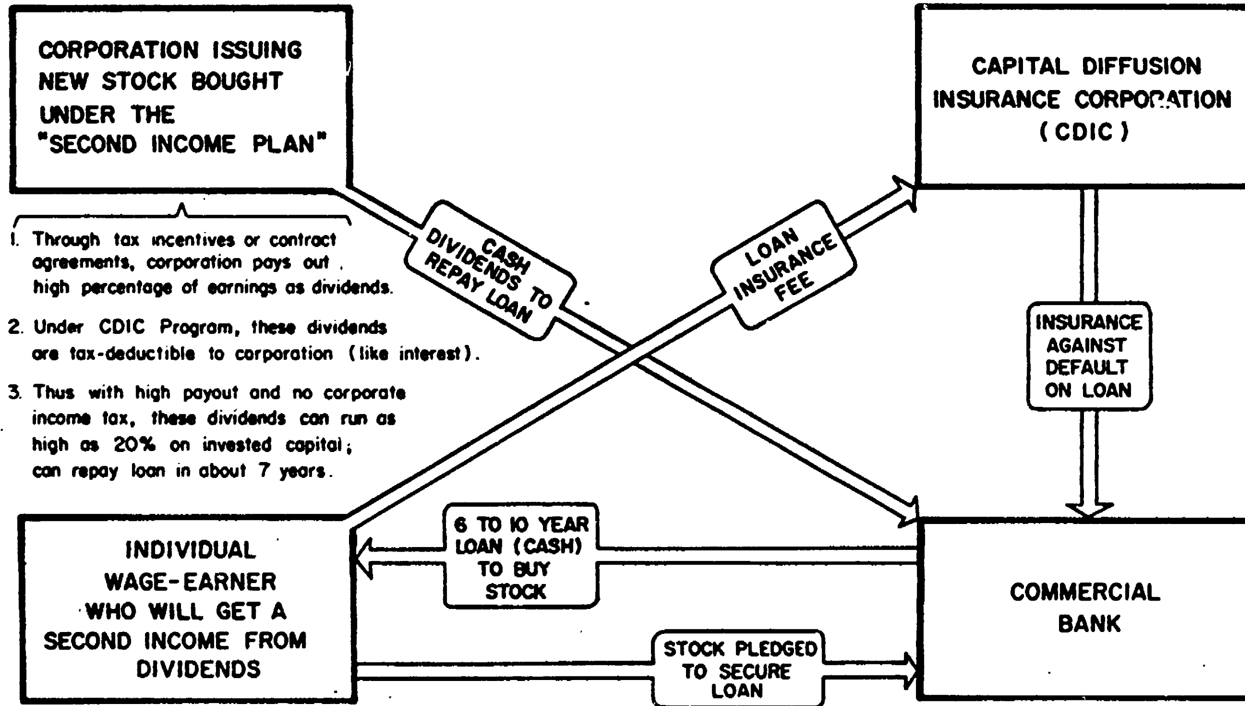
- Stock dividends (at 20%/yr. with no corporate income tax) pay off loans in 6 to 7 years from start date.

- Family then owns $20,000 worth of stock. Dividends provide Second Income of about $80/week or $4000/year.

How the Second Income Plan finances the purchase of stock by individual families.



How stocks pay for themselves under the Second Income Plan.



How a change in death taxes could create more capitalists at upper income level:

- Total U.S. wealth is at least $1000 billion. Most of it is owned by rich people who pass it along to heirs about once every generation (say 25 years). Thus about $40 billion changes hands each year.

- If through a change in death taxes, this could be distributed tax-free to less wealthy relatives and friends, in chunks up to $50,000 each, it would create about 800,000 to 1,000,000 new capitalists a year (or 20 to 25 million in 25 years).

- Present confiscatory death tax does not create revenue for government. All it does is drive the big estates into tax-exempt foundations, wherein the wealth is frozen forever.

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What's in it for INDUSTRY ?

- A stable economy (no more boom-bust cycles).
- Increased markets because of increased consumer purchasing power.
- An opportunity for accelerating economic growth to supply increasing markets.
- Unlimited funds for expansion (through tax-exempt employee stock trusts or CDIC-insured loans).
- Less labor trouble (as employees become shareholders in industry and look to dividends as an important alternate source of income).
- An opportunity to automate without resistance from labor.
- An opportunity to compete again in foreign markets. (As wages remain stable and as automation cuts costs, U.S. products can undersell their competition all over the world).
- Less government interference.
- Ultimately, the repeal of all corporate income taxes.

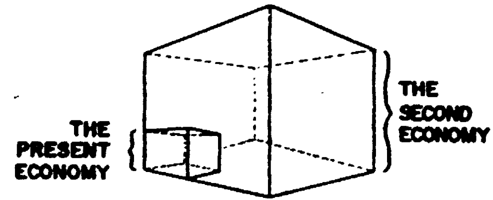
What's in it for LABOR ?

- A stable economy (no more boom-bust cycles).
- Full employment (at least for this generation, or until automation can catch up with an economy that will be expanding at several times its present rate).
- No more demoralizing featherbedding, make-work, spread-work, etc.
- A better approach to collective bargaining. (Ask for stock trusts instead of wage increases).
- An answer to automation. (Let industry automate, the faster the better. But let the displaced workers acquire enough stock to have an alternate income from dividends).
- Lower personal income taxes.
- In addition to wages, a <u>second income</u> from dividends (from stock acquired through employee stock trusts, through CDIC loans, or both). Thus, provision for future unemployment or ultimate retirement.
- A capital estate to pass on to one's heirs.

What's in it for the ELDERLY ?

- An end to the creeping inflation that has been eroding their retirement dollars (pensions, annuities, savings etc.)
- An opportunity to retire with dignity on a private, adequate, dependable income which (unlike Social Security), continues whether one works full-time, part-time, or not at all.
- An end to the humiliation of being dependent on children or on welfare.
- A capital estate to pass on to one's heirs, thus assuring the elderly that their children will continue to give them some consideration, right down to the reading of the last will and testament.

What's in it for YOUTH ?



- A challenge to build the SECOND ECONOMY - one that will do for the non-capital-owning 90% what the present economy does for the capital-owning 10%.

- This will require a doubling and re-doubling of our present industrial capacity, with economic growth rates of several times our present 3% per year.

- This in turn will create severe labor shortages. We will need all the talents of all our young people for at least a generation or more.

- It can be the most demanding and rewarding era thus far in America's history.

What's in it for the IMPOVERISHED ?

- A second income from dividends that's adequate to live on, one that's several times bigger than Social Security or Unemployment Insurance or local relief handouts.

- A private income based on the productivity of capital, free from the stigma of welfare or charity.

- A dependable income that continues whether one is able to find and keep a job or not.

- A capital estate to pass on to one's heirs (perhaps the only thing of value the family was ever able to own).

What's in it for those who are already CAPITALISTS ?

- A stable economy (no more boom-bust cycles).
- A government policy dedicated to protecting private property (instead of socializing it).
- No more hoarding of earnings by corporations. (After reserves for depreciation and operation, they would have to pay out most of their net earnings to the owners - the shareholders.)
- No more double tax on the earnings of capital. (Corporate income tax would be repealed and personal income tax would be reduced because cost of government would be drastically reduced.)
- No more death taxes, to the extent that one's estate is distributed in gifts which do not make the recipients richer than $50,000 each. (Above $50,000 a graduated tax would apply.)

What's in it for FARMERS ?

- A stable economy (no more boom-bust cycles).
- An increased market because of increased consumer purchasing power.
- Improved farm prices because of increased consumer demand.
- An opportunity to acquire stock and have a second income from dividends, whether there's a job on the farm or not.
- An opportunity for the small farmer to get out of farming, if he wants to.
- Lower personal income taxes.
- Ultimately, the end of government control of agriculture.
- A capital estate (in addition to the farm) to pass on to one's heirs.

What's in it for PUBLIC SECTOR WORKERS ?

(Civil Servants, Legislators, Teachers, Ministers, Writers, Artists etc.)

- A second income which can be as big as the typically low salaries paid to these professionals.

- Some freedom from the grinding necessity for subsistence toil; thus, greater freedom from anxiety and an opportunity to devote more time to the works of civilization.

- This should result in a vast increase in the precious goods of civilization - good government, philosophy, literature, religion, art and the like - which after all are finest creations of any culture.

What's in it for U.S. FOREIGN RELATIONS ?

A tremendous improvement in our position as leader of the Free World:

- As 50 million American families become owners of productive capital, they will begin to have second incomes from dividends.
- This increased purchasing power will accelerate industrial growth to several times its present rate of 3%. (Japan's is 12%)
- Increased industrial strength will give us increased military strength.
- Meanwhile, our expanding economy will show the whole world that CAPITALISM works better than COMMUNISM, when everyone has a chance to become a capitalist.
- This will win back the "neutral" nations.
- We can then export these ideas to the under-developed nations. They can use our SECOND INCOME PLAN to spread capital ownership among thousands of their own families and thus build purchasing power to consume while they build industrial power to produce. (Thus we can provide them with a far better alternative than socialism.)

B. Questions Most Often Asked About the Second Income Plan.*

1. Would the Second Income Plan cause inflation?

No, it is designed to avoid inflation. Its tendency would be to stabilize and eventually reduce prices, and permit competitive setting of wages without loss of income to the worker. It is the one-income economy we now have that is inherently inflationary. Remember that the familiar devices we use to artificially create employment -- public works not sought for their own sake, but for the employment they create, agricultural and industrial subsidies, production of military overkill, crash space race programs, production of goods to give away to foreign nations -- all produce non-economic goods; that is, goods that create purchasing power within our economy but that add no consumer goods and services within the economy to absorb such purchasing power.

Similarly, each time wage costs are increased in order, by one means or another, to distribute more income (welfare) to workers without increasing (in fact usually decreasing) their work-input into the economy, the cost of the product is increased. But neither its quantity nor quality is comparably improved. This too is inflationary. This is, in fact, what inflation is -- the creation of purchasing power not offset by simultaneous creation of useful goods and services. Thus, ten million dollars worth of savings or credit "invested" in building space missiles, for example, is permanently inflationary unless counteracted by increased taxes. The same ten million used to build a furniture factory or to expand an airline may have a temporary inflationary effect initially only until the new facility produces sufficient net income to defray its costs of construction -- normally a matter of three or four years at most. Thereafter, for an indefinite period, as it pours goods or services into the economy, its effect would tend to be beneficially deflationary: the consumer's dollar would purchase more without depriving the consumer of his source of purchasing power.

Since the introduction of new plants into the economy as it expands is a continuous process, the long-term deflationary forces would more than offset the short-term inflationary forces. Such a Second Income Economy would be free of the bloating of prices with costs that represent welfare, rather than productive input.

Even the initial and temporary inflationary tendency can be eliminated by the government's reducing its make-work subsidies by a portion of the amount invested in new capital.

*Copyright 1966
Louis O. Kelso and Patricia Hetter

2. Isn't the Second Income Plan socialistic?

Hardly. The Second Income Plan builds ownership of the means of production into individuals as their private property. It then protects the right of each individual to receive all the wealth his property produces. This is a wide departure from what is popularly called "socialism" -- where the capital is owned by the state and a broad income is sought through employment of one or more workers in every family and wages are set by the political apparatus. Since both the government's capital costs (usually reckoned by analogy to competitive economies) and the often artificially high labor costs are passed on to the consumer, the prices of goods and services are high. Incentive to produce (an important part of which is the acquisitive instinct or instinct to own capital) is low.

By placing a main source of economic power in an industrial economy (namely, the ownership of capital) in the government bureaucracy where it is combined with their political power, the socialist economy tends toward totalitarianism. A Second Income Economy, on the other hand, would put all economic power in individual hands and would bring about its wide diffusion. Thus it would tend to be a power-diffused, hence free, society.

So far in history, there has never been an economy in which every household owned a viable share of productive property, and this is the ideal of the Second Income Plan.

3. Would not the financing of business expansion primarily by sale of newly issued stock to new or small stockholders dilute the equity of existing stockholders?

No economic dilution would be involved. If General Motors, for example, expands its productive capacity 20% and finances this new capital by sale of new stock at market price to its employees or other buyers under Second Income financing, the equity of the existing stockholders is not diminished in the slightest. Each new share of stock issued results in investment of the proceeds in new productive plant and equipment. The pre-existing stockholders own exactly what they did before the expansion -- namely, all the General Motors equity that existed

up to the date of the new stock issue. For every dollar of new stock, a dollar's worth of new productive capital has been added.

There is, however, a dilution of voting power, and this is a dilution that is intended. The great corporations of America, effectively owned by 2 million families, have a narrow voting control. The same corporations--vastly expanded and owned by 65 million families-- would have a broad voting control. That is precisely what ought to be. Certainly from management's standpoint, the more broadly ownership is diffused, the better.

The Second Income Plan breaks up the monopoly access to new capital formation now enjoyed by existing capital owners. But when you stop to think about it, why should those who own the economy's existing assets automatically acquire ownership of all future assets forever and ever? Why shouldn't private and individual ownership of the means of production be as widely diffused as the power to vote? The Second Income Plan is intended to protect existing ownership against dilution. Indeed, by tightening up the laws of private property, it is designed to reduce dilution suffered by existing stockholders. But it is also intended to create tens of millions of new stockholding families as it brings about the building of the Second Economy.

4. Is there really enough corporate stock to provide every American family with a second income from dividends?

There would be, given 25 years or so in which to do the job. The Second Income Plan does not propose governmental redistribution of any of the existing stock ownership. Quite the contrary. The protection of both present and future private property in capital ownership is the essence of the plan. We are proposing that only newly issued stock be made available under the plan. This would be new capital created by industry as it expands its productive facilities to provide more goods and services to families with second incomes to spend. Currently, new capital formation in the American economy is taking place at a rate of about $70 billion a year. Based on $20 billion a year of this yearly increment, this is enough new capital to allocate about $20,000 worth to each of one million families per year. After an initial start-up period of about 5 years, during which the first new capital estates would be paying off their acquisition costs, one million families annually could leave the welfare rolls, each producing a legitimate income of $4,000 or more per year through its productive capital. Within a second 5-year period, 5 million families per year could similarly benefit. Hence, within 10 years, half of all American families would acquire a capital estate.

5. Where does the money come from to buy the stock?

You borrow it from a bank on a promissory (non-recourse) note, secured by pledging the stock itself. The bank can, if the rate of growth warrants, "discount" your note by turning it over to its Federal Reserve Bank in exchange for cash equal to the note's face value less the discount. The money to pay the bank comes directly from the Federal Reserve; it is new money issued against your promissory note. Except for the purpose involved, this banking procedure is conventional; nothing new has been added. It is a rational system for monetizing carefully controlled new capital formation -- the chief source of the goods and services that money buys. It would be the first rational monetary system in history.

6. Who decides what stocks you get?

You do, within the limits of what is available among "qualified" stocks at the time you buy. It would depend on which corporations were seeking funds for expansion at that time. It is proposed that a monetary regulatory agency (Capital Diffusion Insurance Corporation), under proper statutory authorization, establish a qualification procedure whereby a corporation seeking to qualify its shares for financed purchase by new stockholders under the Second Income Plan could, by conventional means, establish the financial feasibility of the proposed expansion. When "qualified", the shares could be offered by the investment banking house for sale to new stock buyers who borrow funds through the banking system or from other lending sources.

The financing bank would insist that the portfolio of stocks be suitably diversified.

7. What happens if, after you buy stock, you find that someone else's stock is doing a lot better?

Almost every stockholder finds himself in this situation at one time or another. The Second Income Plan can, after all, only offer equality of economic opportunity, not equality of income or exemption from ordinary investment risks. However, the very fact that corporations have qualified for insured loans on their stock would be important assurance that they were sound. Diversification offers further protection from the risk of faring too badly in comparison with other financed capitalists.

When you select stocks for purchase under your second, third and fourth capital-financing loan, you can use your experience to upgrade your holdings if you have not chosen too well the first time around.

8. If families are allowed to buy capital without first working and saving for it, won't it corrupt them?

Not unless you believe that every well-to-do family that has inherited all or some of its wealth is thereby corrupted. A list of families who did not work and save their way to capital ownership would have to include the families of most of America's founding fathers, many of our presidents, and disproportionately many of our most distinguished artists, scholars, writers, statesmen, public servants and business leaders. The fact is that it is almost impossible for a man to contribute significantly to the work of civilization until he has provided his family with a minimum income that relieves him from having to toil for their living.

Furthermore, the families do "save" to pay for their stock. The stocks produce dividends. Instead of spending these dividends, the family plows them back to pay off the loan. It is only as the stock is paid for that they begin to use the dividends as a "second income". This procedure is exactly the same as that followed by business throughout the industrial era. Businessmen have always "borrowed" money to invest in productive capital, and then let the earnings of the new capital pay off the loan. This is how our first families became first families. And what's proper for the first families of America is proper for all families, isn't it?

9. If a poor family winds up owning some $20,000 worth of stock, won't it squander it?

A few might. But even as to profligates, the privilege of running through a capital estate should not be confined to those who already have one.

But most new Second Income families will treasure their new capital estate and will husband it and hang onto it for dear life, just as a family a century ago would fight to the death to retain possession of its farm under the Homestead Act; just as our peasant ancestors went hungry rather than eat the last of their herds or flocks, and just as the most primitive agricultural tribes hoarded their seed corn throughout winter even though many of them starved. The belief that the average man does not have the wisdom to preserve capital and the ability to use it constructively is not borne out by history. Moreover, inexperienced families can be taught a great deal about how to manage their capital estates during the time it takes for the dividends to pay off the loan. This would be a place where unions could make an invaluable educational contribution; so could benevolent societies, civic groups and bank trust departments.

A thoughtful economist, after studying the Second Income Plan, expressed the opposite concern, and with some reason. He suggested that when the average citizen finds that the acquisition of productive capital by himself in quantities sufficient to provide a significant income is actually feasible, it will arouse in him, as it has so many times in history, a sharpened acquisitive instinct, and he may then seek to save so much of his income that his consumption may suffer. Here again, education must come to the rescue. The proper use and enjoyment of wealth is one of our least understood subjects.

10. Aren't you overestimating the earnings of mature corporation? If earnings are really 20% of invested capital, why are dividends today only about 5%

A 5% yield on invested capital is about the best that can be expected today. But this figure does not represent the stockholder's real equity in corporate earnings. The corporate income tax at the federal level alone takes 45% of earnings at source, and this level may return again to its recent higher levels. The state

corporate income tax removes another 4 to 5%. Even prior to this, an incalculable part of the wealth produced by capital has been redistributed to employees through such devices as non-competitively determined or administered wages and welfare benefits. Add to this the earnings withheld by the corporation itself to finance expansion -- often as much as half of what remains after taxes. A myriad of accounting practices, too, are employed to conceal much of the productivity of capital. So do such tax practices as excessive depreciation allowances and investment credits.

As things are now, the stockholder does not receive more than a fraction of the wealth his capital actually produces. Under the Second Income Plan, the full 20% or even higher yield would be paid out on stocks financed under the plan's approved techniques. Note that this does not mean that all stocks will be subject to the full dividend payout principle -- stocks bought and sold in the conventional market would be unaffected by the Second Income Plan.

The annual survey of industry profits contained in the April issue of National City Bank's Monthly Economic Letter has shown for years that the average net profit before taxes of more than 1,200 U.S. corporations exceeds 20%, notwithstanding the universally used devices to conceal profits.

11. Won't the Second Income Plan lead to more government interference instead of less?

No, the government acts only as a superviser of the credit system (which it is now) and as a referee to see that every American family gets a fair chance to buy and pay for a share of American industry. Once the plan gets under way, present government involvement in business and personal affairs could be cut way back. The source of most government interference today is the need to redistribute income and to artificially create unnecessary work on a massive scale in order to keep the economy from collapsing. From this need springs such things as make-work programs, subsidies, corporate income taxes, etc. Needless to say, the government would not have to fight an anti-poverty war when there are no more impoverished families.

Of course, the present situation did not come into existence over night and we cannot change it over night. However, we can change the <u>tendency</u> of events. The goal of the Second Income

Plan is to build privately-owned economic security into each family rather than welfare into the society. Economically independent families mean economically independent villages, towns and cities. Such communities can manage their own affairs and provide for their own needs democratically at the local level. They do not have to risk impairment of their liberties in return for government benefits. A government does not have to do for its citizens those things the citizens can do for themselves. Hence, the tendency of the Second Income Plan is toward less government, less government interference and less taxation. It most emphatically does not mean, however, a return to laissez faire. The government must umpire the game, but the Second Income Plan will provide the rules, and the economically independent citizen with an affluent second income is the goal.

12. If everybody gets an income from capital, who will do unpleasant work in the economy?

First of all, let us remember that the immediate result of the Second Income Plan will be genuine full employment, i.e., jobs actually necessary to produce goods and services for people rather than non-economic space hardware and war goods. Then let us remember that even at growth rates double and triple the present 3 to 4%, the Second Economy (to be owned by those not owning assets in the existing economy) will take some years to build. Thus, for a few years -- frankly no one can predict just how many -- second incomes from capital ownership will supplement labor incomes, not replace them, for the majority of families. Thus, the answer to the question of who will do the necessary work in the economy for the next generation or so is: many more of us than are working now.

As technological advance eliminates the need for human labor in the economy (and this it will continue to do whether we adopt the Second Income Plan or not), incomes from capital will gradually become primary sources of income instead of secondary. The economy will always need some labor, no matter how advanced the technology. But no one can predict just what labor's work will consist of after the Second Economy is built. Whether work will be fascinating or boring, delightful or disagreeable, require geniuses or morons -- no one can say. The question as asked assumes that the work required two generations or so from now will be disagreeable, and that persons having incomes from capital will not be motivated to perform it. But the facts may be just the opposite. One thing is certain. With plenty of purchasing power

around, the price of any work for which there is need in the economy will rise to the point where the work will be done. The question cannot be definitively answered today, and twenty years from now perhaps it won't even be asked.

13. If mature corporations finance their growth through future savings, won't this destroy investment opportunities for those who have accumulated savings?

Those who already own a capital estate may invest their excess in new capital formation, in the financing of the Second Income Plan for others, and in enterprises that either do not utilize Second Income Plan financing or do not qualify for it. These latter types of enterprise generally involve a higher investment risk than do mature corporations; they also yield larger rewards to the successful investor. Inasmuch as the social justification for accumulated savings has always been that their owners put them at risk in order to add to the productive assets of the economy, owners of substantial capital estates should not object to carrying out their self-proclaimed social duty. Moreover, the building of the Second Economy will open up hundreds of times more investment opportunities than exist today, opportunities for creative and profitable employment of capital. In the one-income economy, there is normally more capital available for investment than places to invest it -- a frustrating situation for the capital owner. (And one reason why existing stocks are bid up far beyond the level justified by actual dividend return.) We must keep in mind too that Second Income Plan financing is only an alternative method of finance. It is not meant to supplant the conventional techniques based on past savings, but to supplement them, in order to make capital ownership possible for families without savings.

14. What effect would the Second Income Plan have on the stock market?

Gradually, stock prices would develop a direct relation to income and the continual churning of existing outstanding stock

would be reduced. Stocks would ultimately be bought primarily for their income yield, rather than in anticipation of speculative profits or for the purpose of avoiding normal income tax rates.

The total volume of stocks outstanding would be multiplied dozens and dozens of times as the proportion of new capital formation financed by issuance of new stock rises from 4% as at present to -- ideally -- 100%. The normal and non-speculative market in stocks would thus vastly exceed in volume the most speculative and unhealthy booms of today's stock market.

15. How does the Second Income Plan differ from the Guaranteed Income proposed by the Ad Hoc Committee on the Triple Revolution?

There is virtually no similarity -- only differences. The Second Income Plan is designed to enable every household to buy a viable share of the thing that produces affluence -- productive capital -- as its private property, to own, enjoy, increase and pass on to its heirs. The Guaranteed Income is simply a super-redistributive measure that makes each household's economic welfare dependent on political and bureaucratic decisions. The Second Income Plan would diffuse economic power throughout all households in the society, thus building an economic foundation for political democracy and securing the rights and liberty of the individual. The Guaranteed Income proposal necessarily fuses in the hands of politicians economic power with political power, thereby tending to create a totalitarian system hostile to the rights of the individual. It is impossible for a citizen to retain his civil rights when others have the power to determine his material needs.

The Second Income Plan offers detailed and specific measures for bringing about tremendous economic growth -- a Second Economy -- which will be capable of producing for the many the high level of affluence now enjoyed by only the upper 10% of families in the existing economy. Thus the Second Income Plan offers a blueprint for enlarging the economy's productive capacity in ways which build the power to consume simultaneously with the power to produce. It stimulates the economic motivation of the individual.

The Guaranteed Income merely subdivides the wealth produced by the existing economy -- already too small to produce real affluence for the non-capital owning majority. Its basic mechanism is political redistribution of the wealth produced by capital. This

weakens economic motivation and destroys the institution of private property and makes it unavailable to the many.

Lastly, the Second Income Plan encourages responsible government and the integrity of elected office holders. Imagine how our political institutions would degenerate if the main campaign issue became the size of the guaranteed annual income to be offered by the winning candidate or party!

16. How do we decide which American families will become financed capitalists first?

Since the first aim of the Second Income Plan is to provide equal economic opportunity to all Americans, logic and justice would demand that the first financed capitalists be households now totally or partially excluded from economic participation. Families whose breadwinners have been disemployed by automation, especially those men and women who have spent long years in the work force. Elderly persons who have never earned enough from their labor to retire in comfort and dignity. Ministers, school teachers and members of the civil service. Policemen and firemen and other municipal employees who have served a specified number of years in their posts. Working mothers of dependent children. Not everyone can go through a door at the same time, nor by the same token can everyone become a capitalist at once. The question of priority will have to be decided politically. But the financed capitalist door is strictly a one-way thoroughfare -- those families who pass through are on their way to material well-being and independence. It is also a door which grows wider and wider. As policy becomes more and more oriented toward the objectives of the Second Income Plan, and as families with second incomes increase, economic expansion will create more and more productive capital to be bought and paid for by new capital owners.

C. Some of the Implications for National Economic Policy for Recognizing that Double-Entry Bookkeeping is the Logic of a Market Economy.

Note: This section was written by Mr. Kelso in August 1968 to explain why the input-outtake logic of double-entry bookkeeping was equally applicable to the economy as a whole. It is addressed primarily to persons seeking to understand the underlying logic of Two-Factor Theory and the Second Income Plan. It is equally addressed to those seeking to understand why our present economic strategies have failed.

L = Labor or Human input into production, i.e., the time, control (or skill) and energy of humans engaged in producing goods or services, measured in dollars, for a given time period.

N = Input into production by the nonhuman factor (land, structures, and machines) measured in dollars, for the same given time period.

W = Market value of real wealth, i.e., goods and services, produced in a given time period.

Then, in an economic system constructed on the logic of double-entry bookkeeping (i.e., the logic of two-factor theory) $L + N = W$.

PL = Purchasing power received by labor in the form of wages, salary, bonuses, commissions, or other compensation as the result of its input into production of goods and services (control [or skill] and energy for a period of time).

PN = Purchasing power received by the owners of the nonhuman factor as compensation for the use (input) of their land, structures or machines in the production of useful goods and services for a given period of time.

Then: PL + PN = W.

Now:

C = Dollar value of capital goods produced during the time period.

X = Dollar value of consumer goods and services produced during the time period.

So: PL + PN = C + X

and

C + X = W

for things equal to the same thing are equal to each other.

But:

PN increases as C increases, for as the purchasing power arising from production is invested in new capital formation, the ownership of which accretes to the owners of previously existing capital goods as a direct result of financing new capital formation out of past savings, the productive power of these owners expands. Unless their consumption expands proportionately, the rate of increase of their productive power over their consumption expenditures accelerates with time.

Since:

$PL + PN = W$,

PN increases relative to PL as C increases.

So a rigid linkage between the ownership of the non-human factor at the beginning of the time period and the ownership of the non-human factor added (through C) during the time period, necessarily results in a diminition of PL in relation to W as PN increases.

The relationship between C and X is important. C, the value of capital goods produced during the period, is a derived demand. Capital goods (land, structures and machines) are not directly consumable by humans. It is the human need for consumer goods and services alone that ultimately gives value (through market demand) to capital goods. If the purchasing power of the fixed group of

owners of the nonhuman factor increases constantly, but their consumption of consumer goods, which would contribute to the value of the nonhuman factor does not increase in proportion to the increase in PN, a serious imbalance arises. PL diminishes in relation to W, and surpluses of consumer goods and services and underutilization of capital goods, or the excess funds seeking investment over opportunity for such investment of PN arises.

-- Poverty of the non-owners of capital goods, the workers and the unemployed, arises.
-- Depression of market value of capital goods, and the lack of investment opportunity for PN (a recession or depression) occurs.

Furthermore:

-- Underproduction, because of lack of market demand arises.
-- Poverty flourishes.

Clearly:

Technological change, which results in an accelerating reduction of PL and increase in PN, both in relation to W, cannot continue unless the number of families and individuals who are able to make only labor input diminishes, and the number of capital owning families and individuals increases at an accelerating rate.

If, as the families and individuals who make up PL either move from the class of owners only of labor power, and either become owners of viable holdings of capital, or both remain employed and acquire significant capital ownership, and thereby receive Second Incomes, then technological change, which shifts the population out of the exclusively-labor-dependent class, and fosters leisure, can advance without restraint.

Similarly, poverty (the inadequacy of purchasing power of families and individuals where adequate supplies of such goods and services could be brought into existence) which arises automatically in a double-entry bookkeeping society from diminishing L, can be attacked at its source by transferring the families and individuals in the L class into the N class. Ideally, the rate of transfer from L class to N class [or to simultaneous membership in both the N class and the L class] would be identical with the rate of shift in productive input from N to L through technological change. Thus the growing general affluence and leisure of the masses would synchronize with -- and would be a direct function of, the rate of technological advance, and would not be impeded by institutional hangups.

This means that C, the investment in capital goods, could increase as rapidly as the physical factors would permit, for as C increased, the individuals in the PL class would shift to, or would simultaneously also become members of the PN class. . . .

X would increase up to the level of affluence desired by the population as a whole.

C would increase as rapidly as the increase in the desire for consumer affluence increased, since the demand for C is derived from the demand for X.

The effect of financing new capital formation out of PN as compared with the effect of financing it out of pure credit.

Since PL + PN = W

and

C + X = W,

the greater X is in relation to C, the greater the level of general affluence. This is true because C cannot be produced, under free market conditions, in excess of the demand for it derived from demand for consumer goods, and the physical capacity of individuals for consumer goods and services is finite and cannot be indefinately increased.

If new capital formation is financed out of PN, then, since the capital-owning class is small at the outset, and does not significantly increase, because of the institutional arrangements that cause the present owners of capital to acquire ownership of all newly formed capital, X cannot legitimately increase with the advance of technological change. Only PN will increase, and the propensity and desire to increase C will be limited to the excess of funds

seeking investment in the non-human factor. A tendency to use such funds to drive up the market value of existing assets will arise, leading to stock market speculation and the like. But increase in C is limited by the lack of demand derived from increase in X.

To some extent, the loaning of funds by the owners of the non-human factor to the owners of labor (the non-capital-owning masses who have only their labor to contribute to production) which is a dual attempt to close the purchasing power gap and to employ for profit their excess purchasing power, will postpone the recession or depression and severe readjustment of values through market value changes, as will increasingly severe measures of political redistribution in an attempt to correct the purchasing power gap.

But it is elementary that such attempts, to the extent they involve the loaning of purchasing power by the high income owners of the non-human factor to the financially underpowered and non-capital-owning masses, while postponing the readjustment, will also increase its severity. For the consumption capability of a particular family is diminished by the aggregate effect of compound interest where borrowing takes place in order to increase consumption. Aggregate real power to consume useful goods and services is diminished by the amount of compound interest paid. For example, twenty-five year or longer

financing periods for financing of home ownership may double or even treble the amount of dollars paid for a home. The time of enjoyment of consumption is influenced favorably to the consumer, but the absolute supply of consumer purchasing power, which determines the health of trade and the degree of general affluence, will be greatly diminished by this practice. It extends the earning power of excess funds of the owners of concentrated capital holdings, but in absolute terms it actually reduces the real standard of living of those dependent on consumer finance.

Attempts to close the purchasing power gap through consumer credit also assure the eventual deflation of value of capital assets, since their value is derived from the market demand for things produced by capital goods, i.e., consumer goods and services. Clearly, the delaying action of consumer finance is not a solution to the problem of how general affluence and general leisure can be attained by the masses at the maximum rate physically possible.

On the other hand, the financing of new capital formation out of credit -- pure credit where such credit is made available to the non-owners of capital, and the owners of sub-viable capital holdings -- has quite different effects within the economy. New capital formation, at least, in the dominant and more productive

part of the economy, does not occur unless potential derived demand for it will be adequate to enable it to pay for itself within a short time -- usually three to five years. So such financing of new capital formation through pure credit mechanisms will not diminish X but in fact, with some time delay, will relentlessly increase X and will also increase the purchasing power to consume X by reason of increasing the number of persons in the PN class. At the same time, such pure credit financing of new capital formation, if properly regulated, need not cause unemployment of funds held by the owners of concentrated capital holdings (PN), since pure credit need not be used until available financial savings have first been used for this purpose under the techniques of the Second Income Plan. This process may also force such financial savings into higher risk and more innovative investments.

Such change will permit expansion of production and the broadening of the consumption of affluence to the full limits of technological, labor, and resource capability, since the previously non-capital-owning families whose incomes are thereby enhanced through the Second Income derived from capital ownership abound in unsatisfied needs and desires, and will expand their purchases of consumer goods out of current income in their quest for the enjoyment of affluence.

It should be noted, too, that if political constraints or business policy constraints bring about the financing of new capital formation through pure credit in ways that generate the ownership of productive capital on the part of those who previously owned no capital, or held negligible amounts of it, and this results in excess PN in the hands of the owners of concentrated capital holdings, they will inevitably seek to employ their excess PN in financing of new capital formation under Second Income Plan techniques for the purpose of broadening the capital ownership base by offering to loan such funds at rates competitive with those available through the banking system [ultimately controlled by the discount rate of the central bank] for the use of pure credit for the same purpose.

Thus excess PN in the hands of the owners of concentrated capital holdings can generally be profitably employed, though probably at rates lower than would be available if the combined efforts of government to redistribute purchasing power from the apparent owners of capital to the non-owners of capital and the use of high-interest consumer loans in a futile effort to close the purchasing power gap were, in effect, subsidizing the return on otherwise-surplus financial savings.

Such use of governmental and business policy

restraints in order to validate a business strategy by which management takes the initiative to expand the economic power of the population of the economy to consume synchronously with expansion of the physical power of the economy to produce would amount to nothing less than the minimum use of intelligent economic system design to conform to the double-entry bookkeeping logic of the market economy.

From another aspect, such constraints would amount only to that imperceptible curtailment of individual liberty required to keep senselessly greedy individuals from injuring their fellowman without benefit to themselves other than to feed unproductive avarice.

Such restraints, in short, are an application of the principle of limitation, which is one of the three foundation stones of economic justice. See The Capitalist Manifesto, by Kelso and Adler, Random House, 1958, Chapter 5, pp. 66-69.

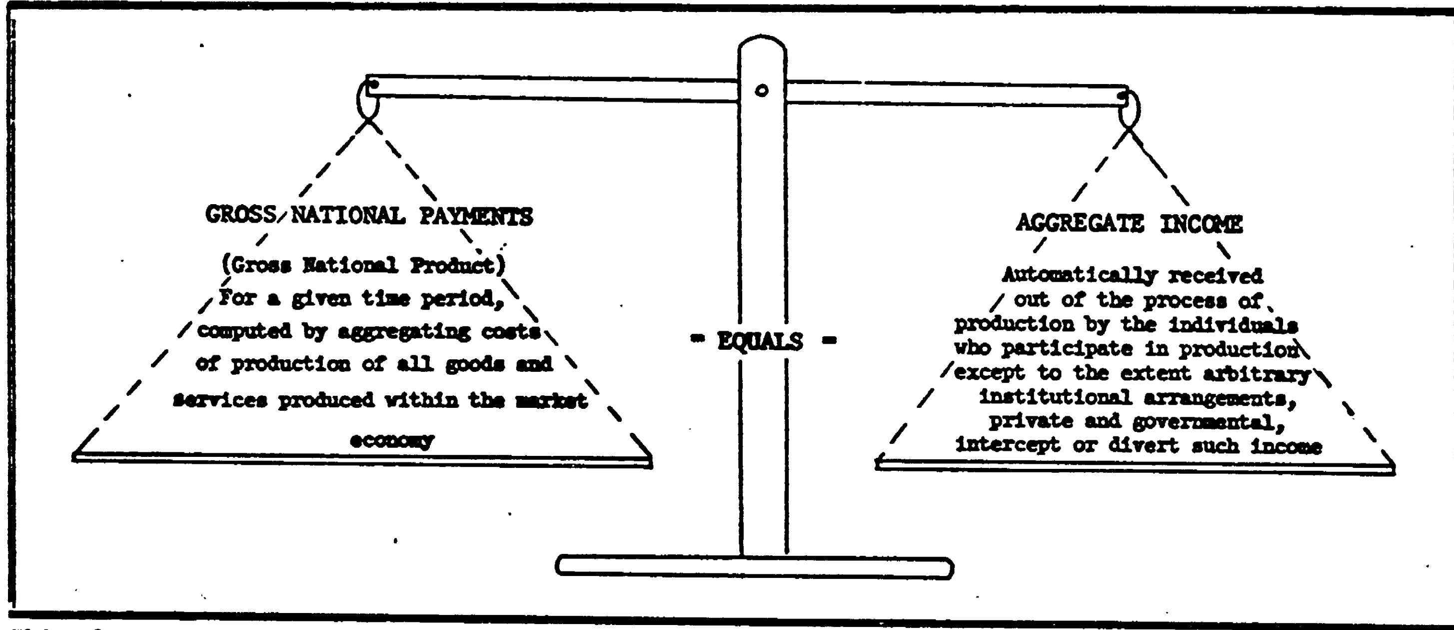
As the employment of two-factor theory in the umpiring of economic activity reduces the tendency of PN to accumulate in excessive quantities, the new policy being to build viable capital holdings of reasonable size in all families rather than to permit the accumulation of grotesque quantities of financial savings by individuals or families whose economic power to produce long since

has exceeded their physical capacity or desire to consume, the PN seeking employment in the process of financing new capital formation will diminish and the use of pure credit for this purpose will become dominant as the goal of universal capitalism, every family and individual owning a viable capital estate, is achieved. Thereafter, it appears that the policy implications of the choice between financing of new capital formation through past savings or through pure credit would turn largely on factors other than national economic policy.

Louis O. Kelso

SAY'S LAW: THE BASIC LAW OF TWO-FACTOR ECONOMIC THEORY

(For every dollar spent, somebody gets a dollar in economic value)



This chart is intended to illustrate Say's Law interpreted through Two-Factor economic theory, i.e., the assumption that each of the two physical factors of production (the human factor and the nonhuman factor) produces wealth or income in the same physical, economic, political, and ethical senses. Say's Law confirms the identity in a market economy between the market value of goods and services produced in a given time period and the aggregate purchasing power created out of the process of production and arising in the hands of the participants in production. "Property right" in a factor of production is the right to receive the entire income or wealth produced by the thing owned (labor power owned by the worker, or physical capital or equity in physical capital owned by the capital owner), evaluated through the mechanism of competitive markets. "Redistribution" from the owners of capital to the non-owners of capital is effected by a wide variety of means, including coercive bargaining of wages, discriminatory taxation (like the corporate income tax which falls only on the wealth produced by capital), payments for nonwork, etc.

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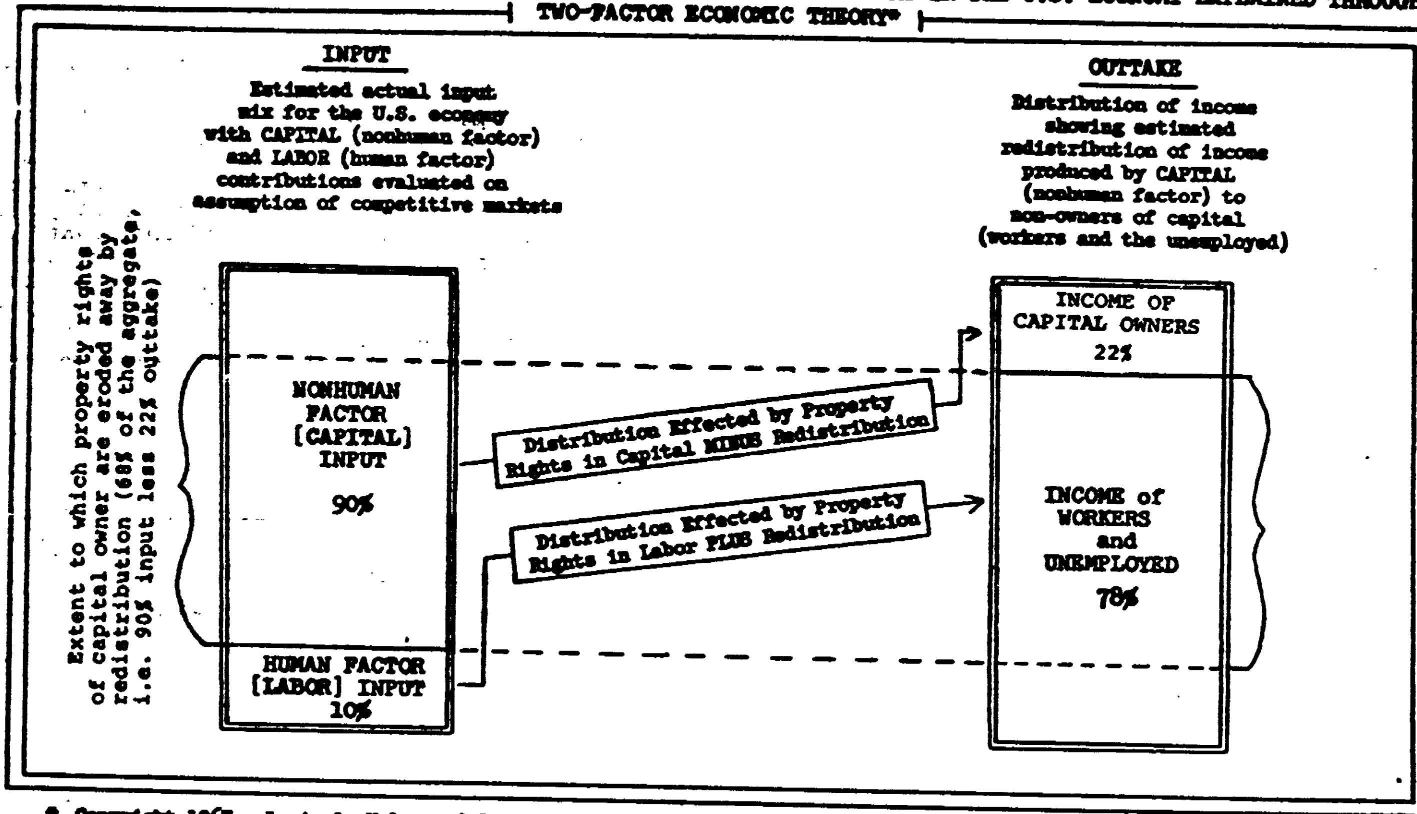
REDISTRIBUTION OF INCOME FROM CAPITAL OWNERS TO NON-CAPITAL OWNERS IN THE U.S. ECONOMY EXPLAINED THROUGH TWO-FACTOR ECONOMIC THEORY*



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"Redistribution" from the owners of capital to the nonowners of capital is effected by a wide variety of means, including coercive bargaining of wages, discriminatory taxation (like the corporate income tax which falls only on the wealth produced by capital); payment for nowork, etc.

V. RECOMMENDED TAX REFORMS

If we grant the desirability of the goal both of achieving legitimate full employment in the production humanly useful goods and services, and enabling a rapidly expanding proportion of the families of the economy to acquire reasonable-sized holdings of productive capital, than it becomes possible to design a program of tax reform designed to achieve these goals. Specifically, the objective would be to use governmental tax guidance to create millions of new capital-owning families with second incomes from the largest corporations, in the course of stimulating the building of a second economy: a building task that amounts to at least twenty-five years of the most intensive full employment. Such a continuous expansion, if it is to be free from the oppressive accumulation of consumer debt, welfare-push inflation, and governmental redistribution of income, can only be supported by raising the economic productiveness of the underproductive through enabling them to acquire ownership of productive capital.

Such a program of tax reform might consider the following:

(1) Qualified Stock Bonus Trusts.

The provisions of the Internal Revenue Code (Section 401) and applicable regulations relating to stock bonus trusts should be liberalized to encourage U.S. corporations that today account for some 80% of the production of goods and services to build equity ownership into their employees. Such liberalization should:

* Increase the present limits of deductibility of corporate contributions to qualified stock bonus trusts from 15% of covered payroll to 30% of covered payroll, independently of deductions for contributions to qualified pension trusts.
* Make dividends payable into such trusts deductible by the corporation as interest presently is;
* Permit a pass-through of dividends to employees without deferment where the trust has fully paid for its stock;
* Broaden the provisions of the Code and applicable regulations to permit joint multi-employer stock bonus trusts, similar to the provisions for joint multi-employer profit-sharing trusts, except that the joint stock bonus trusts would permit the distribution of benefits in diversified stocks of the several participating employers.

(2) Bank Escrows for Members of General Public.

Internal Revenue Code should be modified to permit private escrows to be established with banks to finance the purchase of newly issued stock by low-income individuals through non-recourse financing, with dividends being made tax-deductible by the paying corporation, provided a specified high proportion of corporate net income is paid out in dividends, and exempting such dividends from personal income

taxation on the buyer until the stock is fully paid for. (See section IV. A.)

(3) Contributions to Qualified Employee Trusts Deductible from Income, Gift, and Estate Taxes.

Contributions by individuals to any qualified profit-sharing plan or stock bonus trust should be afforded the same treatment as contributions presently made to qualified charitable foundations. Thus individuals, whether connected with a particular corporation or not, would be given income, gift and estate tax deductions for contributions which tend to build new capital ownership into those who otherwise are capital-less. The rich would thus be motivated to make capital owners out of the propertyless, rather than continue to disconnect their capital accumulations from the ownership of human beings.

(4) Gifts to Qualified Individuals Deductible from Income, Gift, and Estate Taxes.

The wealthy should be provided the same deductions under income, gift and estate tax laws for gifts of income-bearing property or securities to individuals as they are presently entitled for gifts to qualified charitable foundations, so long as the recipient, after the gift, has an estate of no more than a specified value -- say $50,000 or $75,000 -- after which a graduated tax would apply.

(5) New General Purpose Foundations Discouraged.

The Internal Revenue Code should discourage the creation of new general purpose foundations, which tend to prevent

acquisition of increased productive power through capital ownership by the poor. The Code should give maximum encouragement to the use by existing general purpose foundations in following the lead of Ford Foundation, as announced September 29, 1968, to use a portion of its portfolio assets for loans to employee Second Income Trusts to enable employees to acquire ownership of productive capital without diminishing their take-home pay.

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on
Two-Factor Economics

(The Theory of Universal Capitalism and the Second Income Plan)

Conventional economic concepts, from Adam Smith through J. M. Keynes, and the governmental and business institutions based upon them, assume that the performance of labor is the sole or primary method of legitimating individual income; that capital instruments increase "labor productivity" and that the goal of an economic system is to keep labor employed.

The real world of industrial production, however, operates on opposite assumptions: It is constructed on the reality of the full productive equality of the two factors of production: the human factor (labor) and the non-human factor (capital in all of its forms, including land, structures and machines). The theory of Universal Capitalism and the Second Income Plan are concerned with the proper structuring of an economic system in the two-factor economic world, and the updating of pre-industrial mores and ethical precepts to conform to the technical facts of an economy in which capital instruments produce most of the goods and services.

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BROCHURE

A brochure describing the goals and activities of the Institute for the Study of Economic Systems is available from the Institute's Washington office: 2027 Massachusetts Avenue, Washington D.C. 20036.

FILM

THE SECOND INCOME PLAN, the action program for implementing two-factor theory (universal capitalism), is described in a 60-minute stripfilm with recorded narration, designed for showing on the Dukane micromatic stripfilm projector (available for rental in all Western Hemisphere cities). The stripfilm is available for $25 from the Institute for the Study of Economic Systems, One Maritime Plaza, San Francisco, California 94111.

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STATEMENT OF
WALTER P. REUTHER, PRESIDENT, UNITED AUTOMOBILE,
AEROSPACE, AND AGRICULTURAL IMPLEMENT WORKERS OF AMERICA (UAW)

My name is Walter P. Reuther. I am President of the United Automobile, Aerospace, and Agricultural Implement Workers of America, representing approximately 1,800,000 members. I present these views on tax reform proposals on behalf of the UAW.

Among UAW members and among the American people at large, there is today a surging demand for reform of the tax system. Over the years, inequities and injustices have multiplied and compounded, so that countless citizens in the low and moderate income brackets bear a disproportionate share of taxation, while higher bracket taxpayers have their tax burdens reduced and even eliminated by loopholes in the law.

Increasingly, low and moderate income taxpayers have become acutely aware of tax injustice. Today, that awareness has resulted in firm demands that Congress restore justice to the system. A tax revolt is truly in progress.

The burden of federal taxation which the average taxpayer bears is made more onerous by the additional weight of state and local taxes. These taxes are sharply regressive, hitting those with lower income proportionately much harder than the

Table 1

When All Taxes Are Counted: Who Gets Hit, How Much

Income Group	Average Annual Family Income a/	Average Total Taxes Paid b/	Taxes as Percentage of Income	Average Income After Taxes a/
Under $3,000	$ 1,659	$ 564	34%	$ 1,095
$ 3,000-$ 5,000	3,939	1,221	31	2,718
$ 5,000-$ 7,000	6,000	1,980	33	4,020
$ 7,000-$10,000	8,578	2,745	32	5,833
$ 10,000-$15,000	12,387	3,840	31	8,547
$ 15,000-$25,000	20,232	5,665	28	14,567
$ 25,000 and over	51,879	14,526	28	37,353

a/ Calculated from other data in table.

b/ Includes federal and state income taxes; Social Security payroll taxes; sales, property, and all other taxes.

Basic data: U.S. Departments of Commerce, Labor, Treasury and Health, Education and Welfare; Federal Housing Administration; Tax Foundation and other private sources

SOURCE: U.S. News & World Report

rich. The extent to which federal, state, and local taxes combined (including business taxes which are passed on to consumers in the form of prices) bear more heavily on those who can least afford to pay is detailed on Table 1. This table was prepared by the economic unit of U. S. NEWS AND WORLD REPORT, and appeared in that magazine on December 9, 1968.

The average family receiving less than $3,000 in annual income has to pay 34% of its income in federal, state, and local taxes. The percentage falls to 28% for the average family receiving $25,000 and over. (We have added data on average family income before and after taxes calculated from the figures provided by U. S. NEWS AND WORLD REPORT.) The unjust sharing of the tax load would undoubtedly be even more apparent if the figures were broken down to give separate averages for families with very large incomes.

Recently, members of Ford Local 600 in Detroit, one of the largest local unions in the UAW, with a membership of about 50,000, collected thousands of names of other workers, housewives, and retirees on a petition seeking tax reform, addressed to the Hon. Wilbur Mills, Chairman of the House Ways and Means Committee. These men and women are angry at the injustice and inequity they see in our present tax system. They are petitioning you, as Members of Congress, to do something about it. They are going to get angrier unless Congress acts to assure that the tax burden is shared more equitably based upon

the sound and democratic principle of ability to pay.

In our opinion, that should be the first and overriding principle of any tax system--the achievement of justice and equity based upon the principle of ability to pay. It requires that at one end of the scale, there should be no net taxation of incomes which fall below the poverty line; at the other end of the scale, there should be no opportunity for wealthy individuals or corporations to escape taxation at equitable rates on all or part of their income; and in-between, there should be a reasonable progression of effective tax rates, so that a higher percentage of large incomes is taken than of small.

A second principle is that taxation should be of a nature which interferes as little as possible with the natrual processes of the economy, except to the extent that such interference is a matter of deliberately planned public policy to meet national goals and objectives. Sound tax policy should avoid the situations in which a tax provision enacted for one purpose has a secondary, unintended consequence of distorting the economy by making attractive, through tax avoidance, a form of economic activity which, without such special treatment, might be found uneconomic. We are thinking in particular of some of the provisions regarding taxation of capital gains, and the effects of tax exemption on the interest of state and local government bonds.

The third principle is that, subject to the other two principles stated, tax programs should be as much simplified as possible.

Of the many inequities in our tax structure, few can match the complete avoidance of tax payments by the well-to-do. The income tax statistics for 1966, the latest year available, show that there were 12,088 individual tax returns which reported adjusted gross incomes of $15,000 or more, with an average income of over $35,000, but which were completely nontaxable. Of these 12,088 nontaxable returns, 367 reported incomes of $100,000 or more, averaging $383,000 apiece; 18 of them reported incomes of $1,000,000 or more, averaging nearly $3,340,000 apiece. (See Table 2)

At the other end of the scale, we are today taxing many families who live in actual poverty--and taxing into poverty families who are on the verge. Table 3 shows the poverty-line and near-poverty-line income figures, as defined by the Social Security Administration and adjusted to reflect price levels as of January, 1969, for nonfarm families of various sizes. Table 3 also shows the combined income tax and Social Security premium that would be paid by the head of such a family, assuming all his income is earned and is subject only to the appropriate exemptions and the standard deduction. (In the case of a family of "7 or more," the taxes are calculated on the basis of 8 members, since it is clear from the figures that this is

approximately the size of family for which the income is indicated.) These poverty and near-poverty income figures are conservative in the extreme. For example, the allowance for food budgets for the poor is considered by the Department of Agriculture as "temporary or emergency use when funds are low."

For the near poor, the food expenditure "by no means guarantees that diets will be adequate." (Social Security Bulletin)

Impact of Federal Taxes Alone

While the income tax system is intended to be progressive throughout, it is in fact regressive for the higher income brackets. Based on data from the table on page 81 of "Tax Reform Studies and Proposals, U. S. Treasury Department, Part 1," of last year, together with data from the "1966 Statistics of Income," Table 4 shows that while the standard tax rate--the rate that would be paid if no deductions were taken except the standard deduction--increases steadily with rising income, actual taxes paid begin to decline as a percentage of income somewhere near the $200,000 income bracket.

While these figures do reflect the excluded portion of long-term capital gains, there are additional kinds of income not included which make the presentation conservative--e. g., exempt interest on state and municipal bonds, deductions for unlimited charitable contributions, special percentage depletion allowances, etc. (The chart following the table graphs

Table 2

Nontaxable Returns Reporting Income Over $15,000 -- 1966

Adjusted Gross Income Class (AGI)	Nontaxable Returns		
	Number	Total AGI (millions)	Average AGI Per Return
$ 15,000 under $ 20,000	6,0[illegible]0	$ 103.7	$ 17,226
20,000 under 50,000	5,084	141.6	27,852
50,000 under 100,000	617	42.7	69,206
100,000 under 200,000	213	28.5	133,803
200,000 under 500,000	103	30.8	299,029
500,000 under 1,000,000	33	21.2	642,424
1,000,000 or more	18	60.1	3,338,889
Total $15,000 and over	12,088	428.6	35,457
Total $100,000 and over	367	140.6	383,000

SOURCE: U.S. Treasury Department, I.R.S.; 1966 Individual Income Tax Returns

Table 3

Federal Taxes Paid By Families at Poverty and Near-Poverty Line Incomes

Household Size a/	Poverty Line Income b/	
	Amount	Total Federal Tax c/
1 Member	$1,903	$ 211
2 Members	2,338	206
3 Members	2,782	190
4 Members	3,568	238
5 Members	4,205	259
6 Members	4,719	254
7 or more Members	5,810	257 d/

Household Size a/	Near-Poverty Line Income b/	
	Amount	Total Federal Tax c/
1 Member	$2,188	$ 294
2 Members	3,151	365
3 Members	3,665	357
4 Members	4,649	439
5 Members	5,436	489
6 Members	6,099	513
7 or more Members	7,431	562 d/

a/ [illegible] farm household head, under 65.
b/ Adjusted to reflect price level of January 1969.
c/ Federal income tax plus Social Security tax.
d/ Tax calculation based on 8 members.

SOURCE: Based on 1969 Economic Report of the President;
U.S. Master Tax Guide

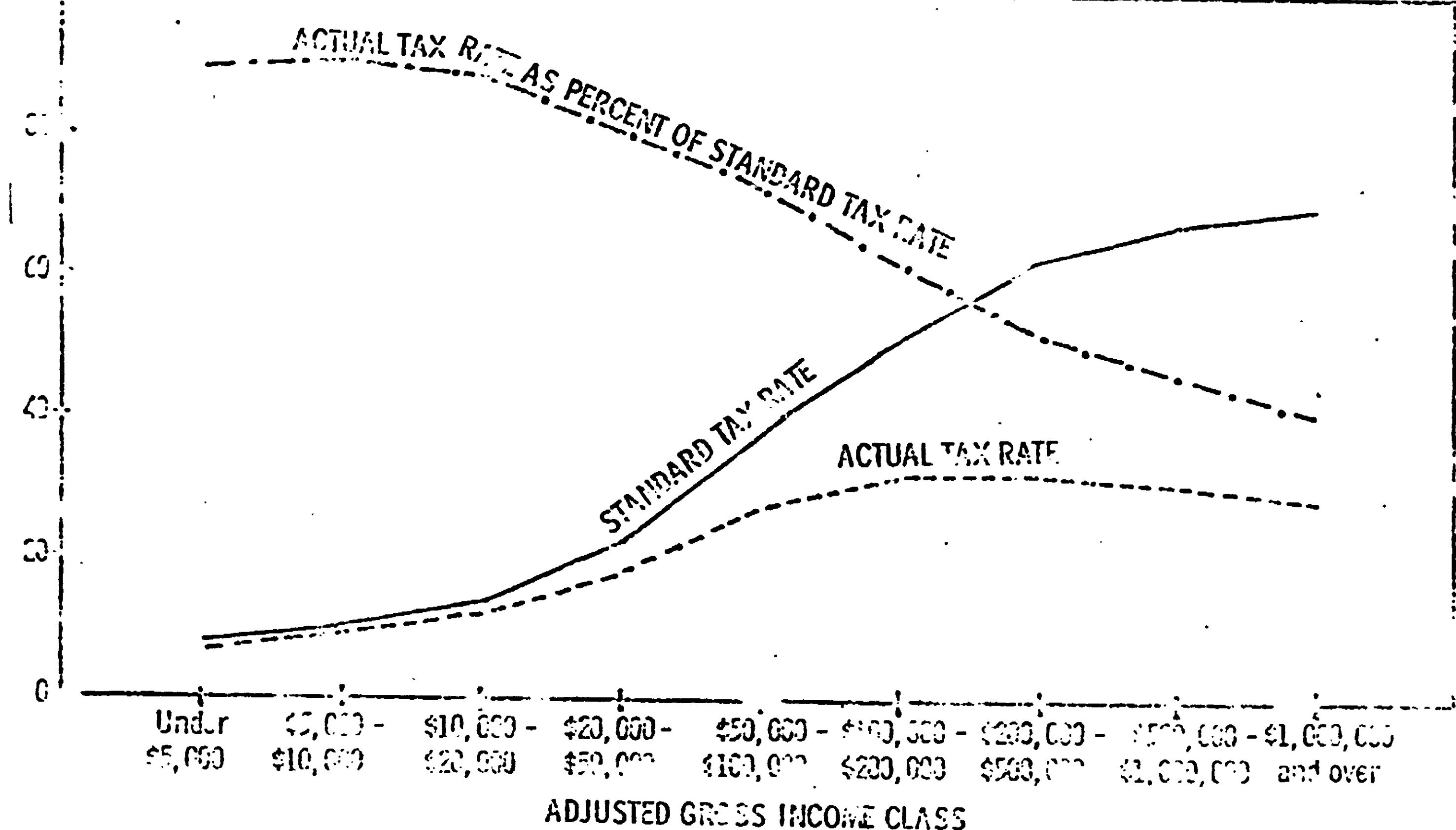
Table 4

Effective Actual Tax Rates and Effective Standard Tax Rates By Income Group 1966

Adjusted Gross Income Class (thousands)	Effective Rate on Amended Adjusted Gross Income a/		
	Standard Tax b/ (percent)	Actual Tax (percent)	(standard=100) c/
0 - $ 5	8.3%	7.4%	39
5 - 10	10.4	9.4	90
10 - 20	13.9	12.2	88
20 - 50	22.5	18.0	80
50 - 100	38.0	27.3	72
100 - 200	51.1	31.9	62
200 - 500	62.1	32.0	52
500 - 1,000	67.1	30.7	46
1,000 and over	69.2	28.4	41

a/ Amended adjusted gross income includes income from capital gains.
b/ Standard amended taxable income computed by subtracting exemptions and standard deductions from estimated amended adjusted gross income. All standard amended taxable income taxed at rate for joint returns except that reported by single individuals.
c/ Actual effective tax rate divided by effective standard tax rate.

SOURCE: Tax Reform Studies, Part 1
UAW Research Department estimates based on "1966 Statistics of Income"



DATA: Tax Reform Studies, Part I; 1966 Statistics of Income

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the fact that the actual tax rate paid by income group as a percentage of the standard tax declines the higher the income group.)

The effect of including these amounts is shown for the higher brackets on page 110 of the same Treasury study. For incomes from $100,000 to $500,000, while the income tax paid is 46.3 percent of taxable income, it is only 16.8 percent of total income. In the $500,000 to $1,000,000 bracket, the tax has risen to 54.1 percent of taxable income, but it has fallen to 11.7 percent of total income. Over $1,000,000, the tax is 52.3 percent of taxable income, but only 10.3 percent of total income. In other words, over 80 percent of total income in this top bracket is nontaxable.

Taxing the Poor Must End

The chief inequity afflicting low income taxpayers is the taxation of poverty incomes. There are various proposals which have been advanced to eliminate this unconscionable levy. In my testimony before the House Ways and Means Committee (April 3, 1969), I suggested several alternative methods.

An additional proposal calling for a minimum standard deduction of $1,100 for all families has been put forth by the National Committee on Tax Justice, of which I am a member. With such a minimum standard deduction, plus current exemption provisions, families living below the poverty line, as presently defined, would be excluded from the payment of federal income

tax. Such a minimum standard deduction would benefit millions of families, mostly wage earners, who are now being squeezed between the pressures of inflation and an unjust tax burden. The minimum standard deduction of $1,100 would modestly assist most of these overburdened taxpayers with incomes up to $11,000.

The Tax Reform Act of 1969 (H. R. 13270) adopted this part of the reform package which the National Committee on Tax Justice had proposed. That provision goes far in meeting the objective of the reform of the NCTJ to remove from the tax rolls persons who fell below the poverty line income figures. It has been estimated that close to six million poor persons who now, despite their impoverished state, pay federal income taxes will be relieved of that inequitable burden.

A second step taken by the Tax Reform Act of 1969 which we support is the raising of the standard deduction to 15% with a $2,000 maximum. That long-needed liberalization of the standard deduction provisions, along with the new minimum standard deduction, will provide much needed tax relief for low and middle income families. That too was an important component of the reform advocated by the National Committee on Tax Justice, and we urge its retention by the Senate.

Among the special provisions that favor the wealthy and which must be corrected if we are to have a fair tax system, are the treatment of capital gains and percentage depletion allowances, the handling of charitable contributions, provisions relating to interest-free bonds of state and local governments,

fictitious farm losses, and a range of tax favors which corporations enjoy.

Capital Gains

There can be no basis in equity for giving specially favorable treatment to money which has been gained on the stock market or through other forms of speculation, or even by sound long-term investment, as compared with income which a man has earned by the sweat of his brow.

If long-term capital gains were taxed as ordinary income is, we recognize that there might be some inequity when a very large appreciation is realized in any one year. This could be dealt with through an extension of the averaging provision, which would allow the taxpayer to average such amounts over a longer period of years.

A particularly inequitable loophole in the law is the provision that if assets are held to death, any appreciation that has taken place is wiped out at that point for capital gains tax purposes. This seems to us completely unjustifiable. We support the proposal that such appreciation should be taxed in the same manner as any other long-term capital gain.

In light of the estimated $10 billion in tax revenues which escape through the preferential treatment of capital gains--by far the largest single loophole--the changes recommended in the Tax Reform Act of 1969 are incredibly limited. They recoup only a tiny fraction of the revenue lost and leave

completely intact the capital gains transferred by gift or death.

Making a Profit on Property Contributed to Charity

Several highly technical loopholes permit wealthy persons in some cases to make a profit out of a charitable donation--that is, the taxpayer is actually better off after making the gift and taking a corresponding tax deduction than he would have been if he had sold the gift, retained the money himself and paid the appropriate taxes on it.

We support the Treasury proposals designed to prevent such a taxpayer from not only forcing his fellow taxpayers to completely subsidize his charitable giving, but to pay him a profit on it as well.

Interest-Free Bonds

Failure of the federal government to tax the interest on bonds issued by state and local governments provides wealthy persons with still another tax haven. Such bonds carry a very low interest rate--typically about three percent--which makes them uneconomic for the ordinary taxpayer to purchase. But

(continued on page 14)

since the interest is nontaxable, it is worth much more to the top-bracket taxpayer than a much higher rate of interest that would be taxable. Another aspect of tax exempt interest on state and local bonds relates to industrial development bonds.

The situation is inequitable enough when it is merely a matter of a company which is deciding where to expand its facilities. But one injustice is piled upon another when the device is used to lure a plant away from a town in which it is already located. The local government which does this is stealing away another town's economic lifeblood, depriving workers of their jobs and the whole town of its economic security--and we taxpayers, through the exemption, are paying to have it done.

We propose that the privilege given state and local governments to issue tax-exempt bonds should be ended immediately. The federal government should be giving more financial aid to state and local governments, but it should be done directly, not by tax devices.

Proper safeguards should be devised so that the equity of taxpayers currently holding bonds with tax exempt status be protected.

Fictitious Farm Losses

Farming is probably the only industry in this country where the bigger your income is, the bigger your losses are. This is because of loopholes in the law regarding taxation of income

from farming operations, which enable so-called "gentleman farmers" with large nonfarm incomes to show factitious paper losses on their farm operations and charge them up against their nonfarm income.

By taking advantage of these provisions, taxpayers with large nonfarm incomes are able to show their actual capital expenditures on the farm as apparent losses, which are then offset against nonfarm income at a large tax saving. At a later period, the asset so created can be sold, and taxed only as a capital gain at a much lower rate.

We consider Senator Metcalf's proposed remedy (S.500) which limits the amount that may be deducted from nonfarm income while at the same time protecting the genuine farmer who may also have an off-farm job, to be sound.

Percentage Depletion Allowances

The tax treatment of depletable resources urgently needs revision. The preferential tax treatment applies primarily to the oil and gas industry, though some other industries based on depletable resources do get favored tax treatment also.

No other industry, however, has succeeded in getting so many tax favors or making so much out of them as the oil companies.

They are permitted to charge off intangible drilling costs as a current rather than a capital expense.

They are permitted a so-called depletion allowance which is not really a depletion allowance at all, but a direct tax

deduction. It consists of the lesser of 27.5 percent of gross income from oil or gas, or 50 percent of net income from the property, each year. Over the years, this can exceed the actual cost of the assets used up many times over.

Other Oil Industry Loopholes

Fairly recently, a new device has been dreamed up by the tax lawyers, called a "carved-out production payment," which effectively removes the 50 percent of profit limitation on depletion. A company sells the right to all or part of the following year's production, receiving payment in advance but usually paying interest on it. This is added to the current year's sales thus increasing the sales figure and greatly increasing the profit figure, since no expenses have been incurred against it. This, in turn, enables a much greater depletion allowance to be taken. In the following year the costs of production are charged up to income, but since the sales of that year have already been taken account of, the result is a large paper loss in the second year. This loss in turn can be written off either against the profits of other years, or against profits of other investments in the same year.

In addition, a statement by Senator Proxmire indicates that oil companies are permitted to write off foreign royalties as though they were actually taxes. That is, instead of writing them off against income, as would be normal with royalties, they are permitted to write them off against U. S. tax liabilities.

The result of these tax favors is that the oil companies pay far less than their share of taxes.

The Quarterly Financial Report of Manufacturing Corporations, published by the Federal Trade Commission and the Securities and Exchange Commission, shows that for the twelve months ending September 30, 1968, companies in the "petroleum refining and related industries" paid federal income taxes equal to only 13.3 percent of their profit before taxes. By comparison, all other manufacturing industries combined paid 45.3 percent of their profits before taxes in federal income taxes.

Many individual oil companies pay much less than the industry average. A table inserted in the Congressional Record on January 2?, 1969, shows that in 1967 Texaco paid only 1.9 percent of its gross profit in federal income taxes; Standard Oil of California paid 1.2 percent; Union Oil paid 6.3 percent; Marathon paid 2.8 percent; in many years some companies paid no federal income tax at all--some even received a tax credit in spite of profits running into the tens of millions of dollars.

Many huge personal fortunes have been made in the oil industry, partly through these tax favors. Any list of the wealthiest persons in the U. S. would include a number who had made their fortunes from oil.

We would strongly urge your Committee, not only to approve putting an end to obvious attempts to evade the intent of the law, such as carved-out production payments, but to examine carefully all the special tax favors allowed this and other

mineral industries, with a view to taxing them as nearly as possible on the same footing as other industries.

Foundations

Foundations have come in for considerable criticism recently in Congress and in the press. Those criticisms have centered largely on situations where foundations have been used to serve the private purposes of individuals rather than any philanthropic purpose, and there has been some criticism also of the activities financed by some foundations.

According to the Treasury report, while it is true that "the preponderant number of private foundations are performing their functions without tax abuse," nevertheless it is also true that "a minority of such organizations are being operated so as to bring private advantage to certain individuals, to delay for extended periods of time benefits to charity, and to cause competitive disadvantage between businesses operated by foundations and those operated by private individuals."

Where such abuses exist, they must be tracked down and stopped.

We support, for example, the proposed prohibition against financial transactions between a foundation and its founders, contributors, officers, directors or trustees.

In order to prevent foundations hoarding their funds to build up little- or big- empires, we support the proposal that private foundations be required to distribute their income

(other than contributions) within a year after the year of receipt, unless they were accumulating the income for a specific, stated charitable purpose. An exception might also have to be made in the case of a lump sum of income from long-term capital gains, but in this case the time limit for distribution should merely be extended for an appropriate period of years--perhaps, five years.

In order to prevent foundation managers from becoming more concerned with the operation of a business than with the pursuit of the foundation's philanthropic purposes, we would approve of the proposal that, in general, no foundation be allowed to own 20 percent or more of any business.

In order to prevent use of a foundation to maintain family control over a corporation or other property, we support the proposal that where an interest in such a corporation or property is given to a foundation, no charitable deduction be allowed unless the donor's control over the business or property ends. We do not think the proposals to allow the deduction if the foundation disposes of its interest or devotes the property to active charitable activities will adequately meet the problem.

We support the proposal that speculating and foundation borrowing to purchase investment assets be prohibited, and that foundation lending be confined to categories which are clearly necessary, safe, and appropriate for such institutions.

We would also support the provision to prevent perpetual family control over a foundation to the extent that the donor

and related parties may constitute no more than 25 percent of its governing body after 25 years.

These restrictions, we believe, are clearly desirable. They are the kind of limits that would be placed unilaterally by a reasonable man desiring to establish a foundation with a purely philanthropic purpose.

We would urge, however, that the Committee resist any proposals to limit the philanthropic scope of foundation activities. One of the virtues of a foundation is that it can break new ground, pioneer new territories, try out new ideas. It can finance research into areas that no government and perhaps not even a university would be prepared to enter--and the advancement of science in large part has rested on researches and experiments that in the beginning were frequently considered a waste of time. It can finance efforts in other countries, particularly underdeveloped countries, to find answers to specific problems where it might be politically unwise for the U. S. government to provide similar assistance. In so doing, foundations can help to brighten and strengthen the image of this country in the world.

Proposals tentatively agreed upon by the House Ways and Means Committee preventing the use of foundation funds in projects which may influence the decisions of government bodies are, we believe, indefensible.

We would have no objection to language spelling out prohibitions against foundation sponsorship of partisan political activity or direct lobbying campaigns. But, the Committee should diligently protect the right of foundations to fund projects which explore national social problems or the effectiveness of government programs, which encourage voluntary organizations to seek solutions to community problems, which seek to protect and enhance constitutional rights and liberties before the courts, and which in general encourage orderly social progress and change.

Order of Priorities

We suggest the following order of priorities for the Committee's consideration:

1. Plug as many tax loopholes as possible, especially those recapturing the most revenue, such as capital gains, oil depletion, tax-free interest, etc.

2. Out of the additional funds available, provide assurance that no family in poverty will be taxed and no family will be taxed into poverty.

3. The next priority is to lighten the tax burden for those above the lowest income brackets, and to lighten the taxes of all those who have been meeting their full obligations.

33-865 O - 69 - pt. 2--40

However the House bill reduces the rates on higher income taxpayers, the resulting revenue loss is far greater than the revenue gain from loophole closing.

In addition to contributing to inequities in sharing the total tax burden, the bill fails to produce revenues to be applied to domestic needs.

We believe that extra revenues must be obtained by plugging loopholes to meet the pressing social needs of our time--the problems of our cities and our rural slums, the health and housing needs of the people, the education of our children, the need to clean up the air and the water around us.

We urge the Committee to fashion a bill to achieve these ends.

NEW YORK STATE BAR ASSOCIATION

TAX SECTION

Summary of Report on

Tax Reform Bill Proposals affecting Employee Benefits

(H. R. 13270 as passed by House of Representatives)

by

Committee on Employee Benefits

H. R. 13270, as passed by the House of Representatives (hereafter referred to as the "Bill"), proposes seven measures affecting employee benefits that have been considered at a series of meetings held by the Committee on Employee Benefits.

General observations: Effect on Committee's views of 50% limitation of maximum tax rate on earned income [Bill, §802]

The views of the Committee on Employee Benefits towards provisions of the Bill which would affect employee benefit plans are in part based on the Bill's limitation of the maximum tax rate on earned income to 50%. Of necessity, the provisions of the Bill relating to employee benefit plans must be considered in connection with this proposed limitation.

Our Committee favors the proposed limitation for the following reasons:

1. We concur that the limitation will tend to reduce the variety of complex plans that have evolved which have as an important purpose the reduction or averaging of ordinary income so as to prevent application of the highest tax brackets. The Bill would thus encourage payment of current compensation in lieu of deferred compensation.

2. There has long been an unjustifiable discrimination in the tax laws against individuals whose income is primarily derived from their services, as compared with individuals with capital to invest. This discrimination has been caused by the substantial spread between the high progressive rates of tax on ordinary income and the capital gains rates. Any measure which reduces this discrimination is a forward step essential to the equitable application of the tax law constituting a basic objective of the Bill.

SUMMARY

Our Committee's views on each of the seven measures proposed in the Bill may be summarized as follows:

I. Employee Stock Purchase and Restricted Stock Option Plans-increase in holding periods [Bill, §§514(b)(7) and (8)]. If the holding period for long-term capital gains treatment on the sale of securities generally is to be extended from six to twelve months (a question not within the province of the Committee on Employee Benefits), our Committee concurs in a similar extension of the holding period requirements for favorable tax treatment under employee stock purchase and restricted stock option plans. If the employee is to be required to hold the employer's stock for twelve months to obtain long-term capital gains treatment, as proposed in the Bill, simplicity would best be served by requiring the employee to hold the stock for the same period to avert receipt of compensation.

II. Qualified Retirement Plans of Subchapter S Corporations [Bill, §541]. We do not favor further extension of the present restrictive limitations on contributions applicable to qualified retirement plans for the self-employed, i.e., sole proprietors and partners. Moreover, the proposed changes for Subchapter S corporations would result in three different sets of tax rules for qualified plans - one for corporations other than Subchapter S corporations, a second for Subchapter S

corporations, and a third for the self-employed. Thus, still further complications would be added to already complicated tax rules.

Our Committee favors the development of a single set of tax rules which should be applicable to qualified retirement plans and contributions to such plans; the objective of a retirement plan is the same, irrespective of the form of business operation, and no distinction should be made based on the form of business operation. A uniform set of rules has become even more necessary now that the Commissioner of Internal Revenue has agreed to corporate tax treatment for individuals engaged in a profession who incorporate as a professional corporation (TIR 1019, August 8, 1969).

III. Employee Relocation (Moving) Expenses [Bill, §231]. Our Committee is generally in accord with the provisions of the Bill relating to employee relocation expenses for reasons stated in our prior reports*. Our only reservations concern (a) the proposed $2,500 ceiling on deductible expenses, which we would like to see replaced with a qualitative limitation based upon reasonableness similar to that imposed on business

* See Supplementary Report on Proposals for Liberalization of Federal Income Tax Treatment of Employee Relocation Expenses, dated May 9, 1969, and the prior Report on Proposals for Liberalization of Federal Income Tax Treatment of Employee Relocation Expenses, dated November, 1968.

and travel expenses generally, and (b) the proposed increase in the minimum distance for moves (in respect of which expenses may be deducted) to 50 miles, which we would like to see replaced by the 20-mile test in the present law, to provide for office or plant relocations between densely populated areas and suburbs.

IV. Lump Sum Payments from Qualified Retirement Plans [Bill, §515]. We do not favor the five-year carry-forward formula, with the accompanying procedure for refund claims, proposed by the Bill as a means of alleviating the bunched-income problem incident to receipt of lump sum payments from qualified plans. The Bill's method of taxation involves administrative complexities and burdens on Government and taxpayers alike. Particularly if the 25% ceiling on the tax on capital gain is eliminated or curtailed and taxes on earned income are to be reduced, as proposed in the Bill, the disparity between the rate of capital gains tax on a lump sum payment and the rate of ordinary income tax on annuity payments in lieu of a lump sum will be sufficiently small in the preponderance of cases to call for continuation of the present simple method of taxing the entire lump sum payment in excess of employee contributions at capital gains rates.

V. Restricted Property [Bill, § 321]. Our Committee is in the process of completing a study, which has extended over a period of several months, directed toward the varied business practices in the use of restricted property. Pending completion of that study, our Committee makes the following recommendations:

1. The Bill does not make provision for the deduction by the employer of the amount considered compensation to the employee in respect of restricted property. Our Committee believes that, if restricted stock is to be made the subject of legislation, provision should be made for the employer's deduction by statute rather than Treasury Regulations.

2. Numerous employees who have been receiving bonuses in the form of restricted stock under existing plans have rendered services during 1969 in the expectation of receiving such bonuses for such services. Many employees irrevocably elected in 1968 to forego cash or other compensation in favor of such bonuses. Against this background, the Bill would make the new rules inapplicable to transfers of stock prior to February 1, 1970 if made pursuant to a plan adopted and approved prior to July 1, 1969. However, bonuses are usually

fixed with reference to corporate profits and the amount of such profits is not known with certainty until certified by accountants. Certification of the profits is usually not available until the month of February for calendar year corporations, and the committee or other body making the awards usually does not act until the end of February or early March. To permit normal conservative corporate procedure, our Committee accordingly recommends that transfers of restricted stock pursuant to plans in existence on July 1, 1969 be permitted under present tax rules until April 1, 1970.

3. Restricted property might be considered as involving deferred compensation. If so regarded and if the minimum tax provisions in the Bill relating to deferred compensation were to be adopted, the Bill should make it clear that the minimum tax provisions are not to be applicable to transfers of restricted property made prior to the effective dates of the new rules relating to restricted property. It would be anomalous for the minimum tax provisions to be interpreted to apply in future years when restrictions lapse with respect to property transferred subject to restrictions prior to the effective dates of the new rules relating to such property.

VI. Payments to Non-Qualified Trusts and Annuity Plans [Bill, §321(b)]. Our Committee agrees with the principle proposed by the Treasury and accepted in the Bill that the tax rules relating to payments to non-qualified employer trusts and under non-qualified annuity plans should generally correspond to the tax rules relating to restricted property. To this end, statutory provision should be made for the employer's tax deduction to allay the uncertainty that has existed in this area and foreclose further litigation. While approving the principle proposed by the Treasury, we believe that there should be a special rule in the case of disqualification of a qualified retirement plan, so that the innocent employee-beneficiaries will not be adversely affected, as, for example, by becoming subject to tax on vested benefits prior to the year in which the benefits become distributable to them.

VII. Other Deferred Compensation [Bill, §§802, 331]. Our Committee believes it inappropriate and unnecessary to enact tax measures against individual deferred compensation arrangements represented by (a) the Bill's general exclusion of deferred compensation payments from the definition of earned income and (b) the additional minimum tax provisions for deferred compensation. Deferred compensation arrangements often

have business purposes other than spreading of taxable income. In any event, a 50% maximum tax on earned income should itself be sufficient to discourage future use of deferred compensation arrangements stimulated solely by a desire to shift taxable income into low tax years after retirement. The Bill presents numerous technical difficulties, such as the absence of a definition of "deferred compensation", and the entire subject calls for further study, as requested by the Treasury Department.

COMMITTEE ON EMPLOYEE BENEFITS

By: V. Henry Rothschild 2nd
Chairman

DISCUSSION OF VIEWS

OF

COMMITTEE ON EMPLOYEE BENEFITS

I. Employee Stock Purchase and Restricted Stock Option Plans - increase in holding periods [Bill, §514(b) (7) and (8)]

1. As part of the provisions of the Bill lengthening from six months to twelve months the holding period which separates short-term from long-term capital gains and losses, the Bill would extend the six months' holding period applicable to employee stock purchase plans and to restricted stock options [Bill §514(b) (7) and (8) which would amend Code §§ 423(a)(1) and 424(a)(1) and (c)(1) and (2)]. Thus an employee would be required to hold stock acquired under an employee stock purchase plan or upon exercise of a restricted stock option for twelve months, instead of six months as under present law, if no income is to result from the exercise of his option.

2. Our Committee considered the limited retroactive effect of such a change on employees who now have a right to purchase stock or hold a restricted stock option, particularly on an employee who had already purchased stock or exercised a restricted stock option with the six-months' holding period having expired or nearly expired on January 1, 1970, the effective date of the proposed change of the law on employees on a calendar year basis [Bill, §514(d)]. If the general holding period for long-term capital gains is to be extended from six to twelve months (a question not within the province of the Committee on Employee Benefits), our Committee concurs

in a similar extension of the holding period requirements for favorable tax treatment under employee stock purchase and restricted stock option plans. In the event that the employee is to be required to hold the employer's stock for twelve months to obtain long-term capital gains treatment, as proposed in the Bill, simplicity would best be served by requiring the employee to hold the stock for the same period to avert receipt of compensation.

II. Qualified Retirement Plans of Subchapter S Corporations [Bill, §541]

1. The Bill would impose limitations on contributions to qualified retirement plans by individuals who are "shareholder-employees" of corporations that have elected to be taxed under Subchapter S of the Code. Such limitations are intended to be generally similar to the limitations now applicable to contributions by self-employed persons (proprietors and partners). For this purpose, a shareholder-employee would be defined as an officer or employee who owns or controls at any time during the taxable year more than 5% of the shares of the corporation's stock (as distinguished from the 10% ownership or control to which the "owner-employee" rules for partnerships apply).

2. A shareholder-employee of a Subchapter S corporation would be required to include in his gross income the contributions made by the corporation under a qualified plan on his behalf to the extent that such contributions exceed 10% of his salary or $2,500, whichever is less. The amount the shareholder-employee would thus be required to include in his income would be treated as his contribution to the trust and would be recovered tax-free at the time he is entitled to benefits from the plan. In the case of profit-sharing or stock bonus plans, the Bill would prohibit forfeitures of con-

tributions that had been deducted in Subchapter S years to be used to benefit shareholder-employees (except forfeitures of contributions made in taxable years before 1970).

3. Except for the proposed changes with respect to contributions and forfeitures, the present tax rules for qualified plans of corporations would continue to apply to qualified plans of Subchapter S corporations. Thus the additional requirements for qualification applicable only to plans covering self-employed "owner-employees" would not apply to plans of Subchapter S corporations. The rules applicable to certain distributions, such as Section 101(b) of the Code relating to the $5,000 death benefit exclusion, and Section 105(d) relating to the sick pay exclusion, which apply to distributions from corporate plans but not to plans covering self-employed individuals, would continue to apply to distributions from plans of Subchapter S corporations.

4. Our Committee does not favor extension of the present restrictive limitations on contributions applicable to qualified retirement plans for the self-employed. Moreover, the proposed changes for Subchapter S corporations would result in three different sets of tax rules for qualified plans - one for corporations other than Subchapter S corporations, a second for Subchapter S corporations, and a third for the self-employed. Thus, still further complications would be added

to already complicated tax rules.

5. Our Committee favors the development of a single set of tax rules which should be applicable to retirement plans and contributions to such plans; the objective of a retirement plan is the same, irrespective of the form of business operation, and no distinction should be made based on the form of business operation. A uniform set of rules has become even more necessary now that the Commissioner of Internal Revenue has agreed to corporate tax treatment for individuals engaged in a profession who incorporate as a professional corporation (TIR-1019, August 8, 1969).

33-865 O - 69 - pt. 2--41

III. Employee Relocation (Moving) Expenses [Bill, §231]

1. The Bill would eliminate any distinctions still remaining between old and new employees and direct and indirect moving expenses, by requiring the inclusion in gross income of all amounts received in reimbursement of moving expenses (proposed new Code §82) and the deduction of such expenses only pursuant to Section 217 of the Code. Our Committee affirms its previous support for such uniform tax treatment.*

2. The Bill would also eliminate from the provision for deduction for house-hunting expenses the previous limitation to moves essentially within the geographical limits of the United States which was made in the Treasury proposals and in previous bills. Our Committee affirms its support for the elimination of this restriction.

3. The Bill would also codify the provision prev-

* See Supplementary Report on Proposals for Liberalization of Federal Income Tax Treatment of Employee Relocation Expenses, dated May 9, 1969, and the prior report on Proposals for Liberalization of Federal Income Tax Treatment of Employee Relocation Expenses, dated November, 1968.

ously contained in the Treasury proposals limiting such deductions to expenses incurred on trips started after obtaining employment at the new place of business. Our Committee supports this provision.

4. The Bill would add to deductible expenses those incurred in leasing a new residence at the new place of work (other than payments or prepayments of rent). Such expenses were not included among those deductible in the Treasury proposals or in previous bills. Our Committee affirms its support for this addition.

5. The Bill also makes technical provision to prevent the inclusion of deductible items in cost basis, which we heretofore recommended and believe sound.

6. The Bill would change the minimum distance from the present 20 miles to 50 miles for moves in respect of which expenses may be deducted. Our Committee believes the 20-mile test should be retained to permit the deduction of expenses incurred by employees incident to office and plant relocations between densely populated areas and suburbs.

7. The Bill would impose an overall limit of $2,500 ($1,250 for husband and wife filing separate returns) on the three new categories of deductible expenses (house-hunting, temporary living, and qualified residence sale, purchase or

lease expenses), with a sub-limit on expenses for house-hunting and temporary living of $1,000 ($500 for husband and wife filing separate returns). Our Committee affirms its previous position that it would be more desirable to impose a qualitative limit, based upon reasonableness or a prohibition of expenses that were lavish or extravagant, for expenses of all types other than those of disposing of the employee's old residence. However, if revenuo considerations require the imposition of dollar limitations, our Committee believes tho classification employed in the Bill not unreasonable.

IV. Lump Sum Payments from Qualified Retirement Plans [Bill, §515]

Summary of Changes

1. The Bill would confine capital gains treatment of lump sum payments from qualified pension, profit-sharing and similar plans to appreciation and income on employer and employee contributions, with employer contributions being subject to tax at ordinary income rates when payment is received.

2. The Bill would tax and in effect treat securities of the employer distributed under a qualified plan as part of, and on the same basis as, the employer's contribution, with only income and appreciation considered subject to capital gain. Taxation of the net unrealized appreciation in employer securities would continue to be postponed, as under present law, until the securities of the employer are sold (Code, §402(a)(1), second sentence, and §402(a)(2), second sentence).

3. (a) Benefits accrued after December 31, 1969 attributable to amounts contributed by the employer would be taxed as ordinary income under a five-year "forward" averaging formula (five times the increase in tax resulting from including 20% of the distribution in gross income). However, if the tax paid by the employee proves at the end of the five-year

period to be more than the tax that he would have paid in each of the five years during such period on 20% of the distribution, the employee would be entitled to a refund. If the employee dies before the fifth taxable year, recomputation of the tax with respect to the ordinary income portion of the distribution would be made by adding 20% of such distribution in each of the taxable years the employee lived of the five-year period (other than the taxable year ending with his death), and multiplying the average of the increase in tax so computed by five. If the recomputed amount is less than the tax actually paid, the employee's estate would be entitled to a refund.

(b) The carry-forward formula would be available only to employees who had been participants in the plan for at least five years.

(c) Although the amount taxed as capital gains would be eligible for averaging under the provisions of the Bill [§311] permitting capital gains to be included in income averaging, if the employee chooses the benefit of income averaging, the five-year carry forward averaging provision for the ordinary income element of the lump sum distribution would not be available to him (Code §1304(b)(2) as proposed to be amended by Bill §515(c)(4)).

Reasons Given for the Change

The following reasons are given by the House Ways and Means Committee for the proposed change in tax treatment of lump sum distributions:

1. The capital gains treatment of lump sum pension distributions was originally enacted in the Revenue Code of 1942 as a solution to the bunched-income problem of receiving an amount in one taxable year which has accrued over several years. Therefore, as a means of achieving an "averaging" effect for these amounts received in one year, Congress defined a lump sum distribution as a gain from a sale or exchange of a capital asset held for more than six months, subject to the more favorable capital gains tax rate - presently, a maximum of 25 percent, as compared to the top marginal tax rate which has ranged up to 91 percent.

The capital gains treatment allows employees to receive substantial amounts of what is in reality deferred compensation at a more favorable tax rate than other compensation for services rendered.

2. The more significant benefits from capital gains treatment of substantial amounts go to those with adjusted gross income of over $50,000.

Views of Our Committee

A. Specific Problems of the Bill

1. The complicated provisions of the Bill would create a number of practical problems of administration for both the Treasury and employers. A determination would have to be made of the portion of the distribution accrued by the employee before January 1, 1970. This may not be too difficult in the case of profit-sharing plans and pension plans of the money purchase type. Although there is a precedent for determination in the case of other types of pension plans in the present rules for determining the portion of a pension attributable to pre-1963 foreign service (Income Tax Regulation §1.72-8(a)(4)), the individual calculations are often quite complicated.

A determination would also have to be made of the portion of the distribution which is considered attributable to employer contributions for plan years after December 31, 1969. The House Ways and Means Committee indicated in its general explanation (House Report No. 91-413, page 155) that forfeitures would be treated as employer contributions for purposes of the new rules. The problem of determining which portion of a distribution is attributable to forfeitures, which portion is attributable to investment earnings and which

portion is attributable to employer contributions would be administratively complex and unduly burdensome, particularly in the case of the typical aggregate funded pension plan in which determinations are rarely made or records kept as to the amount of contributions made or investment earnings applicable to specific individual employees. It would add a highly expensive cost to make such determination or to maintain such records for individual employees, unnecessary to the proper administration of the plan.

2. The calculation of the amount of tax due on the lump sum distribution would be complex and unduly burdensome for employees, generally requiring the assistance of a tax advisor. In most cases, employees would be making an overpayment of the tax due and would be entitled to a refund five years later, even if distribution were made in the year after the employee terminates employment. The over-payment would be due to the fact that the employee's gross income for the year of distribution would be increased by one-half the distribution attributable to income and appreciation, putting the employee in a higher tax bracket than he would be in the years after the distribution. For an employee with long service, the income and appreciation portion of a distribution may amount to 40% or more of the total distribution.

B. <u>General Comments</u>

Without approving or disapproving the policy of special treatment for lump sum distributions, our Committee does not favor the Bill's substitution of the five-year forward averaging and refund provisions for the capital gains treatment of the portion of a lump sum distribution attributable to employer contributions, for the following reasons:

1. With the maximum capital gains tax rate of 25% and a top tax rate of 77% on ordinary income, there could be a substantial spread between the tax payable on a large distribution from a qualified plan paid in a lump sum and taxed at the 25% maximum capital gains rate and such distribution paid in installments or as an annuity and taxed at ordinary income rates. With the elimination of the 25% ceiling on capital gains and the lowering to 50% of the top tax rate on earned income, as proposed in the Bill, the discrepancy between the rate of capital gains tax on a lump sum payment and the rate of ordinary income tax on annuity payments in lieu of a lump sum will be sufficiently small in the preponderance of cases to call for continuation of the present simple method of taxing the entire lump sum payment in excess of employee contributions at capital gains rates.

The attached tables indicate that in most cases the amount of taxes payable if the distribution is made in

the form of an annuity would be less than the taxes payable if the distribution is made in a lump sum which is accorded capital gains treatment under the proposed new capital gains rules. For example, on a $25,000 total distribution, based on the assumptions outlined in the explanatory notes to the tables, the present value of the employee's total taxes for a 15-year period would be $3,436 if the distribution were paid in the form of a 15-year annuity, as compared to $3,660 if the distribution were paid in a lump sum and the net after tax proceeds reinvested to yield a return taxable as ordinary income over the 15 years. On a $100,000 distribution, with outside taxable income of $5,000 after retirement, the present value of the employee's taxes on a lump sum distribution would be $23,422, as compared to $20,615 representing the present value of taxes on a 15-year annuity. On a $200,000 distribution, with outside taxable income after retirement of $10,000, the present value of taxes for the 15-year period would be about the same for a lump sum distribution as for a 15-year annuity. Even in the atypical case of an employee with high outside taxable income after retirement and a large distribution from the plan, the disparity between the taxes on a lump sum distribution and the taxes on an annuity is not that great.

2. Our Committee believes that capital gains treatment of the entire lump sum distribution in excess of employee contributions, under the proposed new capital gains rules of the Bill, offers a simple alternative to the complex and administratively burdensome averaging approach of the Bill in solving the bunched-income problem caused by the receipt of the amount attributable to employer contributions in one taxable year.

3. A lump sum distribution from a qualified plan generally represents an amount which has accumulated over long years of service to an employer. Capital gains treatment of such lump sum distributions under the proposed new capital gains rules is a simple fair "averaging" method of taxing such distribution which has accrued over many years of service as an employee.

EXPLANATORY NOTES

The following tables show the difference in taxes payable under lump sum and annuity distributions of equal value, using tax rates proposed in H. R. 13270, as explained below. Taxes applicable to the lump sum distribution represent the present value of total taxes payable over a 15-year period. It is assumed that the total distribution is taxed as a capital gain in the year distributed and that the after-tax proceeds are reinvested to yield a 5% annual return taxable as ordinary income over the 15 years.

The taxes applicable to the annuity distribution represent the present value of total taxes payable over a 15-year period. The annuity payout is assumed to start at age 65, the normal retirement age, and the 15-year period represents the average life expectancy of a male aged 65 (Income Tax Regulations, Sec. 1.72-9, Table 1). The annuity payments are based on a 5% annual interest rate.

Taxes shown assume a married taxpayer filing a joint return under the tax rates proposed in H. R. 13270 for taxable years after 1971, assuming that the 25% alternative capital gains rate is not applicable. Present value of the taxes reflects the application of a 5% compound discount factor to tax payments for the second through fifteenth years.

In Table 1 it is assumed that the employee has other income in each of the 15 years, beginning with the year distribution is made or the annuity commences but that the employee's deduction and exemptions equal such other income.

In Tables 2, 3 and 4 taxes are computed on two bases: the first assumes no other taxable income; the second assumes a specified amount of other taxable income each year.

Computations for these tables were prepared by Theresa B. Stuchiner with the assistance of George B. Buck Consulting Actuaries, Inc. Presentation of these tables was prepared by Towers, Perrin, Foster & Crosby, Inc.

TABLE 1 - $25,000 TOTAL DISTRIBUTION

	Lump Sum Distribution	Annuity Distribution
Taxes (Present Value)	$ 3,660	$ 3,436
Taxes as Percent of Total Distribution	14.6%	13.7%

TABLE 2 - $100,000 TOTAL DISTRIBUTION

	Lump Sum Distribution	Annuity Distribution
Taxes (Present Value) Assuming No Other Taxable Income	$ 21,848	$ 17,054
Taxes as Percent of Total Distribution	21.8%	17.1%
Taxes (Present Value) Assuming $5,000 Other Taxable Income	$ 23,422	$ 20,615
Taxes as Percent of Total Distribution	23.4%	20.6%

TABLE 3 - $200,000 TOTAL DISTRIBUTION

	Lump Sum Distribution	Annuity Distribution
Taxes (Present Value) Assuming No Other Taxable Income	$ 53,704	$ 40,918
Taxes as Percent of Total Distribution	26.9%	20.5%
Taxes (Present Value) Assuming $10,000 Other Taxable Income	$ 57,436	$ 56,561
Taxes as Percent of Total Distribution	28.7%	28.3%

TABLE 4 - $500,000 TOTAL DISTRIBUTION

	Lump Sum Distribution	Annuity Distribution
Taxes (Present Value) Assuming No Other Taxable Income	$ 167,555	$ 157,568
Taxes as Percent of Total Distribution	33.5%	31.5%
Taxes (Present Value) Assuming $20,000 Other Taxable Income	174,939	$ 215,966
Taxes as Percent of Total Distribution	35.0%	43.2%

33-865 O - 69 - pt. 2--42

V. Restricted Property [Bill, §321]

The subject of restricted property has been under study by the Committee on Employee Benefits for several months and may be made the subject of a separate report.

Pending completion of that study, our Committee made three recommendations, set forth in the Summary to this Report, relating to the transitional rule and clarification of certain provisions of the Bill.

VI. Payments to Non-Qualified Trusts and Annuity Plans [Bill, §321(b)]

1. The Bill would apply to beneficiaries of non-qualified trusts and annuity contracts the proposed rules applicable to restricted property. Thus if an employer makes contributions to a non-qualified trust or under a non-qualified annuity plan and the employee's rights are forfeitable when the contribution is made but later become non-forfeitable, the employee would be taxed on the contribution at the first time his rights are not subject to a substantial risk of forfeiture. Under the present tax rules, if the employee's rights are forfeitable at the time the contribution is made, the employee is not subject to tax at the time his rights become non-forfeitable but is subject to tax only when distribution is made (except in the case of annuity contracts purchased by an employer exempt under Section 501(a) or 521(a) in which case the employee is subject to tax when his rights change from forfeitable to non-forfeitable except to the extent excludible under Section 403(b)).

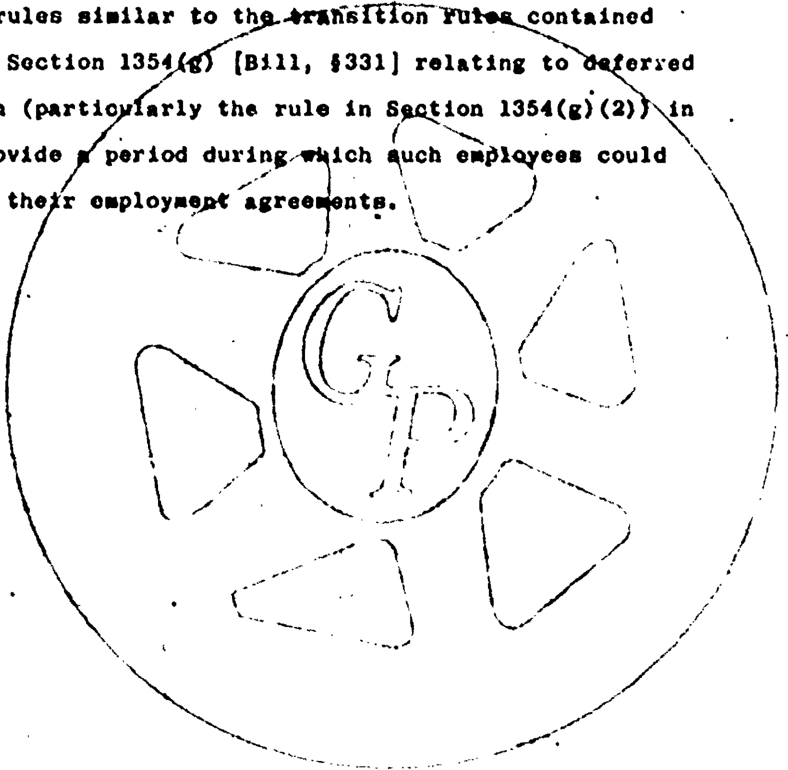
2. The proposed rules would apply in two general situations: (a) contributions made under a qualified plan for employees which loses its tax-exempt status (either permanently or temporarily) and (b) funded deferred compensation arrangements, under which the employees' rights are forfeitable at the time the contributions are made.

3. Our Committee agrees with the principle proposed by the Treasury Department and accepted in the Bill that the tax rules relating to payments to non-qualified trusts and under non-qualified annuity plans should generally correspond to the tax rules relating to restricted property. To achieve such conformity, the present tax rule on deductibility of employer contributions to non-qualified plans (Code §404(a)(5)) would also have to be changed to conform to the tax rule on deductibility of payments in the form of restricted property.

4. Our Committee believes, however, that the application of the proposed rules could have unforeseen and harsh results in the case of qualified plans which inadvertently lose their tax-exempt status. The employees covered under such a plan would be subject to tax at the time their rights become vested or would be taxed immediately if their rights were not subject to a substantial risk of forfeiture. This result would occur in the case of disqualification because of a prohibited transaction even though the prohibited transaction were to be cured and the trust were to qualify for tax exemption in a later year. Moreover, since withholding would probably be required with respect to this income, the employees take-home pay would be reduced even though no distributions were made to the employees from the trust.

5. In a number of instances, funded (rather than unfunded) plans of deferred compensation have been utilized

as a result of bargaining between exempt organizations and key employees. As in the case of deferred compensation arrangements, the result of this bargaining is reflected in existing employment contracts. This is especially true of exempt organizations that are not entitled to the benefits of Section 403(b) of the Code. Since the enactment of Section 321(b) of the Bill would eliminate the use of such funded deferred compensation plans, it would seem appropriate to provide rules similar to the transition rules contained in proposed Section 1354(g) [Bill, §331] relating to deferred compensation (particularly the rule in Section 1354(g)(2)) in order to provide a period during which such employees could renegotiate their employment agreements.



VII. Other Deferred Compensation [Bill, §§802, 331]

Summary of Changes

The Bill contains two sets of provisions affecting deferred compensation payments:

1. The Bill provides that the highest graduated rate on "earned income" will not exceed 50 percent for any taxable year beginning after December 31, 1969, but would exclude "any deferred compensation payment" from the definition of "earned income." (§802)

2. Income tax on deferred compensation payments would continue to be deferred until the year of receipt, but a minimum tax would be imposed on such payments to the extent that they exceed $10,000 in any year. (§331)

(a) The minimum tax would be the lower of two alternative amounts:

(i) The first alternative amount would be the aggregate increase in tax resulting from adding to the employee's taxable income for each taxable year in which the excess is deemed to have been earned, the portion of the excess over $10,000 deemed to have been earned in that taxable year. For this purpose (and for purposes of determining the second alternative amount) the deferred compensation would be deemed to have been earned ratably over the employee's entire

period of service with the employer (or any predecessor or successor, or parent or subsidiary, of the employer), or over a portion of the period of service if, under regulations to be prescribed, the payment is properly attributable to a portion of the period. This alternative amount could be used only if the taxpayer supplies such information as the regulations prescribe with respect to his income for each taxable year in which the deferred compensation payment is deemed to have been earned.

(ii) The second alternative amount would be determined under a short-cut method which would be used if the taxpayer does not supply the information with respect to his income that would be required by regulations for each taxable year in the earning period or in cases in which a lower minimum tax would result -- generally, cases where the employee's income has declined in his last ten years with the employer. Under this method, the average increase in tax would be computed with respect to the portion of the excess over $10,000 deemed to have been earned in the three taxable years for which the employee's taxable income is highest during the last ten years of the earning period.

(iii) For purposes of applying either alternative, the employee's taxable income for each taxable year in the earning period would be first increased by any amount added to the taxable income for that year with respect to any deferred compensation payment received previously.

(b) The term "employee" would include any individual who performs services for any person, even if the individual is not regarded as the employee of that person for any other purpose under the Code.

(c) The above described provisions would not apply to any deferred compensation payment made under a written plan which meets the non-discrimination requirements of Section 401(a) of the Code, or which would meet such requirements but for the fact that the plan is unfunded, or under a plan in existence on August 4, 1969, which is amended to meet these requirements before January 1, 1972.

(d) Although the amendments would apply with respect to taxable years ending after June 30, 1969, the minimum tax would not apply (1) to the ratable portion of any deferred compensation payment attributable to a taxable year beginning before January 1, 1970, or (2) to the ratable portion of any deferred compensation payment attributable to a taxable year beginning before January 1, 1974, if paid or made available

pursuant to an obligation which was binding on July 11, 1969, and at all times thereafter, without regard to the effect of any possibility of forfeiture by the employee.

Reasons Given for the Changes

1. The general reason for the 50-percent maximum tax on earned income is to reduce the incentive for the use of tax loopholes by highly compensated individuals. With respect to the exclusions from the definition of earned income, the explanation of the provision by the House Ways and Means Committee states as follows:

> ". . . Earned income does not include lump-sum distributions from employee's trusts or employee annuity plans when long-term capital gains treatment is afforded the employer's contribution, nor does it include the employer's contribution if that is eligible for the special averaging rules applicable if the total distribution occurs in one year. In addition, any deferred compensation is not to be considered earned income." (House Report No. 91-413 (Part 1), page 209)

2. The general reasons given for the minimum tax provision are that highly compensated individuals who are able to bargain for discriminatory deferred compensation arrangements should not be able thereby to reduce the rates of tax that would have otherwise been applicable thereto. The House Ways and Means Committee Report states:

". . . Your Committee believes that the 50-percent limitation on the marginal tax rates applicable to earned income contained in its bill is a further reason for the adoption of this provision." (House Report No. 91-413 (Part 1), page 90)

3. The arguments in favor of the provision were summarized as follows by the Staffs of the Joint Committee on Internal Revenue Taxation and the Senate Committee on Finance:

"(1) This provision is supported on the basis that the employee who receives deferred compensation has received, in most cases, a valuable contractual right on which an immediate tax could be imposed, and the bill represents a reasonable compromise between immediate taxation and complete deferral. The payment of the tax is deferred until the compensation is actually received, but the original marginal rate is preserved as a minimum rate.

(2) The tax treatment of deferred compensation should not depend on whether the amount to be deferred is placed in trust or whether it is merely accumulated as a reserve on the books of the employer corporation, because an unfunded promise by a large, financially established corporation is probably as sufficiently sound as the amount of deferred compensation which is placed in trust. Usually these benefits are not available to the average employee-taxpayer.

(3) The possibility of shifting income from high-bracket years to low-bracket years after retirement is generally available only to high-bracket and managerial employees who are in a financial position to demand them -- not to the average employee.

(4) Another provision of this bill reduces maximum tax on earned income to 50 percent. With this lower rate, the incentive to seek deferral is lessened and the special tax treatment of deferred compensation can be ended without harsh consequences." (Summary of H.R. 13270, the Tax Reform Act of 1969, page 53)

Views of Our Committee

1. Our Committee believes that enactment of the 50-percent maximum tax on earned income should itself be sufficient to reduce the future use of those deferred compensation arrangements stimulated by the desire of employees to shift taxable income into low-bracket tax years after retirement. Our Committee therefore believes it inappropriate and unnecessary to enact tax measures against individual deferred compensation arrangements represented by (a) the general exclusion of deferred compensation payments from the definition of earned income and (b) the additional minimum tax provision. These provisions impose a new, complex and, we believe, unnecessary set of tax rules very difficult to administer. Such new rules will make it difficult for employers, and particularly small and medium-sized corporations, to make arrangements prompted primarily by the proper business purpose of conserving corporate cash for current business needs or assuring continued employment and non-competition by key employees.

2. Our Committee believes that it would be appropriate to exclude from "earned income" entitled to the 50-percent limitation on marginal tax rates, those deferred compensation payments deemed earned during years prior to the effective

date of enactment of the Bill.

3. On the other hand, if deferred compensation in excess of $10,000 is to be taxed as current compensation in the year in which earned, it should in equity be considered "earned income" in the year in which earned and subject to the 50-percent maximum rate of tax, unless deferred compensation arrangements are considered so much against public policy as to call for a discriminatory penalty tax.

4. With respect to deferred compensation earned after the effective date of the Bill, it would seem that the benefits to be gained by the combination of the exclusion of the 50-percent rate plus the minimum tax are not proportionate to the administrative and computational complexity that will result. The 50-percent maximum rate will tend to assure that most highly compensated employees will not seek such arrangements except perhaps as a compulsory savings device, to provide a continuing source of income in later less productive years. If the 50-percent maximum rate is enacted, we see no reason why the tax law should otherwise affirmatively discourage such arrangements.

Technical Questions Raised by Provisions of the Bill

Maximum Tax Rate on Earned Income

1. There is no definition of "any deferred compensation payment" in Section 802 of the Bill or in the House Ways and Means Committee Report, other than the statement, referred to above, that "any deferred compensation is not to be considered earned income." The question presented is whether the term "deferred compensation" in Section 802 is to be limited to payments under non-qualified plans and arrangements, or whether it also includes distributions under plans which are qualified under Sub-chapter D. Distributions under qualified plans are payments of deferred compensation and expressly so referred to in the title to Sub-chapter D.

Inasmuch as Section 802 specifically excludes distributions under qualified plans to which the special averaging rule or capital gain treatment applies, it is believed that other payments or distributions under qualified plans are not intended to be excluded. If exclusion of all payments and distributions under qualified plans of deferred compensation had been intended, it would not have been necessary expressly to exclude the types of qualified plan distributions now enumerated in Section 802 of the Bill.

If the intention is as stated above, it would appear to be advisable to amend Section 802 of the Bill to provide expressly that payments of deferred compensation under plans or arrangements not qualified under Sub-chapter D are excluded from the definition of earned income. In addition, if the ordinary income portion of any qualified deferred compensation distribution is not to be excluded from the right to maximum tax under Section 802, it would be well to specify that it is the portion of any distribution which is taxed under Section 72(n), 402(a)(2) or 403(a)(2) that is excluded.

2. Many incentive plans provide for the award and payment of bonuses after the end of the taxable year, computed by reference to corporate earnings and employee performance during such year. Payments under such plans would literally be excluded from the definition of earned income. Consideration should be given to providing that all payments received prior to retirement, death or other termination of employment would not be considered deferred compensation within the meaning of the Bill.

3. Many deferred compensation plans involve payments which are measured by the value of stock of the employer contingently credited to the accounts of employees, plus dividend equivalents in respect of such stock, or payments that may otherwise be subject to increase by interest equivalents. The Bill leaves open the question of the years to which such increases would be attributable.

4. Similar definitional questions are presented by the items of income arising in the following circumstances:

(a) Disqualifying dispositions under statutory or qualified stock options;

(b) The exercise of non-statutory stock options;

(c) The vesting of previously forfeitable interests under restricted stock plans (Bill, §321(a)) and funded non-qualified deferred compensation arrangements (Bill, §321(b)).

Since the above-described items of income do not involve "payments" to the employee by the employer, they might well be entitled to the 50-percent maximum rate of tax, but the broader reference in the House Report indicates that the exclusion may not be limited to "payments."

5. Another question is whether payments will be considered "earned income" or "deferred compensation payments" when the right to receive such payments is dependent upon consultation and advisory services, non-competition, and other types of "earn-out" arrangements.

6. The minimum tax provision evidences an intention to encourage non-discriminatory non-funded deferred compensation by excluding them from the minimum tax. Nevertheless, such arrangements do not appear to be entitled under the Bill to the maximum 50-percent rate of tax on earned income. The reason for this disparity in tax treatment is not apparent.

Minimum Tax on Deferred Compensation Payments

1. It is clear under the Bill that no portion of a deferred compensation payment (whether more or less than $10,000) would be entitled to the 50-percent maximum tax. It is not clear, however, whether the 50-percent maximum rate applies for the purpose of the alternative minimum tax calculations. Under both of the alternative methods, the minimum tax is determined by adding to the "taxable income" of certain prior years the "portion of such excess deemed to have been earned in each such year." The Bill does not specify whether, for this purpose, the "portion of the excess" added to the "taxable income" of each prior year is to be considered "earned income" that would have been eligible for the 50-percent limitation in such year.

The 50-percent maximum tax provision of the Bill expressly excludes "deferred compensation payments," but it does not expressly exclude any amount deemed to have been earned. Therefore it might well be argued that an amount deemed to have been earned during the prior year should be considered earned income for the purpose of computing the additional tax liability that would have been due with respect to that year if the amount earned had been paid during that year. Note also that if such amount earned had been paid it would have been eligible for the 50-percent maximum rate of

tax, inasmuch as such payment would not have been deferred compensation for such prior year.

If it was the intention to allow the 50-percent maximum tax to apply to the amounts deemed earned, little if any additional tax will result if such payments are not subject to the limitation for the purpose of computing the tax otherwise applicable to the year of receipt. If, on the other hand, the limitation is not available for the purpose of computing the additional minimum tax, the Bill will operate in punitive fashion against deferred compensation arrangements which are prompted by corporate business reasons.

2. The minimum tax provisions leave open a number of questions:

(a) The minimum tax provision of the Bill states that, "If an individual receives a deferred compensation payment during the taxable year, the tax . . . which is attributable to the excess (if any) of such payment over $10,000 shall not be less than" the minimum tax. The reference to a "payment" raises the question whether the minimum tax is to be computed separately with respect to each such payment. Inasmuch as many arrangements for deferred compensation provide for more than one payment during the year, e.g., monthly or quarterly, the provision should be amended to make it clear that the computation is to be made with respect to all payments of deferred compensation received during the year from whatever source.

33-865 O - 69 - pt. 2--43

(b) How is the period of time over which the payments are deemed to have been earned, as stated in new Code Section 1354(c), to be determined? Under both alternatives, such period is deemed to be the employee's entire period of service with the employer (including any successor or predecessor or a parent or subsidiary) "or a portion of such period, if, under regulations prescribed by the Secretary or his delegate, such payment is properly attributable to such portion." Since deferred compensation payments are almost always made pursuant to written contractual arrangements, it seems likely that such payments will in most cases be attributed to a shorter period of time than the entire period of employment, except in the case of the executive who enters into such a contractual arrangement when he joins a new employer at a high level.

(c) The first alternative provided by Section 1354(a)(1), under which a portion of the excess is added to the taxable income of each year in which it is deemed to have been earned, is applicable only if the information requirement of Section 1354(e) is satisfied. The nature of the information that will be required is not indicated. It would seem that what might reasonably be required is a computation of the taxable income, with and without the earned amount attributable to each of the taxable years over which the deferred compensation payment is deemed or

claimed to have been earned. This would seem to be justified by the administrative difficulties that might otherwise be encountered if the taxpayer did not supply the figures from his returns of prior years, figures which are often difficult for revenue agents to obtain, even though they are on file with the Service.

Nevertheless, it will be necessary for the Treasury to have this information available for the last ten years for the purpose of making the second alternative computation, so that the second alternative seems to be a punitive provision for failure to keep records.

3. The relationship between the transition rule (§331(a)) and the effective date provisions of the Bill (§331(c)) are not entirely clear and should be clarified.

October 7, 1969.

Hon. Russell B. Long,
Chairman, Committee on Finance,
U.S. Senate, Washington, D.C.

Dear Sir: Transmitted herewith are 50 copies of a Report of the Committee on Taxation of the Association of the Bar of the City of New York on H.R. 13270, the Tax Reform Bill of 1969, as passed by the House of Representatives on August 7, 1969.

The Report covers most of the major topics covered by the Bill, but within the time available for preparation of the Report it has not been possible to cover some topics at all and other topics as fully as they should be covered. The Committee on Taxation understands that the Report will be printed in the record of your Committee's hearings and given the same consideration as though delivered orally.

As stated in the Report, the comments contained therein represent a consensus and not the individual view of any particular member of the Committee on Taxation on any particular provision of the Bill.

Respectfully submitted.

Robert J. McDonald,
Chairman, Committee on Taxation.

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TABLE OF CONTENTS

Introduction.
Comments on the Bill.
Limit on Tax Preferences and Allocation of Deductions.
- General.
- Percentage Depletion and Intangible Drilling and Exploration Costs.
- Untaxed Appreciation in Charitable Contributions.
- Tax-exempt Bonds.
- $10,000 Allowance for L.T.P.
- Effect on Partnerships and Subchapter S Corporations.
- Capital Gains.
- Allocable Expenses.
- Effective Date.

Capital Gains.
- General.
- Rates.
- Revision of Limitation of Capital Losses of Individuals.
- Holding Period.
- Effective Date.
- Treating Letters and Memoranda as Non-capital Assets.
- Section 1231 of the Code.
- Transfers of Franchises.
- Lump Sum Distributions from Qualified Pension and Profit-Sharing Plans.

Maximum Limitation on "Earned" Income.
- General.
- "Earned Income."
- Formula.
- The Effect of the 50% Rate.
- Averaging.

Restricted Property and Other Deferred Compensation.
- Restricted Stock.
- Non-qualified Employee Trusts.
- Other Deferred Compensation.

Qualified Plans of Subchapter S Corporations.
Income Averaging.
Debt Financed Acquisitions.
Limitation on Deduction of Interest.
Depreciation Allowed Regulated Industries.
Stock Dividends.
Natural Resources.
Charitable Remainder Trusts.
- Substantive Provisions.
- Effective Dates.
- Charitable Deductions for Trusts and Estates.

Repeal of the Unlimited Charitable Deduction.
Accumulation Trusts, Multiple Trusts, etc.
- Unlimited Throwback.
- Income for Benefit of Grantor's Spouse.

Real Estate Depreciation.
Multiple Corporations.
- General.
- Definition of "Controlled Group."
- Policy Considerations.

Moving Expenses.
Private Foundations.
- General.
- Tax on Private Foundation Investment Income.
- Tax on Termination of Private Foundation Status.
- Special Rules with Respect to Section 501(c)(3) Organizations.
- "Private Foundation" Defined.
- Taxes on Self-dealing.
- Taxes on Failure to Distribute Income.
- Taxes on Excess Business Holdings.
- Taxes on Taxable Expenditures.

THE ASSOCIATION OF THE BAR OF THE CITY OF NEW YORK

October 3, 1969

Report of the Committee on Taxation on H.R. 13270

Introduction

H.R. 13270, the Tax Reform Bill of 1969 (the "Bill") passed by the House of Representatives (the "House") on August 7, 1969, has been characterized as "the most sweeping tax reform measure in the history of the Internal Revenue Code" by the Secretary of the Treasury, David M. Kennedy.

The Committee on Taxation (the "Committee") subscribes to the principle that fundamental reform of the Internal Revenue Code of 1954 (the "Code") has long been needed. By a reluctant consensus, it agrees that if H.R. 13270 is appropriately amended to eliminate at least some major inequities and errors, it is the best legislation that can now be enacted, and that it should be adopted rather than abandoned. Subject to that comment, the Committee believes that:

1. The Code is already far beyond the capacity of the great majority of tax experts, not to mention the rank and file of taxpayers, to understand sufficiently to allow accurate and forward-looking tax planning. Further, because of its complexities, enforcement has become at best inconsistent and at worst arbitrary. The Bill adds 368 pages of complicated and intricate provisions to this complexity, and as such does not accomplish what has long been considered a fundamental of tax reform—*simplification of the Code.* It is believed that even at the expense of some lack of symmetry in its provisions and perhaps even some inequities, the Code and the Bill must be simplified.

2. The Bill is in many respects a piecemeal approach to reform which attempts to correct or partially correct certain tax inequities while at the same time ignoring other tax inequities, which in any tax sense are similar. This is due, among other rea-

sons, to the bias of particular groups with political muscle and to the unhappy practice which has grown up over the years of attempting to use the federal income tax as a mechanism (albeit imperfect) for providing subsidies or regulating conduct.

(a) It is recommended that, in considering what provisions should appropriately be included in or excluded from the Bill, the principal consideration should be the raising of revenues in the most efficient and equitable fashion. If certain businesses or individuals need special subsidies, incentives or regulation, that should be provided by direct subsidies, appropriations or regulation and not through the inefficient, arbitrary and recurring mechanism of a continuing tax statute.

(b) It is recommended that consideration be given to broadening the tax base even more than the Bill provides by the elimination or greater reduction of personal deductions and special preferences, but that such broadening should only occur if more realistic top rates (50% or below) be placed on all income. This would have the added effect of narrowing the available tax arbitrages and would diminish the incentive to defer the receipt of taxable income.

3. Tax reform has been considered necessary for many years by the government and the rank and file of taxpapers, but it has been delayed because of the difficulty in obtaining a consensus with respect to the scope of such reforms. While a consensus in favor of the Bill may now be possible, the Committee notes that: (i) the reform measures are controversial, complicated and difficult to analyze in their effects; (ii) many of the practices to be reformed have been approved by Treasury and Internal Revenue Service authorities by rulings and published policy; (iii) no single taxpayer should be prejudiced unduly by a change in the law with respect to existing transactions from which the taxpayer may only extricate himself at substantial economic detriment; and (iv) it should not prejudice the government unduly to permit presently allowed transactions to continue for a period of time before changing the tax consequences thereof. For these reasons, the Committee recommends that no provision of the Bill (with certain exceptions, such as the investment credit repeal and perhaps the restricted stock provisions) should become effective until January 1, 1970. A review should be made with respect to the effective date of certain provisions

to ascertain whether a later effective date is required to prevent undue hardship with respect to existing transactions which continue after December 31, 1969, such as the provisions of section 305 of the Code already included in the Bill which continue certain existing rules with respect to outstanding stock until 1991.

COMMENTS ON THE BILL

The comments of the Committee contained in this Report in respect of the Bill represent a consensus and not the individual view of any member of the Committee with respect to any provision. These comments are necessarily incomplete in view of the short period of time available to consider the Bill and comment thereon.

LIMIT ON TAX PREFERENCES and ALLOCATION OF DEDUCTIONS

Sections 301 and 302 of the Bill, §§ 84, 218 and 277 of the Code

General

Two of the cornerstones of the Bill which limit the amount of economic income that an individual may shelter from tax through preferential treatment contained in the Code are the Limit on Tax Preferences ("L.T.P.") and allocation of deductions.

In the Report of the Committee on Ways and Means accompanying the Bill (the "House Report"), it is estimated that the revenues from L.T.P. and allocation of deductions are $40,000,000 for 1970 ($85,000,000 when fully effective) and $205,000,000 in 1970 ($460,000,000 when fully effective), respectively. In view of the great complexities of L.T.P. and the limited effect on revenues, it is recommended that L.T.P. be abandoned, but only if the tax advantages in the absence of L.T.P., to the extent that items included in L.T.P. are considered unwarranted or excessive, are resolved by allocation of deductions; if not, a simpler formula should be found for accomplishing the desired result.[*]

[*] For example, if the only L.T.P. of a particular taxpayer is a capital gain, there is no L.T.P. disallowance. If such taxpayer has $50,000 of ordinary net income and $1,000,000 of capital gains of which only $500,000 is taken into account in computing adjusted gross income, there is no disallowance because such L.T.P. item never can exceed 50% of gross income.

If L.T.P. is retained, it is believed that its provisions should be carefully integrated with the allocation of deduction provisions and made more consistent in application. Thus, the two provisions should be the same in respect of the L.T.P. items included in each section, and adjustments to basis should be made similar.

Percentage Depletion and Intangible Drilling and Exploration Costs

The provisions of the Code which are considered by most taxpayers as allowing perhaps the greatest unwarranted tax avoidance are those concerning percentage depletion, at least to the extent it exceeds cost depletion, and intangible drilling cost deductions (which are immediately deductible even though a commercially producing well results from such expenditures). This may be because they have been the most publicized. It is not the province of the Committee to determine whether the oil, gas and mineral activities of U. S. taxpayers require subsidies, but the Committee believes that if such subsidies are essential to national welfare, it is uneconomic and wasteful, and consequently unfair, to provide the subsidies through tax laws which have continuing application without regard to the continuing need for subsidy. Rather it is better provided, if necessary, by direct subsidies. If it is not possible to amend the Code to eliminate the subsidy afforded by the allowance of a percentage depletion deduction in excess of cost depletion and the right to deduct immediately the intangible drilling cost or exploration costs (to the extent presently allowed by the Code) of a commercial oil or gas well or a producing mine, it is recommended that both such excess of percentage depletion and intangible deductions be included in L.T.P. as well as allocation of deductions. It is believed that if these items are not included in L.T.P. as well as allocation of deductions, a measure of public support for the Bill will be missing.

It is believed that the recommendation of the Treasury Department in its reports to the Senate Finance Committee on September 4, 1969 and September 30, 1969 (the "Treasury Reports") to include intangible drilling expenses and percentage depletion as tax preferences for both L.T.P. and allocation of deductions should be adopted, but its recommendation to exclude intangible drilling cost deductions from L.T.P. and allocation of deductions in the case of persons deriving at least 60% of their gross income from the sale of oil and gas should not

be adopted. This latter recommendation is an open invitation to shelter 40% of gross income, and, further, it greatly favors individuals already entrenched in the business as against new entrants.

Untaxed Appreciation in Charitable Contributions

While the Treasury Reports' recommendation of deleting this item for both L.T.P. and allocation of deductions purposes might be justified as a matter of policy with respect to charitable giving, the Committee notes that it would leave unresolved the public concern with abuses in this area with which the House was concerned.

Tax-exempt Bonds

All such bonds, including U. S. government bonds, should be treated similarly for L.T.P. and allocation of deductions, and not only as an L.T.P. item for allocation of deduction purposes.

$10,000 Allowance for L.T.P.

In order to confine the operation of L.T.P. to individuals with substantial amounts of tax preference income, a certain minimum amount of tax preferences is to be permitted. The Bill proposes to set this minimum amount at $10,000 ($5,000 for a married person filing a separate return).

In the view of the Committee, the proposed minimum is too low and engenders — rather than resolves — certain inequities. It would, for example, render L.T.P. applicable to an individual (very possibly retired or widowed) having $11,000 of economic income, of which $10,000 is tax preference income, such as tax-exempt interest. By the same token, L.T.P. would not apply (because of the allowance of preferences up to 50% of economic income) to an individual with $200,000 of economic income, $100,000 of which consists of tax preferences. When tested against the references in the House Report to taxpayers having $200,000 or more of economic income but paying tax at relatively low effective rates, the $10,000 minimum seems unduly harsh. Moreover, it hardly seems wise or necessary to impose the additional record-keeping and tax computation requirements of L.T.P. on individuals who do not have truly substantial amounts of both economic and tax preference income.

For these reasons, it is recommended that consideration be given to increasing the minimum amount, say, to $25,000. This would confine the application of L.T.P. to individuals having economic incomes exceeding $50,000 of which more than $25,000 represents tax preferences. As a practical matter, it is doubted whether there are many individuals with economic incomes of less than $50,000 who derive more than half of such income from tax preference items; in any event, the policy of L.T.P. does not seem to be directed at such persons.

Effect on Partnerships and Subchapter S Corporations

The application of L.T.P. and allocation of deductions to partnerships or individual partners is unclear and should be carefully reviewed to ascertain how the provisions should apply. Since the solution to such problems will be so essential to tax planning, the statute itself should contain the solutions, not the regulations which may not be promulgated for months or even years. For example one of the most difficult conceptual problems which honeycombs the Bill is the manner by which individual items (e.g., interest expense, accelerated depreciation excess) flow through, or should flow through, a partnership to its partners or a subchapter S corporation to its shareholders. How this flow-through works under the L.T.P. and allocation of deduction provisions is impossible to ascertain.

Problems also arise on the formation of partnerships. Suppose that individual A who owns income producing securities or real estate worth $1,000,000, and is not subject to L.T.P., and individual B who owns tax-exempt securities worth an equal amount, but is subject to L.T.P., decide to contribute their respective holdings to a 50-50 partnership. Each partner's distributive share of each partnership item of income and deduction is determined under the partnership agreement in accordance with his distributive share of taxable income or loss of the partnership. As a result, 50% of the tax-exempt interest previously attributable to B's holdings is shifted to A, and thus (1) neither A nor B is subject to L.T.P.; and (2) quite possibly A and B has each increased his after-tax income. Is it intended that this simple arrangement, or other more complicated arrangements that might be devised, would suffice to avoid L.T.P.?

Capital Gains

The proposed treatment of capital gains in the Bill presents highly complex philosophical problems of federal income taxation. The failure of the Code or the Bill to provide any adjustment in historical basis for the effects of inflation makes the approach of the Bill to capital gains difficult to analyze. For example, suppose A buys a building on January 1, 1970 for $100,000, and on January 2, 1980 A sells the building for $190,000; assume also that the increase in value is attributable solely to the effects of inflation. A serious question is raised as to whether the $90,000 excess over historical cost is income or ought to be considered income for any purpose. Admittedly, the example oversimplifies the problem, but the effects of inflation exist to some extent in all capital gains or losses. While difficult to trace, the answer should not be to ignore the effect and tax as income something which is not income in an economic sense.

The inclusion of capital gains in L.T.P. sometimes gives rather an odd result. If the only L.T.P. is a capital gain, there will never be a disallowance under the L.T.P. provisions; it is only when combined with other L.T.P. items that any disallowance will result.

It might be appropriate to give consideration to the exclusion, from L.T.P. and allocation of deductions, of capital gains:

(i) from the sale of a personal residence;

(ii) from a lump sum distribution from a qualified pension or profit sharing plan;

(iii) from a capital gain qualifying as such under section 1231 of the Code other than arising from property covered by a net lease;

(iv) from the sale of property produced primarily by the efforts of the seller, such as a picture or an invention, or a building substantially built by the seller; and

(v) from property held for a long period of time, say, ten years.

Allocable Expenses

The definition of "allocable expenses" apparently includes items deductible in computing "adjusted gross income" but attributable to a trade or business, such as interest, taxes and casualty losses attributable to property held for the production of rents and royalties. Since these items may be part of the cost of, and directly related to, the earning of taxable income, the definition of "allocable expenses" in section 277 should be clarified to exclude such expenses. The allocation of state income taxes attributable to earned income seems especially harsh.

The full amount of unrealized appreciation on charitable contributions is included in the numerator of the section 277 fraction, but if the appreciation were realized prior to making the contribution, only one half of the appreciation would be included in the numerator, assuming the appreciation is a long-term capital gain. This may create an odd disparity in tax treatment between selling appreciated property and giving the proceeds to charity, on the one hand, and merely donating the appreciated property to charity.

Example: Assume a taxpayer has $3,000,000 of ordinary income, $2,000,000 of non-charitable allocable expenses, and has a choice of giving zero basis property worth $1,000,000 to charity or selling the property and giving $1,000,000 cash to charity. Total allocable expenses will thus be $3,000,000. Assume there is no section 170 limitation, and that L.T.P. will not apply in either case. If he gives the property to charity, his allocation formula will be $990,000/$3,990,000 (or .248) x $3,000,000. If he sells the property and gives the proceeds to charity, his allocation formula will be $490,000/$3,990,000 (or .124) x $3,000,000. Thus, by selling the property, he will receive $372,000 in additional allowable deductions. In this example, the tax saving on the additional deductions even at a 70% rate would not fully offset the capital gains tax, but this may not always be the case.

There is no carryover of disallowed allocable expenses under section 277. While this may be reasonable in the case of preference income which is never taxed, it is not reasonable in the case of tax

deferral preferences such as accelerated depreciation on real property. In such a case the taxpayer presumably will have to repay the tax saving attributable to the accelerated depreciation in the early years, but he will never recover the portion of expenses disallowed because of such accelerated depreciation. Possible solutions are (a) to add to section 277 a carryover of disallowed allocable expenses provision, (b) to eliminate accelerated depreciation on real property from the allocation provisions and to revise section 1250 to defer allowance of a portion of deductions related to depreciable real property as the cost of its accelerated depreciation, or (c) allow a basis adjustment. The Treasury Reports recommend a basis adjustment which would apply first to section 1250 income. The Committee agrees with this approach.

The treatment of investment interest as an allocable expense without reduction by investment income (e.g., rental income in the case of net leases) seems inappropriate. This is inconsistent with the approach adopted in Section 221 of the Bill and should be corrected in the allocation of deductions provision even if Section 221 is not adopted.

Effective Date

The effective date provisions of L.T.P. and allocation of deductions, like many provisions of the Bill, present knotty problems. While it may present difficult problems of administration, equity towards taxpayers suggests relief be afforded to transactions already in place and to other items in respect of which the economic impact has already occurred. For example, certain transactions involving interest payments are, as indicated above, locked in place and to disallow part of the interest thereon until loans in respect thereof are discharged in normal course may result in severe hardship; in respect of such transactions, the interest could be exempt from allocation and the excess of accelerated over straight line depreciation excluded from L.T.P.

Such in-place transactions have been approved either by specific Internal Revenue Service rulings or by tax policy evidenced by published rulings; tax reform has been a long time coming and there should be no compelling policy reason to change the tax consequences of such transactions before the entire transaction is closed out.

CAPITAL GAINS

Sections 461 and 511-516 of the Bill, §§ 72(n), 402(a), 403(a), 516(b), 1001, 1201, 1211(b), 1212(b), 1221(3), 1222, 1231(a) and 1252 of the Code

General

In addition to the provisions mentioned above in connection with L.T.P. and allocation of deductions, the Bill contains many revisions of the Code dealing with the taxation of capital gains and related matters. This report will evaluate some of these proposed changes in the context of the present structure of the Code to the extent practicable. However, the Committee wishes to reiterate, what has been suggested by many others, that there has developed over the years substantial logical support for the idea of entirely eliminating the capital gains notion from the Code—which change would permit an incredible simplification of our tax law and would reduce the pressure to abuse the tax structure by seeking loopholes and unwarranted arbitrages. Before any such elimination is considered, however, careful analysis must be made to insure that it would not reduce the available supply of equity or venture capital and the necessary and desirable liquidity of capital; as indicated above, this analysis would have to include the fixing of an appropriate rate structure with the top bracket reduced to 50% or below.

Evaluating most of the proposed changes as a policy matter is a difficult undertaking. First, it has been argued that the existence of the special treatment presently afforded capital gains is essentially illogical. The principal argument for such treatment—the unfairness in taxing in one year gains which have accrued over a long-period—suggests the adoption of a liberal averaging provision for capital gains, not the treatment presently existing. Thus it is hard to evaluate logically proposed changes in that treatment.

Second, there is little hard factual information available concerning the possible effect of changes, and thus arguments relating to changes tend to be *a priori* and difficult to evaluate.

Third, as indicated above, any basic policy considerations regarding capital gains should take into account inflationary effects to eliminate from so-called capital gains, income that is not in fact income.

Rates

(a) Repeal of Alternative Capital Gain Tax for Individuals

Under section 1202 of the Code only one-half of the net long-term capital gains of an individual is included in his adjusted gross income and such gains become subject to tax at the individual's marginal tax rate. In addition, by means of the alternative capital gains tax of section 1201(b), present law limits the maximum rate on capital gains to 25%. Section 511 of the Bill would repeal the 25% limitation for the reason that it provides too great a benefit for taxpayers with marginal tax rates above 50%, and is at variance with the progressive concept of our tax system. The higher a taxpayer's income and marginal tax rate, the greater the benefit of the 25% limitation.

Repeal would result in a top rate on capital gains of 38.5% in 1969 (with surcharge), 35% in 1970, 33.75% in 1971 and 32.5% in 1972 and thereafter.

This Committee supports the principle of the proposed repeal of the 25% limitation. The Committee is concerned, however, that the imposition of a tax of more than 30% on capital gains may tend to distort investment policies and excessively impede capital formation. As indicated above, the Committee favors broadening the tax base and limiting the top rate bracket to 50% or less. The Committee recommends the retention of an alternative tax limiting the maximum rate applicable to long-term capital gains to not more than 30% until such time as the top rate on income generally is reduced to 60% or less.

It should be noted in passing that, if the House proposal is adopted, the economic impact of federal taxation on capital gains will be augmented by the inclusion of capital gains in L.T.P. and as a L.T.P. item for allocation of deductions, regardless of whether the maximum rate is retained, increased or repealed.

The effect of state and local taxation should not be overlooked. For example, New York State levies a tax on capital gains at a top effective rate of 7%, as does, in addition, New York City at a top effective rate of 1%. Since these taxes are deductible, a taxpayer in the 70% bracket for 1970 with up to $10,000 of net long-term capital

gains (but no other tax preference amounts) would pay an effective state and local tax burden on capital gains in New York City of 2.4%.

(b) Increase of Corporate Capital Gains Tax

Under section 1201(a) of the Code, a corporation with net long-term capital gains in excess of its net short-term capital losses must, if that is advantageous, compute its tax upon its ordinary income and such excess gains separately, the tax upon such excess being limited to 25%. Section 461 would increase this 25% limitation to 30%. As set forth the Committee believes that the rate applicable to individuals should not exceed 30%. While there probably is no essential relationship between capital gains of corporations and individuals, it seems desirable to have some form of symmetry between, for example, capital gain rates of individuals and subchapter S corporations on the one hand, and capital gain rates of personal holding companies and mutual funds, on the other.

The proposal to increase the corporate rate to 30% aggravates the presently existing anomaly of section 1201 of the Code in which the presence of capital gains and the operation of the alternative tax computation in some circumstances increases the corporate tax rather than reduces it as intended. For example, under present law, ignoring the surcharge, a corportation with taxable ordinary income of $100,000 will pay a tax of $41,500 ($25,000 at 22% or $5,500 and $75,000 at 48% or $36,000); with taxable ordinary income of $25,000 and capital gains of $75,000, it will pay $24,250 ($25,000 at 22%, or $5,500 and $75,000 at 25% or $18,650); but with taxable capital gains income of $100,000 the corporation will have to pay $25,000 ($100,000 at 25% or $25,000). In other words, where a corporation has a total taxable income in excess of $25,000 and some capital gains income, the effect of section 1201(a) is to preclude the use of the 22% rate applicable to the first $25,000 of corporate income on any capital gains falling into that first $25,000. With the proposed increase to 30%, the tax in the cases given above will be $41,500, $28,000, and $30,000 respectively, and the disadvantage to capital gains in the last case is increased from $750 to $2,000.

This problem probably does not occur frequently. Nevertheless, it is difficult to see why the present anomaly should be continued even

for infrequent cases. Accordingly, this Committee recommends that section 1201(a)(1) and (2) be amended to read:

> "(1) a partial tax computed on the taxable income reduced (*but, in any case where the taxable income is $25,000 or more, to not less than $25,000*) by the amount of such excess, at the rates and in the manner as if this subsection had not been enacted, and
>
> "(2) an amount equal to 30 percent of such excess (*less the difference between $25,000 and the taxable income reduced by the amount of such excess*)."

Such a provision would permit the application of the 22% rate to capital gains to the extent they necessarily comprise a part of the $25,000 of taxable income which is subject to the 22% rate on ordinary income and exempt from surtax.

(c) Treasury Proposals with Respect to Capital Gain Rates

The Treasury Reports recommend that the alternative tax rate should not apply to capital gains (i) exceeding $140,000 in any one year in the case of a married person and $85,000 in the case of a single person if their other tax preferences do not exceed $10,000, or (ii) four times the taxpayer's taxable income (other than long-term capital gains) if his other preferences do not exceed $10,000. If his other preferences do exceed $10,000, the allowable amount would be four times his taxable income adjusted under the L.T.P. and allocation of deductions rules, less the amount of those other preferences. Carry-overs would be permitted.

Without reference to the complexities (which appear to be undue) and the constant scrambling to determine the year a gain should be taken, the principle of special rates of capital gains taxation upon large amounts of capital gains should not be started; if it is valid, it is valid to eliminate the alternative tax. The Treasury proposal would provide a detriment to the realization of large capital gains which would not be provided by the inclusion of capital gains in L.T.P. when such gains are a taxpayer's only L.T.P. income.

Revision of Limitation of Capital Losses of Individuals

Section 512 of the Bill proposes to limit the allowance of capital losses of individuals against ordinary income to 50% of such losses. The reason for the proposed change is to eliminate the disparity in treatment between capital gains where only one-half is taxed and the deduction of capital losses against ordinary income where a full deduction is permitted but only to the extent of $1,000 in any year.

It is true that there is some inconsistency under present law in the taxation of only 50% of capital gains and the full deductibility of capital losses against ordinary income. If gains are to continue to be taxed only to the extent of 50%, it would seem logical to limit the deductibility of capital losses against ordinary income to 50% of their amount. That is the effect of present law when such losses are offset against capital gains.

On the other hand, the argument can be made that the present rule provides a desirable, albeit mild, subsidy to taxpayers suffering net capital losses since this subsidy may have the effect of helping to stabilize the economy in periods of decline.

Moreover, this appears to be a change which will have a more significant impact on taxpayers in the lower brackets than on those in the higher brackets. The discrepancy cited above with respect to capital losses is applicable only to those losses which may be offset (to the extent of $1,000 a year) against ordinary income. Capital losses which are offset against capital gains in the current year or are carried over and offset against capital gains in a subsequent year, have the effect of being used only to the extent of 50% since the capital gain they offset would only have been taxed to the extent of 50% in their absence. It would appear that the privilege of offsetting capital losses in excess of gains to the extent of $1,000 is more likely to be regarded as a significant privilege by lower bracket taxpayers. While the deduction against ordinary income does not provide as great a benefit to such taxpayers as compared to those in high brackets, the $1,000 limitation on this deduction, and the greater likelihood that the higher bracket taxpayer will have substantial gains in subsequent years

against which any excess must first be offset, supports the view that the provision tends to benefit the lower bracket taxpayer.

Thus, the Committee is of the view that there is a weak case at best from the standpoint of tax equity for the proposed change limiting the deductibility of capital losses, and therefore urges the retention of the present rule.

When a husband and wife are concerned, section 512 proposes to limit the amount of their capital losses deductible against ordinary income to $500 each where they file separate returns. This change is proposed to eliminate the anomaly of a greater limitation for a husband and wife where they file separately than where they file jointly. It will also eliminate the present two advantages of community property state couples over couples of other states in connection with the $1,000 limitation. First, community property state couples can more easily utilize the double limitation on separate returns inasmuch as local law attributes the losses equally to husband and wife, irrespective of whose efforts created the property with respect to which the loss was taken. Second, community property state couples who file separately to obtain the double capital loss limitation still obtain, in effect, the benefit of split rates applicable to joint returns. Couples in other states do not. The Committee believes the proposed change is fully justified and that the present rule is an anomaly which has no place in our tax law.

Holding Period

Under section 1222 of the Code, the disposition of a capital asset ordinarily produces long-term capital gain if that asset has been held for more than six months. Section 514 of the Bill would increase this 6 months requirement to 12 months. The stated reasons for the change are to limit more clearly capital gain treatment to investment gains as distinguished from speculative gains, and to provide greater consistency with the theory underlying the special treatment of capital gains, that gains attributable to appreciation over a long period of time should not be taxed at regular progressive rates. If the only factor to be considered is to distinguish in some arbitrary and imprecise fashion between investment and speculative gains and to prevent any

harsh effects from bunching of income, it seems clear that 6 months is too short a period to serve as a dividing line. Whether 12 months is the best alternative is difficult to say.

This Committee has concluded that a lengthening of the capital gains holding period is consistent with the underlying theory of the capital gains advantage and probably desirable in the context of tax reform. The Committee feels its extension to 12 months is not unreasonable.

As indicated above, the ability to mobilize capital and afford it liquidity is very important to the economy of the United States; before increasing rates or the holding period, Congress should satisfy itself that such changes will not interfere seriously with the ability to mobilize capital or with its liquidity.

Effective Date

The change in the holding period to 12 months is to apply with respect to taxable years beginning after July 25, 1969. In other words, calendar year taxpayers may continue to sell property for the rest of this year and receive capital gain treatment even though the property has not been held for 12 months provided it is held for more than six months.

Such an effective date seems inconsistent with the application to transactions taking place in the balance of this year of the new alternative tax rules, and the new 30% corporate capital gains rate. It would seem reasonable to make all of these provisions applicable to taxable years beginning after December 31, 1969. Such a rule as applied to the rate might answer in part the suggestion that appreciation up to July 25, 1969 not be taxed at the new rates. This change should be announced substantially before the end of 1969.

Even if no change is made in the holding period, the Committee believes that any change in the maximum rate should not be effective before January 1, 1970.

Treating Letters and Memoranda as Non-capital Assets

Section 513(a) of the Bill (section 1221(3) of the Code) changes existing law to exclude from the definition of capital assets, letters,

memoranda and similar property (or collections thereof) held by an individual creating such property or to whom letters are addressed or for whom property was prepared or produced. Sale thereof would thus produce ordinary income. Such items would not be capital assets for the purpose of the collapsible corporation provisions, nor would they qualify for capital gains treatment under section 1231 of the Code. Under the Bill, persons owning such items could not after 1969 make a charitable contribution and deduct the value thereof without treating the appreciation as income since this result would be ended for appreciated property the sale of which would have resulted in ordinary income. (Section 201(c)(1) of the Bill, section 170(e)(2) of the Code).

The Committee agrees with the House that such property should be treated the same as copyrights or similar property. Thus, to be consistent, the section should be enacted, or the rules with respect to books and similar property changed. If the sale of such property is made ordinary income, careful attention should be given to affording adequate relief by an appropriate income averaging provision.

Under the Bill, there has been added, as will be discussed below, a provision limiting the federal tax on earned income to 50%. In this provision, there is no satisfactory definition of "earned income"; while the provision picks up the concept of "earned income" under section 911 of the Code, the experience under that section is inadequate to handle the myriad of problems which will arise. For example, some appropriate portion (or possibly all) of the selling price of letters or similar property created by an individual might be considered as earned.

Questions have been raised as to the appropriateness of applying the ordinary income treatment of proposed section 1221(3) to persons other than the producer of the property. This is not dictated by consistency with the treatment of copyrights, and the Committee believes further study should be made before this step is taken.

Section 1231 of the Code

Section 1231 of the Code was enacted during World War II at a time when maximum individual rates had reached 91% and existing

business was often handicapped by the war effort. To eliminate some of the harsh effects of high wartime rates upon dispositions of property, section 1231 was enacted to allow net long-term gains from designated property to be taxed at capital gains rates, and net long-term losses at ordinary rates, which treatment of losses would be the treatment in the absence of section 1231. The measure was intended initially as a wartime expedient.

This Committee believes it is time Congress carefully examined section 1231 and developed a consistent and sensible policy with respect to that section. Two approaches seem possible:

1. Repeal section 1231 outright. This would end the difficulties with uninsured casualty losses at which the Bill is directed. More fundamentally, it would eliminate the capital gain treatment of the gain on the disposition of business assets with the inconsistent allowance of ordinary losses on such dispositions.

2. Repeal the 1958 amendment to section 1231. This would be consistent with the original policy underlying section 1231 of requiring all gains and losses on section 1231 assets to be included in the section 1231 computation. It is this amendment which has created the specific problem to which the present House proposal is directed.

This Committee feels that the repeal of section 1231 may be the more logical step to be taken, and the step most consistent with a sound national tax policy. Whether Congress accepts this recommendation or not, the Committee is firmly convinced that the proposed change in casualty loss treatment is at variance with the policies, such as they are, underlying section 1231. It is equally convinced that the repeal of the 1958 amendment, rather than the adoption of the proposed revision which further complicates and undercuts section 1231, is the better solution to the difficulties cited by the House Ways and Means Committee.

In considering the above recommendations, Congress should note that rates are no longer as high as they were when section 1231 was enacted; depreciation recapture has substantially reduced the favorable treatment of much of the gain originally subject to section 1231 treat-

ment; and section 337 of the Code has virtually eliminated the need for section 1231 where section 337 applies because neither gain nor loss is recognized to a liquidating corporation if that section's provisions are complied with.

Section 1231 also allows capital gains treatment in certain cases of timber, coal, iron ore, livestock, and unharvested crops. If the above recommendation to repeal section 1231 is not adopted, the Committee believes that, in the atmosphere of tax reform of the kind indicated by the House Report and the Bill, these particular provisions of section 1231 should be repealed. Section 212(b) of the Bill would make some changes in the treatment of livestock under these provisions, but the Committee believes Congress should review entirely the application of these provisions to timber, coal, iron ore, livestock and unharvested crops.

Transfers of Franchises

Section 516(c) of the Bill would add section 1252 to the Code. It would provide that a transfer of a franchise will not be treated as a sale or exchange of a capital asset or of property to which section 1231 of the Code applies if the franchiser retains any significant power, right or continuing interest with respect to the subject matter of the franchise; a franchiser who transfers franchises throughout an area of the country, or nationally, and retains some continuing contact or control over the franchises granted seems to be conducting a business and receiving from customers what should be treated as the ordinary receipts of a business. It is not disposing of capital assets to persons other than customers so that capital gain treatment would be appropriate. While the Bill would treat such receipts of franchisers as ordinary income, it still would permit the purchaser of a franchise who desired to terminate his business to sell his franchise in a complete disposition thereof at a capital gain rate to someone else (including the franchiser) who would assume his operation.

This Committee believes that section 1252 is an important first step in developing a logical and appropriate system of taxing transfers of franchises. However, it also believes that substantially more study should be given to the operations of franchisers to determine whether

further legislation is necessary with respect to gains which would be outside the scope of section 1252.

Lump Sum Distributions from Qualified Pension and Profit-Sharing Plans

Paragraph (a) of section 515 of the Bill would limit the extent to which lump sum distributions from a qualified pension, profit-sharing or stock bonus plan would be given capital gains treatment under sections 402(a)(2) and 403(a)(2) of the Code in respect of distributions after December 31, 1969.

The Bill would provide a "grandfather" clause with respect to amounts already in trust for an employee and allow capital gains treatment when it is thereafter distributed together with future earnings thereon and on future employee contributions; only future employer contributions (not including the earnings thereon) would not receive capital gains treatment. Forfeitures would be treated as employer contributions.

There are several unresolved questions in applying these provisions under an existing pension plan. It is not clear how the grandfather clause would work with respect to a particular individual. Would it be tested by the amount funded through December 31, 1969 for the individual? Or would it be tested by the "actuarial equivalent" in the individual's account on December 31, 1969? In this latter event, the result would be an accident of the actuarial method elected by the employer, or the amount of employer funding of benefits to such date. Or is it to be tested by the portion of the final pension amount of an individual on the date of retirement? If this is the method to be followed, attention must be given to plans in which pensions are based upon compensation measured by the best 5 years out of the last 10 of an individual's employment, times years of service; in such plans, funding usually does not occur ratably. Thus, the method of ascertaining the portion to be excluded under the grandfather clause should be clarified.

The Bill would put the above problems on the Secretary to promulgate regulations; the Committee believes that the problems should properly be covered in the Code.

As indicated above, it may be that a capital gain of this kind should not be a capital gain for L.T.P. or allocation of deduction purposes. While the Committee is not recommending specifically that lump sum distributions even as to amounts contributed to plans through December 31, 1969 receive capital gains treatment rather than being taxed by an appropriate averaging provision, if capital gains treatment is to be allowed, it probably should not be a capital gain included under L.T.P. or allocation of deductions. The Committee notes, however, that, as a matter of policy; the tax laws should not necessarily strive too hard to provide special treatment for lump sum distributions not directed to providing for retirement. The Committee notes also that contributions to pension and profit-sharing plans are almost the only form of earnings which receive the special treatment of paying no tax during the saving period; in view of that great advantage, one might question whether the capital gains advantage is required.

While no change in the Bill is suggested, it might be well for the Senate Finance Committee Report with respect to section 515 to discuss the effect of the $5,000 exclusion from gross income allowable under section 101(b) of the Code and the deduction from gross income for estate tax under section 691(c) of the Code, in the case of a future lump sum distribution upon the death of an employee. While the Commissioner is to determine by regulation the extent to which future lump-sum distributions are taxable, it would seem advisable for the Senate Finance Committee Report to suggest that all of the $5,000 exclusion (to the extent otherwise allowable) should be applied to reduce the "capital gain" portion, and none of it applied to reduce the "ordinary income" portion, of such a lump sum distribution, in view of the fact that the $5,000 exclusion is deemed to increase the employee's contribution. See section 101(b)(2)(D) of the Code and Reg. §§ 1.402(a)-1(a)(5) and 1.72-8(b).

Maximum Limitation on "Earned" Income

Section 802 of the Bill, § 1348 of the Code

General

The Bill, taken as an integrated unit, hopes to limit the "arbitrage" between capital gains and ordinary deductions taken in respect

of items which, when sold, will produce capital gains, to limit deductions against earned income of those items creating economic value, and to limit the deferment of income from high bracket years to low bracket years. Part of this policy is to lower the rate of taxation on current earned income, thereby reducing an individual's need to resort to these devices. The Committee believes that if the Congress thinks these devices are wrong, it should eliminate them; if it believes they should be permitted in part, in should permit them in part. But if the desire is to reduce or eliminate the arbitrage or the tax motivation in the types of transaction mentioned, a reduction in rates in the upper brackets with respect to all income, not just earned income, would be substantially more effective.

"Earned Income"

Under the Bill, the concept of "earned income" is derived from section 911 of the Code. That concept is a gross income concept. It is believed that it affords inadequate concepts for the new maximum rates on "earned income."

Section 911(b) of the Code provides:

> "For purposes of this section, the term 'earned income' means wages, salaries, or professional fees, and other amounts received as compensation for personal services actually rendered, but does not include that part of the compensation derived by the taxpayer for personal services rendered by him to a corporation which represents a distribution of earnings or profits rather than a reasonable allowance as compensation for the personal services actually rendered. In the case of a taxpayer engaged in a trade or business in which both personal services and capital are material income-producing factors, under regulations prescribed by the Secretary or his delegate, a reasonable allowance as compensation for the personal services rendered by the taxpayer, not in excess of 30 percent of his share of the net profits of such trade or business, shall be considered as earned income."

The Committee believes that the "30%" rule should certainly not be applied since it is completely arbitrary.

Other difficult questions arise with respect to the characterization of income as "earned" in a partnership, such as any personal service

partnership in which capital is not an income producing factor. Is all of the distributive share of a partner "earned"? Or is part of a partner's distributive share "earned" by employees for the partner? If a person spends $1.00 for canvas and $5.00 for paints, and from these items creates a masterpiece which sells for $20,000, is the $20,000 earned? The inventor has similar problems. A person builds a house with materials he buys. He thereafter sells the house. Is some part of the proceeds "earned"? What about earnings over a period of years? May a man forego his salary in one year and receive double salary in the next?

Problems arise also with allocation of expenses. Suppose a practicing lawyer is also engaged in the real estate investment business. Must he apportion his expenses between his law business and his other activities? And if so, how should he do it? Again, a man and wife own a store which is not making much money; they work hard in the store and draw no salaries. May all of the profits, not in excess of reasonable compensation, be considered salary?

Is a distribution from a qualified pension plan, other than a capital gains distribution, earned? And if not, should it not be? It has not received the benefits of the 50% maximum limitation.

These are but a few of the problems of determining the amount of "earned income."

Formula

The formula in the Bill for determining the amount of taxable income which is attributable to "earned" income seems incorrect. The numerator of the formula is the "earned income" under section 911(b) of the Code; this is a gross income figure without deduction for expenses otherwise deductible in computing adjusted gross income. The denominator of the fraction is adjusted gross income which has many deductions taken out.

The Effect of the 50% Rate

The 50% rate, as presently in the Bill, after reflecting the various rate reductions provided by the Bill, will afford a married individual

with $125,000 of adjusted gross income and $105,000 of taxable income a tax savings of approximately $220. It does afford greater benefits to individuals with greater earned income, but the number of individuals with greater earned incomes is relatively small.

The Bill and the Summary by the Staffs of the Joint Committee on Internal Revenue Taxation and the Committee on Finance seem inconsistent in the treatment of income which is not earned income. The Summary seems to indicate that, if a person has earned income in such an amount that a portion would be taxed above the maximum rate of 50%, and in addition other income, the other income is taxed at the lower rates and the earned income is superimposed on top to be subject to the maximum rate. The Bill does not so provide; it leaves all of the non-earned income in the highest brackets to be taxed as though the earned income were not subject to the 50% limitation. Perhaps the Bill should provide that the earned and the non-earned income will be included ratably in each bracket.

Averaging

The 50% maximum is not made available to taxpayers who use income averaging. The House Report cites complexity as the reason for this, but the result is illogical and the Committee believes an attempt should be made to integrate the 50% maximum and the averaging provisions.

RESTRICTED PROPERTY AND OTHER DEFERRED COMPENSATION

Sections 321 and 331 of the Bill, §§ 85, 402(b), 403(c) and 1354 of the Code.

Restricted Stock

The Committee believes that a revision of current law in respect of "restricted stock" may be justified, but basically the amendments should be limited to the elimination of (1) the taxation at capital gain rates of the appreciation in property during a period in which the property is being "earned out", and (2) deferral of the receipt of taxable income to low-income future years by reason of certain relatively insig-

nificant and tax-motivated restrictions on transferability never really intented to limit the economic value of the stock in the hands of the employee. The Committee believes, however, that the enactment of a provision that would impose current tax on more than the fair market value of property and would require the payment of tax prior to the time at which the recipient can sell or otherwise realize on the property is difficult to justify, particularly in light of the relatively insignificant revenue gains anticipated.

Section 321 of the Bill in effect establishes forfeitability (of a limited type) as the touchstone determining when ordinary income will be recognized by reason of a compensatory transfer of property. While transferability would also trigger current tax liability, a forfeitability condition without restrictions on transfer is for all practical purposes meaningless unless, perhaps, for a donative transfer. While it may not bestow any meaningful right, permitting sale (even if forfeitability survives) might in some cases allow the employee a limited realization from the property and in theory might justify the imposition of tax. There seems to be no reason, however, why the transfer of forfeitable property by gift (possibly other than to charity) should result in the recognition of income, if forfeitability survives the gift. (The Treasury Report of September 30, 1969 concurs with this.) Under the current regulations (and the Treasury Report), any income realized on the later lapse of the restriction would be ordinary income to the employee or constitute income in respect of a decedent to his heirs; this result could easily be insured under the Bill.

Under the Bill, a transferee of restricted property will recognize income when the property is not subject to a substantial risk of forfeiture. Such risk is present if the transferee's rights are conditioned upon the future performance of substantial services, but in other cases resolution of the question depends upon all the facts and circumstances.

The Committee believes that the Bill might appropriately be amended to specify that a meaningful agreement not to compete may constitute a substantial forfeiture risk. In some circumstances, such agreements are recognized as having substance for other purposes under the Code, such as in connection with the sale of a business or the

making of an employment contract. More significantly, non-competition agreements are an important consideration to many employers, and can be expected to become more important in light of ever increasing specialization of the functions of employees, increased life expectancies and lower mandatory retirement ages. The Committee believes that the viability of such agreements should be recognized through a deferral of tax liability or many employers will be forced to abandon the necessary imposition of such conditions upon their employees.

The Committee also believes that if a forfeiture condition of any sort is to be disregarded under the Bill, consideration should be given to allowing the employee a credit, under section 1341 or an analogous provision, for taxes paid with respect to property, if such property is later forfeited. Since the receipt of the property will have resulted in income to the employee only because of a statutory presumption that the forfeiture condition is insubstantial, it would be fairer to treat the transaction as a complete wash for tax purposes if the presumption proves incorrect.

The Bill should specify whether and to what extent income recognized in respect of restricted property is earned income for purposes of new section 1348 (the 50% maximum tax rate provision). Presumably, any income recognized at the time property is transferred to the employee is earned income and not deferred compensation, but the fact that proposed section 85(a) merely provides that such amounts "shall be included in gross income" while section 85(c)(2) specifically states that income recognized upon the release of a restriction which by its terms will never lapse is "compensation" might lead to a contrary construction.

Under the Bill, the amount of income that is recognized when property becomes transferable or it is no longer subject to a substantial risk of forfeiture is determined by the "fair market value" of the property, computed for this purpose "without regard to any restriction other than a restriction which by its terms will never lapse." The Treasury Department's proposal would have also specifically taken into account restrictions imposed by, or solely to comply with, federal securities law, and the House Report does not explain the failure to include this provision. In view of the numerous court decisions taking

into account such factors in valuing stock, the Committee believes that, subject to the comments below, the Bill should be amended to provide that Securities Act restrictions shall be taken into account in determining value, or an explanation for the omission should be given.

Securities Act restrictions on unregistered stock present special problems. Since Securities Act restrictions are not absolute prohibitions on transfer and since the sale of investment letter stock is a common occurrence, it is possible to determine the effect on value of such restrictions in a particular case with a fair degree of accuracy; such restrictions generally reduce fair market value from 20% to 30%. The Committee recognizes the argument that such restrictions generally are not intended to restrict the economic benefits ultimately available to the employee since he does not intend to sell until he may do so under the law. Further, such restrictions do not reduce the economic value of continuing to hold the stock. While the Committee recognizes that the receipt of compensatory stock subject only to investment letter restrictions can be a taxable event, the amount realized at that time should not exceed the fair market value of the stock, determined by taking into account in such valuation the investment restrictions, unless there is a covenant to register the stock. If there is a covenant to register, it is doubtful that the value should be reduced. Even if there is not a covenant to register but the employer in fact registers the stock at its expense within some short period, say 12 months, after the transfer of the shares, the Committee would not consider it unfair to impose an additional ordinary income tax under the rules of proposed section 85(c)(2) applicable to (i) the cancellation of perpetual restrictions, or (ii) to the gain upon any sale, to the extent of the discount from fair market value computed without restrictions.

The Bill provides for the recognition of additional compensation income if a perpetual restriction is cancelled and the taxpayer does not establish that the cancellation was not compensatory and that the employer will not treat the cancellation as compensatory. The latter requirement would appear to permit a non-compensatory cancellation to be turned into deductible compensation merely because an

employer claims a compensation deduction, even though this might be because of uncertainty or protective caution. The Bill should be amended to deal with such possibilities. Further elucidation of the criteria for non-compensatory cancellation should also be provided. The Committee believes that a failure to purchase shares at a formula price should in no event be considered compensatory if the formula restriction carries over to a third party purchaser.

The Bill would subject to current taxation compensatory property transferred to any person subject only to the restriction that it may not be sold or otherwise disposed of for a specified period, and would base the tax upon the full fair market value of the property without any discount by reason of the restriction. In theory there are some similarities between these restrictions and Securities Act restrictions in that while normal channels are not available for dispositions it should be possible to make a disposition of the beneficial interest by contract. However, this is not altogether the same as disposing of unregistered stock subject only to an investment agreement, and as a practical matter nothing comparable to the established market for investment letter stock exists for stock subject to outright prohibitions on transfers for a limited period. Accordingly, the Committee believes that current payment of tax may not be justified in this situation, provided that tax liability (at the time such restriction on transfer lapses or is released) is determined with reference to the taxpayer's marginal tax rates at the time the property was received. It is suggested, therefore, that tax liability be deferred until the property becomes transferable but that the tax imposed at that time be not less than the aggregate increase in tax for the taxable year in which the property was received (or, if subject to a forfeiture condition when received, for the year in which the employee's rights became non-forfeitable), under throwback rules analogous to those to be applied to deferred compensation payments under section 331 of the Bill.

Non-qualified Employee Trusts

Subsection (b) of section 321 would amend sections 402 and 403 of the Code to provide that amounts contributed by an employer to a

33-865 O - 69 - pt. 2--45

non-exempt employees' trust and premiums paid by an employer for a non-qualified annuity shall be included in income in accordance with new section 85. In addition, any current distributions from a trust during employment would be fully taxable without regard to any basis the employee might have therein. However, undistributed trust income would not be taxed currently to the employee.

This provision highlights the different tax treatment afforded by the Bill to restricted property and to unfunded deferred compensation arrangements, since a transfer to a non-exempt trust for later distribution to the employee is analogous in certain respects to both a current transfer of restricted property and a mere contractual promise to pay compensation in the future. The House chose to deal with contributions of property (including cash) to a trust under the restricted property rules, probably because it believed that it would be anomalous to provide a different tax rule for direct transfers of compensatory stock than for transfers of such stock to a trust. This leads to some curious results.

Under section 331 of the Bill, if no trust were used, deferred cash compensation payments would be taxed under a new throwback rule at the marginal tax rates in effect when the deferred payments are deemed earned, even if the employee's right to the payments is forfeitable until paid. If, on the other hand, a contribution is made to a forfeitable trust, the same payments from the trust will be taxed without any throwback at the marginal rates in effect when the payments are received by employee, assuming that the trust interest does not become non-forfeitable prior to such payment. If the trust becomes non-forfeitable, the employee is taxed under the Bill, contrary to present law, at the time the trust becomes non-forfeitable, even though the employee cannot obtain any monies from the trust. The same rules will apply if property is contributed to the trust.

The changes embodied in section 321(b) of the Bill, as applied to stock or other property contributed to a non-exempt trust, point up the difficulties in this area. Since, for example, property in a non-forfeitable trust is by its very nature not transferable by an employee, an appropriate result might be to treat distributions therefrom like deferred

compensation or like restricted stock subject to restrictions so long as it is in trust. While either of such rules might be justified logically, the rule of the Bill is most difficult to justify.

Nothing is said in the Bill about the amount of or the timing of the employer's deduction in respect of contributions to such a trust. Since the Service is still contending for no deduction whatsoever for contributions to a forfeitable trust, the Bill should make some provision therefor.

Other Deferred Compensation

Section 331 of the Bill would add to the Code a new section 1354 that would apply if an individual who has performed services receives a deferred compensation payment exceeding $10,000 in any year. The section would provide that the tax on such excess shall not be less than the lower of (1) the aggregate increase in tax resulting from adding the deferred compensation to the employee's taxable income for each year in which such deferred compensation in excess of $10,000 is deemed earned or (2) the tax determined by multiplying the number of taxable years in the period during which the excess is deemed earned times the average of the increase in tax resulting from adding to the employee's taxable income for the 3 years during the last 10 years of such period in which his taxable income is highest, the portion of such excess deemed to have been earned in each such year. The provision would not apply to certain non-discriminatory plans or to the ratable portion of any payment attributable to a taxable year beginning before 1970, or beginning before 1974 if paid pursuant to an obligation binding on July 11, 1969.

The above provision would, in effect, place a cash basis taxpayer on the accrual method with respect to covered deferred compensation payments, where that would produce a higher tax, but would continue deferral of tax liability until the time at which income would ordinarily be realized under the cash method and apparently would apply the tax rates current at that time if that would produce a higher tax. If a throwback rule is adopted, it should be made clear that it will apply

regardless of whether a tax based on inclusion in the year received would be smaller or larger.

In any event, the Committee believes that the throwback provision is discriminatory, will be difficult to interpret and administer, does not address itself to significant tax avoidance and should not be enacted in light of the insubstantial increase in revenues that will result. If any amendment of the current law governing unfunded deferred compensation arrangements is deemed necessary, the Committee believes that section 331 should be substantially amended. The Committee concurs, however, in the Treasury Reports' recommendation that the entire area of deferred compensation, together with related areas, needs significantly more study before appropriate equitable legislation can be recommended.

Unlike restricted stock plans, deferred compensation arrangements such as unfunded pension plans and phantom stock plans do not have any capital gain possibilities under present law and are not subject to criticism on the ground that what is compensation is improperly being transformed into tax-favored capital gain. Moreover, such arrangements are tax-balanced in that a compensation deduction is allowed the employer, even if on the accrual method, at the same time and in the same amount as compensation income is recognized to the employee. The only possible objection to the current tax treatment of deferred compensation is that, in some cases, it results in the inclusion of compensation in an employee's income in retirement years when it is anticipated that lower bracket rates will apply (although this anticipated result does not always occur) rather than during the term of his employment. This result, conceded by the Internal Revenue Service in Revenue Ruling 60-31, is firmly based on the cash method of tax accounting, under which a taxpayer recognizes income only when he actually or constructively receives payment or when he receives the economic benefit of a payment to another. Unfunded deferred compensation will be considerably less attractive to such persons in the future by reason of the 50% maximum tax on earned income, and thus the application of new section 1354 will be limited as a practical matter primarily to middle-level executives, whose reduction in tax by reason

of forward-spreading is minimal. Consequently, there should be less urgency to cure any problem which may be thought to exist under present law.

Because forfeitability conditions serve an important function for employers, as previously discussed in connection with section 321 of the Bill, the Committee believes that present tax treatment at the very least should be preserved for deferred compensation arrangements under which the employee's rights are not vested but are forfeitable for failure to perform services or for violation of a substantial covenant against competition; without such treatment, it will be difficult if not impossible for employers to utilize forfeiture provisions to retain the services and loyalties of their employees. Therefore, section 331 should be clarified to insure that there will be no change in the present tax treatment of a deferred compensation payment if the employee's rights to the payment were forfeitable, by reason of failure to perform substantial services or to observe the terms of a meaningful non-competition agreement, immediately prior to the receipt of such payment (assuming that such payments can really be called deferred where further affirmative consideration in the form of a continuing covenant not to compete runs from the employee to the employer). The exclusion from the throwback rule of such compensation payments subject to such a forfeiture provision will give recognition to the business-motivated nature of such restrictions, will recognize the legal concept that the compensation is not earned until all conditions to its payment have been satisfied, and will permit employers to impose such restrictions upon their middle-level employees and executives.

The term "deferred compensation" is not defined in the Bill or the House Report. In addition to making it clear that compensation is not earned (and, therefore, not deferred) until all conditions to its payment are satisfied, the application of the Bill should be limited to cases in which the employee has, during employment, some contractual right to the payment. Termination bonuses or voluntary pensions should not be covered.

The Bill applies only to individuals who perform services for any person, and thus not to trusts, estates and, presumably, partnerships,

but it is not clear whether it flows through "earned income" as compensation to partners. It applies to independent contractors as well as common-law employees. There seems to be no valid reason why the throwback rule should not apply to a partnership or indeed a subchapter S corporation rendering the same services. Extension to ordinary corporations is unnecessary in light of the lack of any substantial graduation in tax rates.

The Bill applies only to deferred payments to persons who perform services. This limitation raises substantially the same kind of problems discussed in connection with the 50% limitation of rate to "earned income". Thus, it is questionable whether the Bill extends to an artist or writer who sells property, such as a painting or a novel, he has created while not under contract to a gallery or publisher and with no significant capital outlay. If the exclusion of such cases was intended, this should be made clear. The Bill should make it clear what the rules are to be in such cases, and such rules should be consistent with those applicable in computing "earned income" for maximum rate purposes.

The amount of tax payable under section 1354 is dependent upon a determination of the period during which the deferred compensation payment is deemed to have been earned. Section 1354(b) provides only that such period is (1) the employee's entire period of service with the employer (or any predecessor or successor or parent or subsidiary, which terms are undefined) or (2) a portion of such period if properly attributable thereto under regulations to be prescribed. While the Committee believes that the complexity of this problem may effectively preclude the inclusion in the Bill of more detailed allocation rules, some general guidelines should be laid down, especially as to the portion of a deferred payment that is properly attributable to years before 1970. For instance, under plans, such as a phantom stock plan, which determine the eventual amount of deferred payments not only by reference to deemed employer contributions but also by inclusion of the dividends paid upon and the appreciation in value of the shares in which such contributions are deemed to have been invested, pre-1970 "earnings" should probably include not only the amount of the pre-1970 contributions but also any dividends thereon and appre-

ciation therein, whether occurring before or after 1970, since such dividends and appreciation are not properly attributable to services rendered in later years. In addition, since most employees do not have access to company records which might permit them to make a meaningful allocation, any allocation furnished by the employer should be deemed presumptively correct, with the burden being placed on the Internal Revenue Service to prove the allocation unreasonable. If an employee has earned deferred compensation through 1969 which is not subject to the new provisions but is to be taxed under existing law, the provision of section 1354 which deems the deferred compensation earned after 1969 (or after 1974, if subject to a contract now in effect) and subject to the section to have been earned over the entire period of service of the employee seems strange.

Since it will be extremely difficult (and seemingly impossible in the case of annuities) to make any meaningful allocation of deferred compensation payments made after an extended period of service, by reason of the necessity for maintaining records not only of the employee's income but also of internal credits and apportionments under the plan, the alternative method of computing the tax set forth in section 1354(a)(2) is likely to be relied upon by many taxpayers. This alternative will result in the highest possible tax for most employees, who attain their maximum earnings level immediately before retirement, since it is based upon the 3 highest income years during the last 10 years of the period during which the payment was deemed earned. To mitigate this harsh result slightly, the Committee believes that at the very least the subsection should be amended to permit reference to the average earnings during the 10 year period.

QUALIFIED PLANS OF SUBCHAPTER S CORPORATIONS

Section 541 of the Bill, § 1379 of the Code

Section 541 of the Bill would add to the Code a new section 1379, applicable to taxable years of corporations beginning after December 31, 1969. This section would amend the present corporate qualified plan rules, as applied to subchapter S corporations, in three respects: (a) forfeitures under a stock bonus or profit-sharing

plan which provides benefits for shareholder-employees (persons who own, actually or through family attribution, more than 5% of the outstanding stock) could not benefit shareholder-employees; (b) contributions under an exempt plan paid on behalf of a shareholder-employee would be subject to special excess contribution rules; and (c) no deduction carryover from a subchapter S year to a non-subchapter S year would be permitted. The House Report indicates that the purpose of the section is to subject persons who wish to incorporate for business reasons, but desire to be taxed in a manner similar to a partnership, to limitations similar to those applicable to partnerships under H.R. 10.

The Committee believes that (i) consideration of this amendment to the Code should be deferred until the Treasury Department study of qualified plans and deferred compensation is completed, (ii) consideration of the amendment should be made a part of such study, and (iii) if such consideration cannot be deferred, the amendment should not be adopted in its present form because it complicates the Code unduly by adding another layer of "qualified" pension plans (regular plans, H.R. 10 plans and plans under the proposed amendment). In addition, it would undoubtedly result in inconsistency between plans of subchapter S corporations and plans of "professional corporations". If the amendment is adopted, the Committee recommends that the provisions with respect to H.R. 10 plans be made consistent with the amendment.

The Bill does not subject qualified plans of subchapter S corporations and shareholder-employees thereunder to many of the restrictions presently applicable under H.R. 10 to partnerships and owner-employees. For instance, the normal non-discrimination requirements of section 401(a) would apply to subchapter S plans, rather than the mandatory coverage of all full-time employees with 3 years of service required under H.R. 10; lump-sum distributions to shareholder-employees under a subchapter S plan would be eligible for capital gain treatment (and for the limited capital gain treatment proposed by section 515(a) of the Bill); voluntary contributions by shareholder-employees would not be limited, as under H.R. 10, to the lesser of 10% of compensation or $2500 (or prohibited entirely if only owner-employees are covered by the plan); immediate vesting of the rights of nonshareholder participants would not be required for subchapter S

plans; and subchapter S plans would not be subject to the H.R. 10 rule that distributions to owner-employees may not commence prior to age 59½ and must commence prior to age 70½. The Committee believes that the restrictions contained in the Bill are sufficient to prevent abuses of the qualified plan privilege by shareholder-employees and does not favor extending any additional H.R. 10 provisions to subchapter S plans. The Committee believes that consideration should be given to eliminating or liberalizing such H.R. 10 provisions as they apply to the qualified plans of unincorporated businesses.

The Committee believes that new section 1379(a) of the Code, which would deny exemption to trusts under stock bonus or profit-sharing plans of subchapter S corporation unless such plans provide that forfeitures attributable to any contribution deductible in taxable years beginning after 1969 may not inure to the benefit of shareholder-employees, is justified in light of the exclusion of, and is preferable to, the H.R. 10 mandatory vesting provisions. The House Report technical explanation states that forfeitures will be considered to inure to a shareholder-employee's benefit only if taken into consideration in computing the amount to which he (or his beneficiary) will be entitled under the plan. The Committee understands that the use of forfeitures to reduce future contributions under the plan, which might otherwise be considered to benefit the shareholders by increasing retained earnings, would be permitted, as well as the allocation of forfeitures among participants who are not shareholder-employees. This point should be clarified.

INCOME AVERAGING

Section 311 of the Bill, §§ 1301-1305 of the Code

Under the present law, the benefits of income averaging apply only if the taxable income in the year in question (the computation year) is more than 133⅓% of the average income for the preceding four years (the base years). The Bill would change this to 120% and would thereby allow a larger number of taxpayers in an expanded number of situations to have the benefits of income averaging on a larger sum.

The Bill would also change existing law so as to include in the income averaging calculations the following types of income which are presently excluded: capital gains, income attributable to gifts and bequests, and wagering income. The Committee approves these changes. If, however, the alternative tax computation applicable to net long-term capital gains is retained as recommended in the Treasury Reports, the inclusion of such capital gains in averaging may have to be reconsidered. The Committee notes, however, that the elimination of such gains from averaging would defeat much of the simplification sought to be achieved by the Bill.

Under current law, a taxpayer loses the benefits of certain provisions if he elects to use income averaging. These are: the use of the special tax table for adjusted gross incomes of less than $5,000, the averaging provisions applicable to distributions from H.R. 10 plans, the exclusion of certain earned income from sources without the United States and the exclusion of certain income earned from sources within possessions of the United States. To these, the Bill would add the new averaging provisions applicable to distributions from accumulation trusts and the 50% tax rate limit on earned income. Thus, any taxpayer electing the general averaging provisions of section 1301 *et seq.* must forego, not always very logically, a number of possibly beneficial alternatives, the most important of which probably would be the 50% tax rate limit on earned income. This type of election could lead to frequent mistakes by unsophisticated taxpayers and at the very least might require a number of alternative computations. The Committee believes that such refinements should be avoided if at all possible and urges that an attempt be made to integrate these special benefits with the general averaging rules.

Debt Financed Acquisitions

Section 411 of the Bill, § 279 of the Code

The Committee recommends that section 411 of the Bill not be adopted because (i) its affirmative provisions will virtually never apply because one of the tests for its application is that the indebted-

ness be subordinated to general creditors, a provision which will rarely if ever be included in indebtedness of the type intended;* (ii) the section may be a trap in respect of the right to deduct interest, even as to the first $5,000,000 of interest allowed under the provision, in view of the provision (section 279(i)) that, "No inference shall be drawn from any provision in this section that any instrument designated a bond, debenture, note, or certificate or other evidence of indebtedness by its issuer represents an obligation or indebtedness of such issuer in applying any other provision of this title"; (iii) it is too complex; and (iv) it is essentially a regulatory and not a revenue raising provision.

If the section is to be adopted, some technical problems with its provisions are set forth below.

The applicability of the section should be limited to those transactions which result in the direct or indirect ownership by the acquiring corporation of at least a majority interest in the stock or assets of the acquired corporation. Only in such cases does there exist the concentration of economic power which the section is designed to discourage. Thus, the "except" clause in section 279(b)(1) should be revised to read as follows:

> "provided that, after such acquisition, the acquiring corporation owns, directly or indirectly, more than [one-half] [two-thirds] of the total value of all classes of stock of the acquired corporation entitled to vote or more than [one-half] [two-thirds] of the total value of the [gross] [operating] assets of the acquired corporation."

The Senate Finance Committee Report should make clear that, once the majority ownership test (as well as the other three tests) is met, interest would be disallowed on all obligations previously or subsequently issued to acquire any portion of the acquired corporation's stock or assets. In addition, to prevent a technical evasion of the provision, an attribution of ownership rule, applicable to members of an affiliated group, should be provided.

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* The Treasury Report of September 30, 1969 recommended this provision be amended to provide that subordination need be only to a substantial amount of indebtedness.

The above revision would also clear up the ambiguity now present in section 279(b)(1) as to whether the assets of the acquired corporation in question are its gross assets or its assets net of liabilities.

To remove the ambiguity inherent in the word "generally" as used in section 279(b)(2), that word should be eliminated and the phrase "at least a majority of" should be inserted between "subordinated to" and "the claims of".

It seems inappropriate to calculate a corporation's debt-equity ratio by reference to the adjusted basis of its assets, as is provided in section 279(c)(2). The adjusted basis may bear little relation to the fair market value of the assets, which is a more accurate measure of the corporation's ability to pay its debts. It is that ability which is being, or should be, tested in this section. Although it may be more difficult to value assets than to determine their tax basis in many cases, the task is not insurmountable and is already required under numerous provisions of the Code. Thus, the phrase "fair market value" might be substituted for "adjusted basis for determining gain" in section 279(c)(2).

The definition of annual interest in section 279(c)(4) fails to specify the year to be used in calculating the amount of interest in question. The House Report states that the comparison is to be made with the acquiring corporation's annual interest cost on its total indebtedness "as of the time of determination". Presumably, under section 279(c)(1) this means the last day of the taxable year in which the corporation acquisition indebtedness is issued. Such a test fails to take into account any future maturities of the corporation's other indebtedness which might significantly reduce its projected interest cost and thereby increase its ability to pay the interest on the corporate acquisition indebtedness. It would seem that at least short-term maturities, such as payments of debt principal required to be made within one year after the end of the year in which the corporate acquisition indebtedness is issued, should be eliminated from indebtedness for the interest computation, unless it is clear as of the end of the year of issuance that such debt will have to be refinanced.

In section 279(c)(4)(B), intercompany interest on indebtedness between the acquired and acquiring corporations (or any other members of the affiliated group) should expressly be eliminated, since such interest is not a true economic cost when the two corporations are viewed on a combined basis.

The Bill leaves unclear whether interest which has been disallowed under section 279 would be treated as dividends, for example, for the purpose of the intercorporate dividends received deduction, the dividend exclusion for individuals and the provisions of section 301.

LIMITATION ON DEDUCTION OF INTEREST

Section 221 of the Bill, § 163(d) of the Code

The Bill would amend section 163 of the Code (relating to the interest deduction) by adding a new subsection (c) providing in general that in case of a taxpayer other than a corporation (except a subchapter S corporation) the amount of "investment interest" allowed as a deduction shall not exceed the sum of:

> "(A) $25,000 ($12,500 in the case of a separate return by a married individual), and
>
> (B) The amount of net investment income (as defined in paragraph (3)(C), and
>
> (C) An amount equal to the amount by which the net long-term capital gain exceeds the net short-term capital loss for the taxable year."

It also provides that the amount of disallowed investment interest for any taxable year shall be treated, except for the purpose of the $25,000 allowance, as "investment interest paid or accrued in the succeeding taxable year." It goes on to provide definitions for computing the amount of "net investment income".

The Committee agrees with the Treasury Reports and recommends strongly that this provision not be enacted without further intensive study. The need for this is indicated by some of the technical problems with respect to the provision set forth below.

The Bill provides in subparagraph (4) that the $25,000 allowance shall apply "with respect to the partnership and with respect to each partner". This provision is ambiguous and should be clarified. For example, does it mean that the allowance should be allocated among partners (assuming a particular marital status for each partner and assuming each would or would not file a joint return with his wife) with partnership interest income and expense and other items necessary to a computation flowing through to the partners? If this route were followed, the $25,000 would only be allowed at the partner level. Again would it mean that investment income also would flow through to the partners? Or does it mean that the partnership receives one allowance and each partner a separate allowance with a portion of the individual allowance being used up by the partnership allocation? Or does it mean the partnership receives one $25,000 allowance so that any particular partner may receive an allocation allowance from, say, 25 partnerships even though the aggregate of such allowance exceeded $25,000 for a particular partner?

No carryover is allowed for the $25,000 allowance. It is only allowed for disallowed investment interest. Consideration should be given to the carryover of an unused $25,000 allowance.

The carryover provisions where partnership, joint ventures and syndicates are involved are unclear. Does the carryover apply at the partnership level? Or is it allowed only to the individual partners? Whichever result is desired, careful consideration will be required to achieve the desired result on an equitable basis.

From the provisions of the Bill, it is not clear whether a carryover is limited to the next succeeding taxable year or subsequent taxable years. Section 221 would seem to limit it to the next succeeding taxable year; the House Report would seem to indicate it could be carried over to any subsequent taxable years. It may be that the provisions of section 163(d)(2) which provide that the amount of "disallowed investment interest for any taxable year shall be treated (except for the purposes of paragraph (1)(A) [the $25,000 allowance] as investment interest paid or accrued in the succeeding taxable year" might possibly be interpreted as giving rise to a computation of investment

interest in the first succeeding taxable year which would give rise to a carryover to a subsequent year. If this is intended, the provision should be clarified.

The provision of section 163(d)(4)(B) with respect to a net operating loss of a subchapter S corporation is difficult to interpret. It states that such net operating loss shall be "deemed an investment interest deduction to the extent such investment interest is allowed as a deduction to the corporation"; it goes on to provide that "Section 1374(d) shall be disregarded to the extent such net operating loss deduction is deemed to be an investment interest deduction." While the paragraph is silent as to whether or not this loss flows through to its shareholders, it would seem that, unlike the partnership, there is to be a complete flow-through of interest expense (without any apparent reduction for any "investment income" of the subchapter S corporation) without reduction by or allocation of the $25,000 allowance at the corporate level. The partnership and partners, on the one hand, and the subchapter S corporation and its shareholders, on the other, should be treated more consistently.

"Investment income" is defined as:

> ". . . the gross amount of income from interest, dividends, rents, and royalties and net short-term capital gains derived from the disposition of property held for investment, but only to the extent that such gross income or such gains are not derived from the conduct of a trade or business."

While "interest income" has been difficult enough to define under the Code in the past, it is necessary for this and other provisions of the Bill that it now be defined more precisely. Further, the year of receipt must also be determined with particularity. For example, does interest include:

(i) guaranteed payments under section 707 of the Code to a limited partner;

(ii) original issue discount under section 1232 of the Code;

(iii) interest paid on deferred compensation;

(iv) imputed interest under section 483 of the Code; or

(v) contingent interest paid upon an obligation only out of earnings?

The timing of the inclusion in income as "investment interest" income is particularly troublesome in respect of original issue discount under section 1232 of the Code, as presently in effect, but it may not be so difficult if section 413 of the Bill is enacted which calls for accrual of the discount even in the case of cash basis taxpayers. Interest paid on accumulated deferred compensation, if such interest is to be treated as "investment interest" rather than as compensation, also may present a timing problem.

The gross income derived from rentals under a net lease seems to single out unnecessarily one form of investment. Either similar types of investment income should be included or rentals under a net lease excluded.

Investment expense is offset against investment income if "directly connected with the production of investment income". It would be advantageous for a taxpayer to have investment income unreduced by "directly connected with expenses". This is an ambiguous and difficult phrase with which to contend. It is suggested that more specific language be inserted so that taxpayers will not have their investment income reduced by expenses which they never considered to be "directly connected with" their investment income. This same type of problem will arise with respect to some L.T.P. items for L.T.P. purposes and for allocation of deductions purposes in determining the net amount of L.T.P.

The concept of investment interest being interest incurred or continued to purchase or carry "property held for investment" gives rise to a multitude of problems of the type which have caused problems for years in determining under section 265(2) of the Code interest expenses incurred or continued to purchase or carry tax-exempt securities. For example, is all interest paid by an investment banking partnership excluded since the partnership is engaged in trade or business, or is there some allocation made if it carried securities in an "investment account"? Is the same answer applicable to a subchapter S corporation in view of the principle that everything a corporation does is done as part of its business? Suppose an individual incurs interest expense in buying a home, pledging not only

the home but marketable securities for the loan? If allocation is intended, the allocation formula should be stated specifically.

Probably the most serious problem in connection with proposed section 163(d) of the Code is its applicability to interest incurred on indebtedness involving net leases which interest will be paid after 1969. In many cases, the partnership or syndicate in question obtained a tax ruling from the Internal Revenue Service which allowed the interest deduction. Many cases cover real estate which consists of U. S. government buildings (principally post offices). It may be impossible for the investors or partners to rearrange the partnership or syndicate indebtedness without substantial economic detriment in which event the loss of the interest deduction will undoubtedly result in great economic hardship. This result seems unwarranted, and some provision alleviating this difficulty should be enacted.

Section 163(d) would seem to apply to interest expenses during the period of construction of a building which will ultimately be the subject of a net lease. This raises not only the problems set forth above, but may have serious effects upon construction, for example, of multiple dwelling units.

DEPRECIATION ALLOWED REGULATED INDUSTRIES

Section 415 of the Bill, § 167 of the Code

Section 451 of the Bill would amend section 167 of the Code by adding subsection (l) dealing with depreciation allowed to regulated industries. The effect of the provision would be to "freeze" the method of depreciating both existing and new public utility property to the method which was in effect on July 22, 1969. The purpose of this part of the Bill is to stop rate-making authorities from requiring the utilities to flow through the tax savings of accelerated depreciation.

Without regard to the technical provisions of the Bill, and recognizing the potential revenue loss involved if the provision is not adopted, the Committee believes that section 451 should not be adopted because it constitutes special tax legislation directed against one industry and

33-865 O - 69 - pt. 2--46

does not constitute a depreciation provision of general application. Further, the provision is inflationary.

If the provision is to be enacted, arbitrary effect of the cut-off date for electing accelerated depreciation should be ameliorated, and a utility which had indicated by some objective event (such as keeping regulatory records, filing elections, or filing registration statements) that it had intended to adopt an accelerated method of depreciation should be allowed to elect. The Committee concurs with the recommendation of the Treasury Reports that such changes be made.

STOCK DIVIDENDS

Section 421 of the Bill, § 305 of the Code

The changes in section 305 passed by the House appear to have a much broader scope than curbing the specific and rather specialized abuses that the House Report indicates were the aims of the changes. Because of the confusion cast on certain normal transactions, such as reorganizations, by the Bill, it is believed that the matter should be restudied and that legislation at this time should not go beyond T.D. 6990. It is further noted that the concept of "proportionate interests" which would be incorporated into the statute without definition under the Bill was much discussed under the Internal Revenue Code of 1939 and ultimately rejected in connection with the adoption of the 1954 Code because of its vagaries and elusiveness.

At a minimum, the Bill should be amended to make it clear that the broad provisions such as the reference to "any transaction having a similar effect" will not apply in the following areas: (i) to the issuance of stock in connection with reorganizations; (ii) to redemptions in connection with normal sinking fund requirements, and purchases in anticipation thereof; (iii) to normal purchases for treasury stock purposes; and (iv) to normal anti-dilution provisions providing for adjustments in conversion ratios, for example, on account of extraordinary cash distributions.

The disproportionate distribution provision proposed under the Bill (proposed section 305(b)(2)) would apply if the distribution, or a series of distributions, "has the result" of the receipt of property by some shareholders and an increase in the proportionate interest of others in the corporation's assets or earnings and profits. This proposal would appear to be substantially broader than that recommended by the Treasury Department in its tax reform proposals issued April 22, 1969. Under the Treasury proposal, a disproportionate distribution would result only if the stock or rights were distributed in conjunction with a taxable dividend distribution, i.e., a distribution to which section 301 applies. The proposal in section 421 of the Bill is not so limited; it would apparently be possible to have a property distribution made to some shareholders which qualifies as a redemption under section 302 or 303 of the Code, but which nevertheless would cause a stock distribution made to other shareholders to be subject to tax. Moreover, the proposal in the Bill is not expressly limited, as was the Treasury proposal, to stock distributions made within twelve months before or after property distributions or to distributions of stock and property made pursuant to a single plan. Under the Bill, there would apparently be no time limit applied and it is not clear that any series of distributions would have to be made pursuant to a plan. So long as a property distribution, whenever made, when combined with a stock distribution, whenever made, "has the result" of a distribution of property to some stockholders and an increase in the proportionate interest of others, the stock distribution would or could be taxable. The Committee recommends that proposed section 305(b)(2) be amended to limit the application of the disproportionate distribution rule to situations where the property distribution constitutes a taxable dividend distribution under section 301, and that stock distributions be made taxable only if made in conjunction with a related taxable dividend distribution, incorporating the Treasury's original proposal that a stock distribution would be considered related to a property distribution if made within twelve months of such distribution or if both distributions are pursuant to a single plan.

The concept of the disproportionate distribution provision of the Bill is not that any increase in a shareholder's proportionate interest

by reason of a stock dividend is automatically taxable; it applies only where one or more shareholders of a corporation receive property distributions while others receive stock distributions increasing their proportionate interest. While the examples cited in the Treasury's original proposal and in the House Report involve transactions in which there is a property distribution with respect to one class of stock and a stock dividend having the effect of correspondingly increasing the proportionate interest of other shareholders, the provisions of section 421 as drafted do not require that there be any equivalence or relation between the amount of the property distribution and the value of the stock distribution. Since the principal tax avoidance arrangements to which the Bill is directed presumably involve property distributions accompanied by corresponding stock distributions of substantially equivalent value, consideration should be given to limiting the application of the disproportionate distribution provisions to such situations, although this would seem to present insuperable administrative problems.

The Bill would treat distributions of section 306 stock as property distributions for purposes of the provisions of the disproportionate distribution and distributions in lieu of money exceptions to section 305(a). The exact implications of this proposal are far from clear. The House Report states that if a corporation with two classes of common stock distributes a common stock distribution with respect to one class and a section 306 stock distribution with respect to another class, the distributions on both classes would be taxable, since the section 306 stock distribution is considered a property distribution. Suppose, however, a cash distribution is made with respect to one class and section 306 stock is distributed with respect to the other. Is it intended that the section 306 stock be taxable, not because it is property, but because it represents an increase in the proportionate interest of the shareholders receiving it?

It is presumably intended that the treatment of section 306 stock distributions as property is only for the limited purpose of the exceptions proposed to section 305(a), and that it is not intended by this provision to affect the tax treatment of preferred stock issued for bona fide business purposes in connection with a corporate recapitalization

qualifying under section 368(a)(1)(E). If this is the intention, it would be helpful to include a statement to this effect in the Senate Finance Committee Report in order to avoid possible future controversy.

The Committee supports the provisions of the Bill limiting the exclusion under section 305(a) to distributions made with respect to common stock. Since preferred stock traditionally pays cash dividends, it is not unreasonable to conclude that stock dividends on ordinary preferred stock (except anti-dilution distributions on convertible preferred stock) are in effect a substitute for cash dividends and should be taxed. Difficult questions may arise, however, as to whether unusual classes of stock should be classified as "preferred stock" for this purpose and whether "deemed" distributions under proposed section 305(c) should automatically be treated as distributions for this purpose.

The Committee questions the need for the special provision (proposed Section 305(b)(3)) relating to distributions of convertible preferred stock. The requirement that it be established to the satisfaction of the Treasury that the distribution of convertible preferred stock does not have the result of a disproportionate distribution suggests that an advance ruling would be necessary or at least highly desirable whenever convertible preferred stock is to be distributed. While it is not disputed that certain distributions of convertible preferred stock could have the effect of a disproportionate distribution, it does not appear that separate treatment of such transactions is required. Taxpayers must in any event be prepared to show that the distribution does not come within the disproportionate distribution exception of section 305(b)(2).

The provisions of proposed section 305(c) would confer a broad authority on the Treasury to prescribe regulations dealing with the tax treatment under section 305 of changes in conversion ratios, redemption prices, redemptions under section 301 or other transactions "having a similar effect." The Treasury proposals in this area (e.g., "constructive stock distributions") have in certain respects represented substantial departures from present law, and the Committee, while recognizing the complexities, believes that it would be more appropriate

to provide a statutory basis for such proposals than to confer discretionary authority on the Treasury. The experience with the regulations issued under section 305, which were pending in various proposed forms from 1956 until in 1969, indicates that a more detailed statutory framework in this area is highly desirable.

The Bill would not be applicable to distributions of stock or rights made or considered as made before January 1, 1991 with respect to stock outstanding on January 10, 1969 or issued pursuant to a contract binding on January 10, 1969 on the distributing corporation. In cases to which the January 1969 Treasury Regulations would not have applied, April 22, 1969, the date of the Treasury reform proposal, is substituted for January 10, 1969. Pursuant to the House Report, this transitional rule would apply only if the corporate capital structure or corporate practices on January 10, 1969 (or April 22, 1969, if applicable) provided for disproportionate distributions, or distributions of stock with respect to preferred stock.

It is believed the transitional rules should be broadened to be made applicable with respect to distributions made not only with respect to stock outstanding on the applicable cut-off date, but with respect to distributions made on stock distributed with respect to stock outstanding on such date. Thus, if a corporation has outstanding 100,000 shares of common stock and distributes in 1970 a 2% stock dividend, the distribution of 2,000 shares would not be taxable; in the following year, when another 2% stock dividend is distributed with respect to 102,000 shares, the 2,040 shares that would be so distributed should not be taxable. There is precedent for this approach under Regulations Section 1.305-2(b)(3) of the Treasury Regulations issued in January 1969.

Because the provisions of the Bill in certain respects differ significantly both from the provisions of the 1969 Treasury Regulations and the Treasury reform proposals, it would appear appropriate to change the applicable cut-off date to August 2, 1969, the date of the Bill. Also, to the extent that any regulations issued under the broad provisions of section 305(c) go beyond the regulations already in effect, they should apply only to stock issued after the issuance of such regulations.

NATURAL RESOURCES

Section 501 of the Bill, § 613(b), 615, 617 and 636 of the Code

The Committee has no comments as to the appropriate rates for percentage depletion. It notes, however, that the classifications in the present law, especially in the hard minerals area, seem to be somewhat arbitrary.

If a recapture rule is extended to all mining exploration expenses, as is proposed in the Bill, there is no logical justification for failing to provide for recapture of intangible drilling expenses in the case of oil and gas wells, except as a form of subsidy which, for the reasons previously mentioned, is considered by the Committee as an inefficient alternative to direct subsidies. However, in recognition of commitments made on the basis of the present law, the Committee recommends consideration of a grandfather clause applicable to intangible drilling and exploration costs incurred or committed prior to the effective date of any change in the present law.

The withdrawal of percentage depletion from foreign oil and gas wells provided in section 501(a) of the Bill is opposed by the Treasury Reports on the ground that it will ultimately result in increased foreign taxes and no additional tax to the United States. The Committee does not agree that this result is necessarily true, but it also believes that there is little or no justification for treating foreign wells owned by U. S. taxpayers different than domestic wells or, for that matter, foreign mines different than domestic mines.

Section 501(e) of the Bill (added after the Bill was reported by the House Ways and Means Committee on August 2, 1969) provides that the percentage depletion rate in the case of oil shale would be based on the value of the oil extracted rather than on the value of the rock itself (which has little if any value). The change is accomplished by amending section 613(c)(4) of the Code to include certain treatment processes as mining in the case of oil shale and would have the effect of overruling private rulings previously issued by the Internal Revenue Service. Subject to the comment made above with respect to subsidies, the Committee has no comment on whether this change is appropriate, but it notes that the Bill is silent on the effective date of the changes made by section 501(e). For the sake of consistency with the effective

date provision of section 501(a)(2) of the Bill, the Committee recommends that the amendments made by section 501(e) of the Bill apply to taxable years beginning after July 22, 1969.

Section 501(b)(1) of the Bill would add a new section 636(a), which would treat a production payment carved out of mineral property as a mortgage loan on the mineral property rather than as an economic interest in the property, and a new section 636(b) which would treat a production payment retained on the sale of a mineral property as a purchase money mortgage loan which would not be considered a retained economic interest. Income from the property subject to such production payments, including proceeds in respect of the production payments, would be taxable to the owner of the working interest when received (subject to the depletion allowance), and the cost of producing the mineral used to satisfy such production payments would be deductible by such owner when incurred.

The Committee agrees with the principle that production payments which have the economic effect of mortgage loans should not be permitted to distort the reporting of income and expenses for tax purposes. However, the Bill is not limited to production payments having this effect but would grant the Commissioner broad authority to prescribe regulations specifying both the "existence" and the "amount" of any production payment which would be subject to this treatment. Definition of these items should be provided in the statute, but if this is not deemed feasible, at a minimum, guidelines to be applied in prescribing regulations should be indicated. Otherwise, attempts might be made to bring royalty, net profits and other arrangements into the ambit of production payments.

Section 501(c)(1) of the Bill applies to expenditures which are made after July 22, 1969 (the day after the House Ways and Means Committee approved these provisions). The Committee recommends that the language of new section 615(h) be changed to read "which are paid or incurred after July 22, 1969" to conform with section 617 of the Code (as amended by section 501(c)(2) of the Bill). The Committee also recommends that the parenthetical description of section 617 of the Code contained in section 501(c)(1) of the Bill be amended to read "(relating to the deduction and recapture of certain mining exploration

expenditures)" in order to conform with the new caption contained in section 501(d) of the Bill.

The Bill does not include the tentative proposal of the House Ways and Means Committee to remove the capital gains treatment presently available to the owners of coal and domestic iron ore royalties under section 631(c) of the Code. The Committee believes that this special capital gains treatment should either be extended to all similar royalties or replaced by a direct subsidy to the iron ore and coal industries.

Charitable Remainder Trusts

Sections 201(e), (f), (h) and (i) of the Bill, §§ 170(h), 664, 2055(e), 2106(a) and 2522(c) of the Code

Substantive Provisions

These sections of the Bill would disallow income, gift and estate tax deductions for charitable remainder interests unless the interest is in the form of a remainder interest in a trust which is a "charitable remainder annuity trust" or a "charitable remainder unitrust" as defined in the Bill. These definitions are quite narrow and specific, and would incorporate entirely new concepts into the Code.

The House Report (pp. 58-60) bases this change on the assertion that in the usual trust where the income is payable to an individual with the remainder to charity, it is possible under present law to favor the income beneficiary over the remainderman "by means of manipulating the trust's investments".

On the other hand, the changes proposed in the Bill are revolutionary in nature. By far the vast majority of trusts with which the members of the Committee have had any contact are neither "charitable remainder annuity trusts" nor "charitable remainder unitrusts". Were this proposal to become law, it would be necessary for lawyers to review all their existing wills and trusts of living donors to revise if possible any of those which contain charitable remainder trusts of the common variety providing income to an individual for life and remainder to charity. While experienced and sophisticated tax attorneys may be able to do this in time, the measure would create a trap for

the unwary in the case of practitioners who are not particularly familiar with the intricacies of the tax law, especially since it would require a revision in what has been fundamental practice in drafting trust agreements and wills for many years.

The Committee recognizes that one aim of the Bill is to simplify the problem of valuing charitable remainders. However, the valuation rules that would be required under the Bill, as outlined in the House Report, would be novel and highly complicated. The Committee believes that a more direct effort to prescribe realistic valuation rules under the existing regulation authority, including an attempt to equate them to the expected investment of the trust assets, would be a wiser approach. It is noted that areas other than charitable deductions are subject to the same abuses under the present valuation rules.

Effective Dates

The Bill would apply for income and gift tax purposes to transfers made after April 22, 1969, which was the date of the Nixon Administration proposals in the area of tax reforms, although the Nixon Administration proposals did not include this proposal. The Treasury Report of September 30, 1969 recommended changing the effective date for income tax purposes to August 2, 1969. The Committee agrees with this change and urges that it be adopted for gift tax purposes too. Under the circumstances, to apply on April 22, 1969 effective date would be unconscionable.

The Bill applies in the estate tax area to decedents dying after the date of enactment. This date or even the August 2 date would be unfair since it would require the changing of wills prior to the enactment of legislation without knowing exactly what that legislation will contain. The Treasury Report of September 4, 1969 recommended an effective date of December 31, 1970 for this reason, and the Committee concurs with this recommendation.

The September 4 Treasury Report also recommended that the estate tax provisions should not apply to trusts "heretofore" created that cannot be amended. The Committee agrees, but it also believes they should not apply until December 31, 1970 to revocable trusts created prior to August 2, 1969 or to trusts created under the will of a decedent who dies before December 31, 1970.

Charitable Deductions for Trusts and Estates

Section 642(c) now provides, in the case of a charitable remainder trust or estate, that there shall be allowed a charitable deduction for "any amount of the gross income, without limitation, which pursuant to the terms of the governing instrument is, during the taxable year, paid or permanently set aside" for charity. Section 201(f) of the Bill would delete the words "or permanently set aside", with the result that, unless the trust was exempt as an "annuity trust" or a "unitrust" under the new definitions, the charitable remainder beneficiary would lose 25% (or more if the capital gains tax is raised) of the capital gain, which would be paid in Federal income tax under the Bill, rather than being set aside for the charity.

As a matter of public policy, it is questionable whether such a provision should be enacted. If the proposed section is enacted, however, a step-up in basis to fair market value on the date of enactment should in fairness be included in the Bill since the Bill taxes all capital gains realized and set aside for charity after the date of enactment of the Bill. (Bill § 201(j)(6)) Such a step-up in basis is provided for in section 101(a) of the Bill with respect to the 7½% (2% under the Administration proposal) tax on the income of private foundations. Section 101(a) of the Bill provides that "in determining net capital gain or loss [for purposes of the 7½% tax]—(A) The basis of property held by the private foundation on December 31, 1969 and continuously thereafter to the date of its disposition shall be deemed to be not less than the fair market value of such property on December 31, 1969."

Because of the apparent oversight in section 201(f) of the Bill in not providing a step-up in basis, fiduciaries of charitable remainder trusts and estates may be compelled before the Bill is enacted either (1) to cross their entire portfolios (i.e., selling and repurchasing within a short time the same stock) in order to insulate current appreciation from the proposed capital gains tax under amended section 642(c) or (2) to diversify their entire portfolios for the same reason.

Under section 201(i) of the Bill, "annuity trusts" and "unitrusts" would be exempt from income tax. Section 201(j)(8) of the Bill states in effect that the amendment exempting unitrusts and annuity trusts "shall apply to transfers in trust made after the date of enactment of

the Act." Such amendment, if retained in the Bill, should apply to transfers in trust made at any time.

REPEAL OF THE UNLIMITED CHARITABLE DEDUCTION

Section 201(a) of the Bill, § 170(b)(1)(C) of the Bill

Present law allows a taxpayer an unlimited charitable contribution deduction for any year if in 8 out of the 10 preceding taxable years the total of the taxpayer's charitable contributions plus income taxes (determined without regard to the tax on self-employment income) exceeded 90 percent of his taxable income (computed without regard to the charitable contributions deduction, personal exemptions, and loss carrybacks).

Under the Bill the unlimited charitable contributions deduction would be eliminated for years beginning after 1974, with interim reductions up to 1974.

The Committee expresses no opinion as to whether or not the unlimited deduction should be repealed. It notes, however, that persons with small incomes, as well as the few publicized cases of those with high incomes, would be affected by the repeal. It also notes that even if the untaxed appreciation on property given to charities is eliminated from the L.T.P. and allocation of deductions in accordance with the Treasury Reports, the allocation of deductions proposal is likely to have a very severe impact on persons with large incomes who are taking advantage of this provision, and may thus eliminate or substantially reduce the abuses that have caused public concern. If contrary to the Treasury Reports the appreciation element in charitable gifts of property is retained as an L.T.P. for purposes of the limit on tax preferences and the allocation of deductions provisions, or even allocation of deductions alone, the effect on such persons would be even more severe.

ACCUMULATION TRUSTS, MULTIPLE TRUSTS, ETC.

Sections 341 and 342 of the Bill, §§ 665-669 and 667 of the Code

Unlimited Throwback

Section 341 of the Bill provides that in the case of accumulation trusts (including multiple trusts) the distributees are to be taxed on

distributions of accumulated income in substantially the same manner (as near as may be) as if the income had been distributed to the distributees when it was earned by the trust. The taxes paid by the trust on the accumulated income in effect will be considered paid by the distributees for this purpose.

The Bill would eliminate the 5-year limitation of present law which, except in the case of distributions from a foreign trust created by a United States person, taxes the distributee only on that part of the distribution of accumulated income which represents income earned by the trust in the five years immediately prior to the distribution. The Bill, in effect, also eliminates all the exceptions to the throwback rule under present law (including the exception for income accumulated prior to the beneficiary's attaining the age of 21 and the exception for a final distribution of the trust made more than nine years after the last transfer to the trust).

In determining what portion of a distribution by a trust represents a distribution of accumulated income, the rules will continue to be substantially the same as under present law.

Under the Bill the tax liability of the distributee on the accumulated income may be computed, at the election of the beneficiary, either according to the "exact" method, which in some cases would require preservation for many years of income tax returns of the trustee and the distributee, or according to a "shortcut" method.

Under the shortcut method the tax, in effect, is averaged over the number of years in which the income was earned by the trust. First a fraction of the accumulated income is included in the distributee's income for the year of distribution and for each of the two immediately prior years. Thus, if the accumulated income is attributable to ten years, then one-tenth of the amount distributed would be included in the income of each of such three years. An average yearly additional tax for the 3-year period is determined and that amount is then multiplied by the number of years to which the trust income relates.

While the Committee recognizes that any shortcut method of necessity has to be arbitrary, it believes it would be fairer to employ a 5-year period ending with the year immediately prior to the year of distribution, rather than a 3-year period ending with the year of distribution. The distributee's income for the year of distribution can be

expected to be abnormally high, as compared with his income for previous years, because of the income received by him upon the distributed amount subsequent to the distribution.

The Committee is far from clear as to how it is proposed, under the shortcut method, to determine the amount of tax which had been paid by the trust on the accumulated income; the Bill would seem to require that an exact method be used to determine this. Presumably, if the distributee is unable to prove the amount of such tax payment by the trust for some years, the distributee will suffer. In view of the probable loss in many cases of all records as to the amount of taxes paid by the trust on the accumulated income for some years, the Committee recommends that the distributee be permitted to take into account the taxes paid by the trust on such income for the 3 or 5-year test period and then proceed to compute the taxes paid by the trust for the period of accumulation on the basis of a formula using such taxes.

Income for Benefit of Grantor's Spouse

Section 342(a) of the Bill would amend section 677 of present law which makes the income of a trust taxable to the grantor when it is earned if the income of the trust, without the approval or consent of any adverse party (such as the income, the beneficiary or the remainderman), is, or in the discretion of the grantor or a nonadverse party, or both, may be, (1) distributed to the grantor, (2) held or accumulated for future distribution to the grantor, or (3) applied to pay premiums on policies of insurance on the life of the grantor. The amendment would change the term "grantor" to read "grantor or the grantor's spouse" where section 677(a) refers to income which may be distributed to or for the benefit of "the grantor". Thus, a grantor would be taxed on the income of a trust when it is earned if it may, without the intervention of an adverse party, be (1) distributed to the grantor or to his spouse; (2) held or accumulated for future distribution to the grantor or to his spouse; or (3) applied to the payment of premiums on policies of insurance on the life of the grantor or of his spouse.

The House Report states (at p. 97) that this provision "is not to apply where another provision of the Code requires the wife to include in her gross income the income from a trust", but section 342 does not

explicitly so provide. Subject to clarification of this, the Committee has no objection to the provision. This change would not be limited to accumulation trusts, but it does not seem inappropriate to tax the grantor on income which can be distributed to his spouse even though it is actually distributed to another beneficiary (such as children).

REAL ESTATE DEPRECIATION

Section 521 of the Bill, §§ 167 and 1250 of the Code

Section 521 of the Bill would amend section 167 of the Code to provide that new section 1250 property (other than certain residential property) would not be eligible for either the double declining balance method or the sum of the years-digits method of depreciation unless:

1. construction commenced before July 25, 1969; or
2. a written contract with respect to any part of the construction or for permanent financing was entered into before July 25, 1969.

In the case of used section 1250 property, depreciation would be limited to the straight-line basis as to acquisitions after July 24, 1969.

Section 1250 would be amended so as to make recapture applicable to all depreciation deductions in excess of allowable straight-line depreciation after July 24, 1969.

Under the Treasury Report of September 30, 1969, a percentage reduction in the amount of excess depreciation recaptured with respect to sales of new residential housing in the hands of the original owner would be provided. The Treasury also recommended that the recapture rule of existing law be retained without change for certain Federally-assisted projects under so-called FHA-221(d)(3) and FHA-236 programs. The Committee recommends that similar treatment be afforded to state sponsored residential housing programs.

Section 167 would also be amended by the Bill to provide for elective 60 month straight-line amortization of rehabilitation expenditures for low or moderate income dwelling units, not including hotels, motels, inns or other residences where more than one-half the units are used on a transient basis.

The Committee has no comment on the policy considerations involved in these changes.

The Bill fails to make any provision to protect purchases of used section 1250 property made after July 24, 1969 pursuant to binding contracts entered into before that date. It would seem unfair to deprive such purchases of the tax treatment to which they were entitled at the time the contract of purchase was entered into. Protection has been included in the Bill with respect to contracts to construct new property entered into before July 25, 1969.

Paragraph (3) of the proposed new section 167(j), dealing with depreciation on newly constructed property, provides that rules similar to the rules provided under section 48(h), dealing with suspension of the investment credit, for treating certain transferees as the transferors shall be applied. No similar provision is contained in paragraph (4) of section 167(j), dealing with depreciation for used section 1250 property. No cogent reason exists for this discrepancy. The rules of section 48(h) involve situations which do not appear to fall within the abuse sought to be curtailed.

Section 167(j)(2), as it would be amended by the Bill, would retain the former rates of accelerated depreciation only for residential buildings with respect to which 80% or more of the gross income is derived from the use of dwelling units. It would encourage, therefore, only the construction of buildings which were primarily dwelling buildings, rather than the construction of dwelling units. There would be no incentive to build dwelling units in buildings where more than 20% of the income is derived from sources other than dwelling units (as defined), although such buildings could present a large potential source of living space.

Construction of mixed-use buildings, including such uses as off-street parking, shops, consumer services, restaurants, small theatres, and in some cases, office space, may offer the most rational use of urban space. In New York City it has been proposed that dwelling units be built above a base structure consisting of a school. These uses not only provide additional amenities for the residents of the area, but also tend to increase the efficient use of the urban area.

It is recommended that the 80% gross income test (or perhaps a test based on space would be more appropriate) be used only for the purpose of determining whether the basis of the entire structure may be depreciated under an accelerated method. Accelerated depreciation

should be permitted with respect to all new dwelling units. This can be accomplished through allocating basis as between dwelling areas and non-dwelling areas in proportion to the gross income derived from (or, perhaps more appropriately, the space occupied by) each respective area. In this connection service type buildings, such as schools, which are not to be commercially used, should be included in the residential portion. Failure to make such changes will probably result in complex arrangements to divide ownership of dual-purpose structures by carving out air rights or other unusual layers of ownership of realty.

MULTIPLE CORPORATIONS

Section 401 of the Bill, §§46, 179, 821, 823 and 1561-1564 of the Code

General

Section 401(a) of the Bill would amend section 1561 of the Code to provide that each controlled group of corporations shall share a single $25,000 surtax exemption, a single $100,000 accumulated earnings credit, and, in the case of life insurance companies, a single $25,000 small business deduction, to be apportioned among the various component members of the group equally or in any other manner they choose, subject to regulations, except that in any case where a corporation has a short taxable year which does not include a December 31, it will receive a fractional surtax exemption equal to $25,000 divided by the number of corporations in the group on the last day of the short taxable year and a similar fraction of the accumulated earnings credit or small business deduction for life insurance companies. Section 1562, allowing such a group to elect multiple surtax exemptions, would be repealed.

Section 401(a) would be fully effective for taxable years commencing after 1975. In the interim, percentage reduction would be provided by section 401(b) of the Bill.

Section 46(a)(2) of the Code limits the investment credit to 50% of the tax liability in excess of $25,000 (25% during a suspension period). Section 46(a)(5) requires that the $25,000 be apportioned among the members of an affiliated group, but the term "affiliated group" is used here only to apply to the parent-subsidiary relation-

ship as defined in section 1504 (dealing with consolidated returns). Section 401(e) of the Bill would modify section 46(a)(5) to cover all controlled groups within the meaning of section 1563, as amended by the Bill, which includes brother-sister groups. The $50,000 limitation on "used Section 38 property" is also limited under present law in the case of affiliated groups within the meaning of section 1504, but "more than 50%" is substituted for "at least 80%" for this purpose. Section 401(e) of the Bill would redefine the meaning of "affiliated group" in section 48(c)(3)(C) to conform to the definition of "controlled group" in section 1563 although it would retain the 50% rule.

There is no explanation in the 1962 Committee Reports why an 80% rule was used in defining an affiliated group for the purpose of limiting the investment credit, but a 50% rule was used with respect to the limitation on used property, nor is there any explanation why the distinction should be perpetuated. Certainly, few, if any, enterprises in the 50% to 80% area would form multiple corporations merely to avoid the $50,000 limitation on used section 38 property, especially in view of its imminent repeal. If anything, such an enterprise is more likely to form multiple corporations to take advantage of the full credit for the first $25,000, yet this is not covered.

Section 179 of the Code allows an additional $10,000 deduction for first year depreciation. Section 179(d)(6) requires that this limitation be apportioned among the members of an affiliated group, as defined in section 1504 except that "more than 50%" is substituted for "at least 80%". Section 401(f) of the Bill would substitute the concept of a controlled group, as used in section 1563, as amended, but with the retention of the 50% rule.

Section 821(a)(1) imposes a tax on mutual insurance company (other than life or marine) taxable income at a rate of 22% or, if less, at 44% of the taxable income in excess of $6,000. In section 821(c)(1)(A), which imposes an alternative tax for certain small mutual insurance companies, a $3,000 deduction is allowable. Under section 501(c)(15), if a mutual insurance company (other than life or marine) has gross investment and premium income of less than $150,000 (with certain other adjustments), it is completely exempt from tax. Section 401(g) of the Bill would require a controlled group of corporations within the meaning of section 1563 to apportion each of these

dollar amounts ($6,000, $3,000 and $150,000), and certain other amounts pertaining to the computation of the taxes on such companies.

Definition of "Controlled Group"

A "controlled group of corporations" is currently defined in section 1563(a) essentially as an 80% parent-subsidiary chain, a brother-sister group 80% of whose stock is owned by a single individual, trust or estate, or a combination thereof. Certain stock held by employee benefit trusts and corporate employees, and in a brother-sister group, by a principal (5%) stockholder, other than 50% owner, is excluded from the computation. Constructive ownership rules are set forth in section 1563(e).

Section 401(c) of the Bill would redefine a brother-sister group. A group would exist if there are five or fewer individuals, trusts or estates who own the requisite 80% of the stock, but only if such persons also own 50% of the stock, taking into consideration only the stock which is owned in identical proportions in all of the corporations.

The House Report and the Treasury Department's recommendations give the following as an example of the rule dealing with 50% of the stock owned in identical proportions: A owns 70% of X corporation and 30% of Y corporation; B owns the rest of the stock of the two corporations. A controlled group exists because together they own 80% and, counting only the 30% each owns in both X and Y, they own 60%. If, however, A owned 80% of X and 20% of Y, and B owned the rest, there would not be a controlled group, since only 40% was owned in identical proportions. The policy for distinguishing the two situations is unclear.

How is a group to be ascertained in the following situation:

Stockholders (Individuals)	Corp. X (%)	Corp. Y (%)	Corp. Z (%)
A	50	40	10
B	40	10	50
C	10	50	40
	100%	100%	100%

A, B and C meet the 80% test with respect to corporation X, Y and Z, but only have 30% of the stock, considering only identical holdings. Thus, X-Y-Z is not a controlled group. Yet considering only X and Y as a group, and ignoring Z, A owns 40% in both, and B and C own 10% each in both, for an aggregate of 60%, so X-Y is a controlled group. However, the same can be said for X-Z, or Y-Z. Hence, X-Y, or Y-Z, or X-Z is a two member controlled group, but not X-Y-Z. One corporation should get a full surtax exemption, and the other two should share another, but which one, if any, gets the full exemption? Perhaps X, Y and Z should each have one-half of a $25,000 surtax exemption, adding up to three-halfs in the aggregate. Either solution is far from being a satisfactory interpretation of the statute, and similar solutions may be even more impossible to reach in more complicated matrices.

No changes in the constructive ownership rules under section 1563 are proposed in the Bill. Under these rules, stock ownership is not attributed from a parent or adult child unless the individual already owns 50% of the stock, or from a spouse if the individual owns no stock of, and is not a director or employee of, the corporation, does not participate in its management, the stock is not subject to certain restrictions which run in favor of the individual or his children, and the corporation derives not more than 50% of its income from royalties, rents, dividends, interest and annuities. Thus a sophisticated taxpayer can avoid the rules by having one corporation in his name, another in his wife's, and possibly others owned by his parents or children. The exception for attribution from a spouse has been justified in the past on the grounds that many wives own their own businesses, but there is no requirement that the two businesses be unrelated to each other.

Policy Considerations

The legislative history indicates that the surtax exemption was designed to help small businesses, but nowhere in that legislative

history is there any analysis of what constitutes a small business. The Bill's definition of a controlled group in terms of corporations owned by five or fewer individuals who have an 80% interest in the venture does not accomplish this. Nor does the second part of the test, 50% ownership counting only stock owned in identical proportions. Indeed, the failure to attribute stock owned by a spouse, or by adult children or parents except where the individual in question already owns 50% of the corporation before such attribution, would permit extensive avoidance of the proposed new restrictions.

It would be advisable to consider an entirely different means of securing the desired result.

Moving Expenses

Section 231 of the Bill, §§ 82 and 217 of the Code

The proposed amendments, while enlarging somewhat the kind of "moving expenses" which are deductible, would eliminate the exclusion under existing law for reimbursed expenses and would increase the "mileage test" from 20 to 50 miles.

In eliminating the reimbursement of expenses, it is believed that the proposal is moving in the wrong direction. When an employer reimburses an employee's expenses, there is a self-policing mechanism and the additional convenience to the Internal Revenue Service of accumulating similar expenditures in the same place for auditing purposes. Administrative convenience would not be served by making it necessary for these expenses to appear on the individual employees' returns in order to be deductible.

No justification for increasing the mileage test is given in the House Report, and it seems particularly inappropriate at the present time when a large portion of employee moving is occasioned by the relocation of businesses from urban to suburban areas.

PRIVATE FOUNDATIONS

Section 101 of the Bill, §§ 170, 501, 506-509, 4941-4947, 6033, 6034, 6104, 6652 and 6684 of the Code.

General

The Bill would subject private foundations to a series of seven new levies of which two would be called income taxes and five would be called excise taxes. A simplified outline of the new imposts follows:

Code §	Tax
506	7½% Tax on Net Investment Income (the Treasury Reports recommend 2%)
507	Tax on Termination of Private Foundation Status: either (a) Aggregate tax benefits since 1913 or (b) Value of net assets
4941	Taxes on "Self Dealing" 5% of amount involved, on Self Dealer 2½% on Foundation Manager 200% on Self Dealer if not corrected 50% on Manager (not in excess of $10,000) if not corrected
4942	Taxes on Failure to Distribute Income 15% of undistributed income 100% if not "corrected"
4943	Taxes on Excess Business Holdings 5% of excess holding 200% if not corrected
4944	Taxes on Investments which Jeopardize Charitable Purposes 100% on Foundation 50% on Manager
4945	Taxes on Taxable Expenditures (Propaganda, electioneering, lobbying, etc.) 100% on Foundation 50% on Manager

All of these levies, except possibly the tax on net investment income, are frankly regulatory devices rather than taxes imposed for the purpose of producing revenues. Indeed, the excise taxes are described in the House Report as providing "a graduated series of sanctions," "a graduation of sanctions," "a series of sanctions," "limited sanctions," "more effective sanctions." (H.R. Rep. No. 91-413 (Part 1) 21, 25, 30, 31, 33)

The Committee has in general serious reservations concerning the wisdom or propriety of the wholesale inclusion of purely regulatory provisions in the Code. In general, it is felt that the Code should confine itself to tax matters, leaving to other titles the provision of systems of regulation with appropriate penalties and fines. There is some theoretical justification for inclusion in the Code of the approach adopted in section 507 of recovery of tax benefits arising from tax deductions allowed and income treated as exempt if it appears that funds with respect to which such benefits were allowed are not in fact used for the approved charitable purposes. A fair and reasonable provision along this line might be worked out, although as noted below the Committee does not believe that section 507 as now proposed is either fair or reasonable.

As for the "excise taxes," they are in fact penalties or fines and it is believed that in most cases the penalty will turn out not to fit the crime. More appropriate penalties could obviously be fixed in each case by appropriate proceedings before a court and the Bill in effect assures that such penalties, in addition to the penalties provided in the bill, will be levied under local law. Under proposed section 508 a private foundation would be required to amend its governing instrument to prohibit actions which would incur liability for the new excise taxes. If in fact such taxes are incurred, then under proposed section 6104 (section 101(e) of the Bill) the appropriate state official is to be notified. Since the action giving rise to tax liability will have been a violation of the governing instrument, there will be a breach of fiduciary duty and the state official, being on notice, will undoubtedly take appropriate action, including possibly action to require the guilty person to restore to the foundation the amount of any excise tax incurred.

The Committee believes that the penalty provisions raise serious questions of due process and the exercise of Federal powers, including

the broad question of whether the granting of tax exemption may appropriately be used as a basis for the levying of penalties and fines unrelated to the tax benefits accorded and in respect of acts which are otherwise innocent. While there may be other grounds on which the Federal regulation of private foundations can be justified, such as on a showing that their activities have interstate effect, the Bill does not purport to justify or apply the penalties on such other grounds. There also appear to be serious procedural due process questions, such as whether, if a manager is to be fined (under the guise of a "tax") for engaging in a particular act, the burden of proof should be shifted to the government. As a policy matter, such penalty provisions may make it extremely difficult to persuade responsible persons to act as trustees or managers.

The Committee accordingly disapproves the "graduated series of sanctions" approach of the Bill and suggests that some other approach be considered. It might be fruitful, for example, to consider whether at least in some cases the income tax deduction in respect of a gift to a private foundation should be deferred until the foundation applies or in some way irrevocably commits the gift to a specific charitable project.

Tax on Private Foundation Investment Income

(a) Imposition of Tax

It has been brought to the Committee's attention that the levying of an income tax on private foundations may jeopardize their status as tax-exempt organizations under the laws of certain foreign countries where such status is dependent on their being treated as tax exempt under United States law. It has been suggested that if a tax measured by income is imposed, various states and localities may regard private foundations as no longer tax-exempt in nature.

One of the reasons alleged for imposing the tax on investment income is to defray the cost of the vigorous and extensive administration believed to be needed in order to provide appropriate assurances that private foundations will promptly and properly use their funds for charitable purposes. The House Report accordingly concludes that

the tax may be viewed as being in part a user fee. (H.R. Rep. No. 91-413 (Part 1) 19)

Under these circumstances, it is suggested that the possibility be considered of changing the tax to a "user fee," imposed as an excise tax on capital rather than income, which might make it possible for private foundations to maintain the position for purposes of foreign law and state and local law that they continue to be tax-exempt organizations under United States law.

(b) Net Investment Income Defined

The brief definitions under proposed section 506(b) may not be broad enough in scope to cover all items of income which should probably be included in the tax base. Thus, for example, gains in the amount of the original issue discount under section 1232 from the exchange or retirement of bonds and other evidences of indebtedness issued at a discount are presently treated under the Code as gains from the sale or exchange of property which is not a capital asset. They would therefore appear to be excluded from the definition since they would constitute neither gross investment income nor net capital gain. Under the proposed revision of section 1232, the ratable monthly portion of original issue discount to be included in income is still not specifically designated as interest. (See the reference to a special ruling at 4 CCH 1969 Stand. Fed. Tax Rep. ¶ 4147.022, holding that the excess of proceeds of bankers acceptances and commercial paper over cost is not interest.) In addition, the capital gains to be taken into account are only those arising from the sale or other disposition of property used for the production of interest, dividends, rents, and royalties, and property used for the production of unrelated business income. Gains such as those from the sale or exchange of nondividend paying stock or undeveloped real property would apparently be excluded.

A better approach might be to frame the definition of gross investment income in terms of other well established and long used provisions of the Code, such as those defining fixed or periodical income subject to the 30% withholding tax under sections 871 and 881 of the Code, with such exceptions and additions as might appear appropriate. With

respect to capital gains, it appears that the approach might be to include all capital gains with certain exceptions such as gains on the sale of facilities used by the private foundation in direct furtherance of its charitable purposes and gains on the satisfaction of pledges of support to organizations specified in proposed section 170(b)(1)(B) by transfers to such organizations of appreciated property.

Tax on Termination of Private Foundation Status

The Committee recognizes that it may be appropriate to recover the tax benefits derived from classification as a section 501(c)(3) organization to the extent that funds are not in fact used for the purposes for which charitable deductions and tax exemptions were allowed. If this is the rationale, the remedy proposed is excessive since it may be assumed that the assets or at least the income of the foundation must still be used for what at common law are basically charitable purposes. The reason for voluntary or involuntary disqualification may, for example, simply be that the foundation finds that furtherance of its charitable purposes requires a certain amount of support of appropriate legislation and plans to spend a modest amount for this purpose while the rest of its funds will continue to be used for approved charitable purposes.

At the very least, it seems that the foundation should be allowed a credit based on amounts in fact spent for approved charitable purposes. Note that if there is no credit a foundation of some years standing which has commendably spent its income and any capital appreciation on charitable grants may be wiped out by the interest charged on the tax benefits alone, while one which has hoarded its funds may be able to pay the tax and come off relatively well.

In any event, the Committee considers that the requirement that the foundation surrender all its assets if it fails to prove the amount of tax benefits derived by itself and its substantial contributors for past years back to 1913 raises a serious question of due process of law. It is patently unfair to require at the present time the production of records of events which may have to go back over more than half a century, during which time there was no notice to anybody of a require-

ment that ancient records be kept. In order to avoid the imputation of unfairness, the recovery of tax benefits should be limited to a period no longer than it is reasonable to suppose that tax returns and other records may be kept in the ordinary course. It might, for example, be argued that it was not unreasonable to base a tax on the aggregate tax benefits realized during the five years preceding the change of status.

Under proposed sections 507(c) and (d), the value of assets, measuring the amount of the tax unless it can be shown that the aggregate tax benefit is less than the value of assets, is the higher of the value on the first day on which action is taken by the foundation which culminates in its ceasing to be a section 501(c)(3) organization or the day on which it ceases to be a section 501(c)(3) organization. Moreover, for the purpose of determining liability for tax, the tax is deemed to be imposed on the first day on which the above action is taken. The House Report states that this provision is intended to permit the recovery of the value of transferred assets under chapter 71 of the Code, relating to liabilities of transferees and fiduciaries. It is the view of the Committee that such liabilty is not warranted to the extent that assets have been transferred in pursuance of legitimate charitable purposes.

Section 507(e)(2) would permit the Secretary to abate the tax if the private foundation, in view of the voluntary or involuntary termination of its status as a section 501(c)(3) organization, distributes all of its assets to one or more organizations specified in proposed section 170(b)(1)(B) (churches, schools, hospitals, publicly supported charities, etc.) which have been in existence for five years. In view of the fact that under these circumstances the assets transferred will be devoted to approved charitable purposes, the Committee sees no purpose in giving the Secretary any discretion with respect to the abatement or requiring that the donees have been in existence for any particular length of time.

Special Rules with Respect to Section 501(c)(3) Organizations

Under paragraph (1) of proposed section 508 (g), the governing instrument of a private foundation must require the foundation to distribute its income for each taxable year in such manner as to avoid

the tax on undistributed income under section 4942. Under section 4942, the amount treated as undistributed income for purposes of the tax may in fact not be income at all but a percentage of fair market value of assets. In order to avoid ambiguity, it would therefore seem preferable to require the governing instrument to provide for distribution of amounts sufficient to avoid the tax under section 4942 without reference to whether such distributions are out of income or principal.

Under this subsection, a private foundation "shall not be treated as an organization described in section 501(c)(3) which is exempt from taxation under section 501(a)" unless its governing instrument includes certain required provisions. On the other hand, an organization organized before January 1, 1970 "shall not cease to be treated as an organization described in section 501(c)(3) because of a failure to comply" with this requirement. A possible interpretation is that a pre-1970 private foundation which fails to comply remains a 501(c)(3) organization, contributions to which may be deductible, but becomes subject to tax on its income. It seems unlikely that this was the intent and the provision should be clarified.

"Private Foundation" Defined

"Private foundation" is defined generally to include any organization described in section 501(c)(3) with stated exceptions. The definition fails to exclude foreign organizations although elsewhere it is assumed that foreign organizations do not come within the category. Thus, in section 4942(g)(1)(A)(iii), a qualifying distribution for purposes of the excise tax on the failure to distribute income does not include a contribution to "an organization which would be a private foundation if it were a domestic organization."

It can scarcely be the intent to apply all the different categories of income and excise taxes to foreign foundations and the failure to exclude them appears to be an oversight.

Taxes on Self-dealing

If taxes are to be imposed on acts of self-dealing between disqualified persons and foundations, a reasonable measure of the tax

might be the amount of benefit conferred on the disqualified person. No such reasonable standard is applied in any general way by section 4941. It is true that in the case of excessive compensation, the measure of the tax is the amount regarded as excessive. In the case of services rendered or property loaned by the foundation, the intent is probably to measure the tax by the value of the services or the value of the use of the property. However, in the case of a sale of property by a disqualified person to a foundation, no reasonable measure is applied. Apparently the tax is to be imposed even though the sale is at a bargain price. Section 4941(e)(2) defining the term "amount involved" states that it is the greater of the amount of money and the fair market value of the other property given or the amount of money and the fair market value of the other property received. According to Part 1 of the House Report (p. 23), this is the greater of the value of what the foundation gave or what it received. According to Part 2 of the House Report (p. 9), the amount involved is the greater of the amount of money and the fair market value of the other property given to or received by a disqualified person in a self-dealing transaction. A more natural reading might be that the amount involved is the greater of the amount given to the foundation or received by the disqualified person. Any interpretation may leave the question of whether what was given or received was the net value of the property after subtracting the value of what was received or given. In any event, there is not necessary relation whatsoever in such provisions between the measure of the tax and the value of any benefit conferred on a disqualified person.

(a) Initial Taxes

Paragraph (1) of section 4941(a) imposes a 5 percent tax on the participation of a disqualified person in an act of self-dealing and paragraph (2) imposes a 2½ percent tax on the participation of a foundation manager in an act of self-dealing. Section 4946(a) defines the term "disqualified person" to include a foundation manager. Accordingly, both taxes would appear to apply cumulatively to a foundation manager who participates in an act of self-dealing whether or not he participates on his own account. It is not believed that this is the intent.

(b) Additional Taxes

As in section 4941(a), under section 4941(b), both the taxes on disqualified persons and on foundation managers would literally apply to a foundation manager.

(c) Self-dealing

The special rules in section 4941(d)(2) should exclude from the definition of self-dealing the furnishing of goods, services or facilities by a foundation to a disqualified person in connection with personal services rendered to the foundation by the disqualified person.

Taxes on Failure to Distribute Income

(a) Adjustment of Distributable Amount Where Distributions During Preceding 5-year Period Have Exceeded Income

Section 4942(i) in effect provides a 5-year carryover for distributions in excess of income. It is not clear whether distributions by existing foundations in years prior to 1970 may be taken into account for purposes of the carryover. In addition, it appears that new foundations which make distributions in excess of income in their early years should have the benefit of the carryover. It is recommended that the provision be revised to permit the carryover from years prior to 1970 and further to permit the carryover if the aggregate qualifying distributions for such part of the 5-year period as the foundation has been in existence exceed the distributable amounts.

(b) Operating Foundation

The Committee is concerned that the definition of operating foundation may not be broad enough to cover all cases in which the contributor should be allowed a qualifying distribution. The first requirement for meeting the definition, that substantially all of the income must be expended directly for the active conduct of the activities constituting the purpose or function for which the operating foundation is organized and operated, appears to be an appropriate test. The second requirement is met if either (i) substantially more than half of the assets are devoted directly to the charitable activities or (ii) substantially all of the support is normally received from five or more exempt organizations not under common control with the recipient or from the gen-

eral public and not more than 25 percent of the support is normally received from any one such exempt organization. An active foundation which has such an endowment that more than half of its assets cannot be devoted directly to charitable activities may therefore be excluded because of the nature of its source of support. The statute takes a most indirect approach to what appears to be the real concern: that contributions from other private foundations be expended promptly. It is recommended that this problem be met by a direct requirement that not only income of an organization seeking to qualify as an operating foundation be expended for its charitable purposes but that substantially all contributions received from private foundations also be expended in the current or next succeeding year.

Taxes on Excess Business Holdings

Section 4943 imposes an initial tax at the rate of 5 percent and an additional tax at the rate of 200 percent of excess business holdings of a private foundation, as defined in the section. Where disqualified persons control the business and, in the case of an incorporated business, own 20 percent or more of the stock, the private foundation must dispose of all but 2 percent of the stock. Moreover, except in the case of holdings owned on May 26, 1969, the disposition could not be by sale at fair value to the disqualified persons without attracting the tax on self-dealing. The statute would provide a 10-year period to dispose of present holdings or holdings acquired under the terms of a will executed on or before July 28, 1969 and a 5-year period to dispose of other excess holdings acquired by gift or bequest.

The Committee is concerned that in some cases the disposition may not be possible within the 10-year period or the 5-year period, at least without substantial loss to the foundation. Such a case might arise, for example, when the only practical occasion for the foundation to realize a fair price would be to join in a negotiated or public sale of the controlling interest by the disqualified persons who had contributed to the foundation. The disqualified persons may, however, not desire to or have an appropriate opportunity to sell within the required period.

It is accordingly recommended that a provision be added permitting the Secretary or his delegate to extend the period beyond 10 years or 5 years in cases of hardship.

Taxes on Taxable Expenditures

Section 4945 provides penalty taxes on taxable expenditures made by private foundations, to be levied against the foundation at the rate of 100 percent of the amount of the expenditure and against the foundation manager, who knowingly agrees to the expenditure, at the rate of 50 percent.

(a) Taxable Expenditure

Taxable expenditures are defined in section 4945(b) as follows:

> "For purposes of this section, the term 'taxable expenditure' means any amount paid or incurred by a private foundation—
>
> "(1) to carry out propaganda, or otherwise attempt to influence legislation,
>
> "(2) to influence the outcome of any public election (including voter registration drives carried on by or for such foundation),
>
> "(3) as a grant to an individual for travel, study, or other similar purposes by such individual, unless such grant satisfies the requirements of subsection (e),
>
> "(4) as a grant to another organization (other than an organization described in paragraph (1), (2), or (3) of section 509(a)), unless the private foundation exercises expenditure responsibility with respect to such grant in accordance with subsection (f), or
>
> "(5) for any purpose other than for a purpose specified in section 501(c)(3)."

The statement of the Chairman of the Committee on Federal Legislation of the Association of the Bar of the City of New York, which has already been filed, criticizes these provisions in some detail and the Committee on Taxation endorses these criticisms. Thus, the Committee feels that voter registration drives are in general to be encouraged

and should be penalized only if carried out in a flagrantly selective and partisan manner. The restrictions surrounding grants to individuals for travel, study, or similar purposes are so severe that they may well result in the elimination of such grants by private foundations. The expenditure responsibility required to be exercised in connection with grants to other organizations, including the requirement "to see that the grant is spent solely for the purpose for which made," is so onerous that many foundations will feel it impossible to make such grants.

Paragraph (1), quoted above, paraphrases the limiting language in section 501(c)(3). There is, however, a most important difference. Under section 501(c)(3), no *substantial* part of the activities may be "carrying on propaganda, or otherwise attempting, to influence legislation." Under the taxable expenditures provision, any attempt to influence legislation which involves an expenditure may attract tax with no *de minimis* rule. Moreover, the practical effect may be to amend section 501(c)(3) since section 508(e) would provide for termination of tax exempt status if there are willful repeated acts or a willful and flagrant act giving rise to liability for tax under chapter 42. Termination of the status would of course trigger the tax on termination under section 507. In addition, since the governing instrument must under section 508 be amended to prohibit any acts attracting the chapter 42 taxes, and the appropriate state officials are to be informed, further penalties will be applied under local law. Finally, the new section 6684 of the Code (added by section 101(c) of the Bill) would levy a further penalty equal to the amount of the tax for repeated liability for tax under chapter 42. Added together, these potential taxes and penalties, which may be applied as a result of merely minimal attempts to influence legislation, apply *in terrorem* tactics to a very sensitive area involving freedom of expression.

(b) Certain Activities Expressly Included

Section 4945(c) goes on to include as taxable expenditures amounts paid or incurred in:

"(1) any attempt to influence legislation through an attempt to affect the opinion of the general public or any segment thereof, and

33-865 O - 69 - pt. 2--48

"(2) any attempt to influence legislation through private communication with any member or employee of a legislative body, or with any other person who may participate in the formulation of the legislation,

other than through making available the results of non-partisan analysis or research."

This gloss on the traditional words "carrying on propaganda, or otherwise attempting, to influence legislation" would apparently expand the meaning of that term well beyond the limits set by the present regulations which deny section 501(c)(3) exemption to "action organizations" as well as beyond any limits set by the courts. The Committee believes that the restrictions on freedom of expression by or on behalf of charitable organizations under the present statute as interpreted by the Treasury and the courts approach the limit of advisable or even permissible restraint. They can perhaps be justified by pointing out that the only sanction is withdrawal of the privilege of tax exemption which need not have been accorded in the first place. There is, however, a valid counter-argument that the grant or withdrawal of a privilege should not be used as an instrument to suppress First Amendment freedoms. The approach of the Bill is especially odious at this time when Congress and other organizations are urging individuals and institutions to participate actively in government and politics, and Congress is considering legislation to finance political parties through tax deductible contributions. Further, any real inhibitions on "fair comment" on proposed legislation certainly should not be encouraged.

The provisions of section 4945, taken together with other provisions of the Bill, would first expand to some unknown degree the area in which private foundations are denied license to express opinion and then, by a system of compounding penalties, in effect prohibit such expression within the area. The Committee disapproves the provisions in question.

ILLINOIS STATE BAR ASSOCIATION,
October 23, 1969.

Senate Finance Committee,
New Senate Office Building,
Washington, D.C.

GENTLEMEN: Enclosed herewith are the views of the Council of the Section on Federal Taxation of the Illinois State Bar Association, with regard to the following features in the Tax Reform Bill of 1969, currently before the Committee: Subchapter S Corporations, Deferred Executive Compensation, Tax Treatment of Charitable Contributions, Income Averaging, Corporate Mergers and Multiple Surtax Exemption. The absence of comments on other proposals of the Bill should not be construed to mean that the Section on Federal Taxation of the Illinois State Bar Association either agrees or disagrees with said proposals.

Very truly yours,

JOSEPH Z. SUDOW, *Chairman,*
Section on Federal Taxation.

STATEMENT OF THE ILLINOIS STATE BAR ASSOCIATION, SECTION ON FEDERAL TAXATION 1969–1970

I. SUBCHAPTER S CORPORATIONS

Section 541 of the Tax Reform Bill would limit pension plans for shareholder-employees of Subchapter S corporations to approximately the same limitations imposed in this respect on the self-employed under H.R. 10.

This proposed limitation became part of a "package" of changes to the entire Subchapter S area worked out by the Treasury and a special group from the Committee on Partnerships of the Section of Taxation of the American Bar Association which in the aggregate would have made Subchapter S corporations more nearly taxable as partnerships. The Council of the Section on Federal Taxation of the Illinois State Bar Association (hereinafter the "Council") is of the opinion that if an enterprise which is incorporated still wishes to be taxed as a partnership, then it would seem to be proper for such corporation to accept the detriments of partnership taxation as well as its benefits. There is no justification for giving this group the best of both the partnership and the corporate worlds as far as taxation is concerned.

However, Subchapter S corporations are in fact corporations, and the present provisions of Subchapter S do not entitle such corporations to partnership taxation. Subchapter S corporations do not presently have all of the benefits of partnership taxation, and they should not, therefore, be subjected to the same detriments.

Further the limitations imposed by H.R. 10 are overly restrictive and are discriminatory. They should not be broadened to another group of taxpayers, but instead H.R. 10 should be relaxed or even eliminated in favor of rules that are identical with respect to both the employed and the self-employed.

In any event the Council believes there should be no limiting amendments to Subchapter S until the entire revision of that subchapter is considered by Congress, and even then any change in the law with respect to pension benefits should be made a part of a Congressional review of the entire field of pension benefits and should be enacted if at all as part of a general revision in that area.

II. DEFERRED EXECUTIVE COMPENSATION

1. Stock Options

The provisions of law governing the taxation of stock options remained substantially unchanged from the date of their enactment in 1950 until 1964. Congress carefully reviewed the treatment of stock options in connection with the Revenue Act of 1964, and concluded that stock options were fundamentally sound as a type of tax-favored incentive for employees. However, it did conclude that the rules applicable to such options should be tightened in several important respects. For example, the period in which an option may be exercised was shortened from 10 to 5 years, the period that stock must be held after an option is exercised was lengthened from as little as 6 months to 3 years, and the mini-

mum option price was raised from 85% to 100% of the fair market value of the stock at the date the option is granted.

The Council believes that the stock option provisions are basically working in the way intended, and that there are no evidences of abuse which would require another reexamination so soon after the extensive revisions made in 1964. Some have argued that the stock option provisions are an unwarranted tax incentive and should be repealed. This argument has been made since the stock option provisions were included in the law in 1950, and was rejected by Congress when it reviewed the treatment of stock options in 1964. Others argue that certain of the 1964 amendments, for example the 5-year limit on the period in which an option may be exercised, are too restrictive. However, the Council believes that more experience is needed under the 1964 amendments and that it would be premature to again revise them at this time.

2. Restricted Stock Plans

At one time the courts, with the acquiescence of the Internal Revenue Service, took the position that if stock received by an employee upon exercise of an option is subject to restrictions which substantially affect its value no tax will be imposed either when the stock is received or when the restricions lapse. The Internal Revenue Service issued regulations in 1956 which were designed to close this unwarranted loophole. Under these regulations the employee is subject to tax, at ordinary rates, when the restrictions lapse, but the tax is limited to the spread between the option price and the fair market value of the stock when the option is exercised or when the restrictions lapse, whichever is lesser.

The so-called restricted stock plan is merely a variation of the option described above, and the Internal Revenue Service formally ruled early in 1968 that the restricted stock plan would be taxed under the rules of the 1956 regulations.

The Internal Revenue Service became concerned over the spreading use of restricted stock plans and issued proposed regulations a few months ago which, in the case of restricted stock plans, would tax the spread between the purchase price and the value when the restrictions lapse as ordinary compensation.

The Council is not persuaded that the restricted stock plan is an inequity calling for remedial legislation by Congress. The employee who purchases stock under a restricted stock plan immediately pays full value for the stock. He does not have an option on the stock, and so he immediately bears the full risk of any gain or loss on the investment. At the same time he is locked into his investment since he is usually prohibited from selling the stock or borrowing on it for a period of time.

The arrangement does not result in a loss of revenue on balance. It is true that any gain to the employee is taxed as a capital gain, and that such gain is not taxable until the stock is sold. However, his employer does not receive a deduction at any time for the amount of such gain. In most cases there would probably be some small loss of revenue if the gain were taxed to the employee as ordinary income and the employer were allowed an offsetting deduction.

In the opinion of the Council, it is not at all clear that the restricted stock plan produces an inequity. It is an arrangement which has distinct disadvantages both to the employee and his employer which must be paid as the price for the tax advantages. We are not convinced, based on experience to this date, that such plans are an undesirable compensation device which Congress should restrict or regulate at this time.

3. Deferred Compensation Contracts

The Internal Revenue Service published a ruling in 1960 which holds, in substance, that an employee and his employer may agree to defer the payment of part or all of his compensation, and that the employee will not be taxed until such deferred payments are received. The agreement to defer compensation must be made before the services are performed and the agreement must be backed only by the employer's promise to pay—it must not be funded.

The tax treatment of deferred compensation contracts had been clouded with uncertainty for 20 years or more and the ruling, which is clearly supported by the case law, removed the confusion which had long prevailed in the area. The Council believes that the ruling not only is sound under the law but that it reaches a fair result. The employee is not permitted to turn his back on income after it is in fact earned. The agreement must be executed before the services are performed. Moreover, the employee is currently taxable if the agreement is funded and the employee's rights are nonforfeitable. We believe that an employer and his employee should be free to agree on the time that an employee will receive his com-

pensation, and that the employee should not be taxed until he actually receives the compensation when the conditions described above are met.

III. TAX TREATMENT OF CHARITABLE CONTRIBUTIONS

Such questions as the maximum amount which should be allowed as a charitable contribution deduction, whether a deduction should be allowed for charitable contributions in addition to the standard deduction, whether deductions under a specified percentage of adjusted gross income should not be allowed as charitable contributions, and whether the deduction for gifts of appreciated property should be limited to the cost of such property, are fundamentally questions of tax policy on which the Council generally does not wish to express a view. However, we would like to raise two basic questions which we believe the Committee should carefully weigh in considering the proposals to allow a deduction for charitable contributions in addition to the standard deduction, but to allow a deduction only to the extent that charitable contributions exceed some percentage of adjusted gross income.

1. The fundamental principle underlying the standard deduction is that it serves as an alternative to itemizing various personal deductions. The fundamental justification for the standard deduction is that it simplifies the Federal income tax system, both in terms of administration by the Internal Revenue Service and compliance by taxpayers. The Council believes that the fundamental principle of the standard deduction is sound and that there is a strong presumption against the desirability of any exceptions permitting taxpayers to claim certain deductions in addition to the standard deduction. If an exception is made for charitable contributions it is difficult to see why an exception should not also be made, for example, for heavy medical expenses. The proliferation of such exceptions would be inconsistent with, and seriously undermine, the purpose and long term usefulness of the standard deduction.

2. Congress should consider very carefully whether a denial of any deduction for contributions below a stated percentage of adjusted gross income would seriously affect the amount of charitable giving. The Treasury Department has indicated in the tax reform studies released early this year that the disallowance of deductions under the 3 percent level would increase revenues by $1.5 billion and affect 21.6 million taxpayers who itemize deductions, while the allowance of a charitable deduction outside the standard deduction would involve an annual revenue loss of about $440 million. The Treasury Department implies that charitable gifts under 3 percent of adjusted gross income are routine and will be made without regard to the availability of a tax deduction. The Council is concerned about the correctness of such a conclusion. We believe that the proponents of the proposed disallowance of charitable contributions below a stated level should bear the burden of proving that the proposal will not significantly affect the amount of charitable giving. It is reasonable to expect, in the absence of evidence to the contrary, that a proposal which will increase tax liabilities by a net amount in excess of one billion dollars will affect the amount of charitable gifts.

IV. INCOME AVERAGING

1. *Whether the restriction in present law limiting income averaging to those cases where there is an increase of one-third above the average income of the four prior years should be modified.*

There were two stated reasons for limiting income averaging to cases where there was an increase of one-third above the four-year average and restricting benefits to income in excess of that amount: (1) to limit the number of cases to which income averaging would apply to a manageable level, from an administrative standpoint, and (2) to make the averaging rule available where it was needed most, in cases where the fluctuation in income levels varied widely.

Unfortunately, the result of the application of the limitation is that there can be a rather wide fluctuation in income without very much in the way of tax relief.

We doubt that the elimination of the limitation would impose any insurperable administrative burden on the Internal Revenue Service. The limitation of the application of the statute to cases where the averageable income exceeds $3,000 already eliminates most of the administrative burden. If, as we later suggest, the adjustments to taxable income and average base period income are simplified, the verification of a taxpayer's Schedule G computation should be a simple matter.

The Council is of the opinion that Section 382 should be amended to cover those few situations not now covered by it—i.e., loss carryovers in B reorganiza-

tions and actual changes in ownership which do not constitute changes in stock ownership under Section 382(a)—and the application of Section 269 to loss carryovers should be eliminated.

The Internal Revenue Service and the courts have strained the language of Section 269 inordinately, particularly in the area of loss carryovers, and we think that in the interests of good administration, the rules applicable to loss carryovers should be set forth objectively and exclusively in Section 382.

2. *The tax treatment of bonds or debentures received for stock in a merger.*

What is presumably referred to here is the method of acquiring stock of a corporation in exchange for bonds or debentures, convertible or otherwise, in such a manner that the recipient of the bonds or debentures treats the transaction as an installment sale, deferring taxation on the gain until the bonds or debentures are disposed of, and the issuer of the bonds or debentures deducts the interest thereon from its taxable income.

H.R. 7489, recently introduced, provides: (1) that a bond or debenture issued by a corporation or by a government or political subdivision thereof, with interest coupons attached or in registered form, shall not be treated as an evidence of indebtedness of the purchaser for purposes of the installment sale provisions of the Code; and (2) that where a corporation acquires stock of another corporation, and more than 35 percent of the consideration for the acquired stock consists of "evidence of indebtedness of the acquiring corporation or of other property attributable to borrowing by the acquiring corporation," the interest otherwise deductible with respect to the evidences of indebtedness or other borrowing or with respect to any refinancing thereof shall be reduced to the amount obtained by multiplying the interest by the fraction which 35 percent bears to the percentage of the consideration representing evidences of indebtedness or such other property.

From a tax standpoint, we do not think this type of transaction presents an abuse situation. The recipient of the stock or debentures will ultimately realize his gain, or his estate will. Assuming that the bonds or debentures are true indebtedness of the acquiring corporation, the acquiring corporation should get its full interest deductions. If there is abuse, it lies in the fact that this type of transaction is being used by conglomerates to acquire sound corporations with unsound securities, and this may well be an appropriate situation for statutory revisions in other fields of the law. We do not think that the revenue laws are the best vehicle for curing this sort of abuse.

3. *Whether the present income averaging provision should be simplified and made available for capital gains and certain other types of income.*

Average base period income is computed under the statute by adding to base period taxable income excluded income earned from sources without the United States, and by subtracting therefrom capital gain net income (50% of the excess of long-term gains over short-term losses) and net income attributable to property interests acquired by gift, bequest, devise or inheritance. Adjusted taxable income for the year to which averaging is applied, is computed by subtracting from taxable income the following items:

1. Capital gains net income.
2. Net income from gifts, bequests, etc.
3. Income from wagering.
4. Income from sales of oil and gas properties to which Section 632 of the Code applies.
5. Income from claims against the United States to which Section 1347 of the Code applies.
6. Excess of community-earned income over income attributable to services.
7. Income of owner-employees subject to Section 72(m)(5) penalty.

In converting adjusted taxable income to averageable income in addition to the previously discussed limitation to the excess over 133⅓% of average base period income, there is a further reduction for the excess of average base period capital gain net income over capital gain net income for the computation year.

While most of these adjustments are probably justified as a matter of absolute fairness, they make the Schedule G a most complex document, and one which is inordinately time-consuming in preparation for taxpayers and their representatives.

The Council thinks that the interests of good administration and simplified return preparation would be best served by eliminating all the foregoing adjustments from the income averaging provisions, and simply providing that income averaging will apply to the excess of the taxable income for the computation year over the four-year base period average taxable income. Some taxpayers will receive minor windfalls, and some will suffer minor inequities from such a simplified computation, but the overall result will be fairness and simplicity.

4. *Whether income averaging should be available where the income in the current year is below, instead of above, the average income in the four prior years.*

This suggestion would appear to be logical, but it might require considerable further complexity in the statute, and there is, of course, a built-in relief where current income drops, in the form of lower tax brackets.

V. POSSIBLE REVISIONS OF TAX PROVISIONS RELATING TO CORPORATE MERGERS

1. *The extent to which net operating loss carryovers should be available where one corporation is acquired by another.*

The case law since the enactment of the 1954 Code has demonstrated that the combined arsenal of Sections 269, 382 and 482 and the *Libson Shops* decision (under the 1939 Code) has provided the government with more than adequate ammunition to eliminate most abuses in this area.

In any event, we feel that H.R. 7489 may lead to unintended results. With respect to the restrictions imposed upon the availability of the installment method, there is a real danger of hardship in the ordinary situation, where stock in a family corporation must, for any number of reasons, be sold. Unless the installment method is available, it is unlikely that the shareholder will sell other than for cash, and this will mean that the sale will be made, not to the corporation or its employees or to other family members, but to some purchaser with a ready concentration of wealth. One more family corporation will have disappeared.

Regarding the provisions disallowing interest deductions where stock of a corporation is acquired, and part of the consideration is debt or property attributable to debt, there are several objections: (1) we see no valid reason why interest deductions should be disallowed on debt issued to acquire stock and allowed on debt issued to acquire assets; (2) we think that the 35 percent of consideration permitted to be in the form of debt is too low, and will simply result in 65 percent of the consideration being in alternative forms—warrants and convertible preferred stocks, for example, and (3) we think that the phrase "or other property attributable to borrowing by the acquiring corporation" will cause the same difficulties of construction as the phrase "interest incurred or continued to purchase or carry obligations" has under Section 265(a) of the Code.

VI. MULTIPLE SURTAX EXEMPTION

Whether the multiple surtax exemption should be eliminated, perhaps over a period of years, in the case of a related group of corporations.

Improper or unrealistic multiplication of the corporate surtax exemption is a matter of long continuing concern. Prior to 1964, four major controls existed:

1. Section 482 authorizes reallocation of gross income, deductions, credits or allowances between or among organizations in order "* * * to prevent evasion of taxes or clearly to reflect the income of any of such organizations. * * *" Disallowance of multiple surtax exemptions may be effected under section 482 by reallocation of taxable income of related corporations to a single member of the related group. See *Hamburgers York Road, Inc.*, 41 T.C. 821 (1963).

2. Section 269 authorizes reallocation or disallowance of gross income, deductions, credits or allowances where (a) control of a corporation (defined as ownership of 50% of total combined voting power of stock or 50% of total value of all classes of stock) is acquired by a person, persons or corporation, and (b) "* * * the *principal* purpose for which such acquisition was made is evasion or avoidance of Federal income tax. * * *" (Emphasis added.) Section 269 clearly affects multiple surtax exemptions. See Treas. Reg. § 1.269-3(b). It has been treated as more or less interchangeable with section 1551. See, *e.g.*, *Bush Hog Mfg. Co., Inc.*, 42 T.C. 713 (1964).

3. Section 1551 authorizes disallowance of surtax exemptions and the accumulated earnings credit where (a) a corporation or less than 6 persons (who are in control of a corporation) transfer property to a newly created or previously inactive controlled corporation (defined as ownership of 80% of total combined voting power of stock or 80% of total value of all classes of stock), and (b) the transferee corporation does not establish, by a clear preponderance of the evidence, "* * * that the securing of such exemption or credit was not a *major* purpose of such transfer." (Emphasis added.)

4. Section 61, bolstered by the theory of "disregarding the corporate entity" provides a basis for disallowance of multiple surtax exemption by disregarding multiple corporations. See, *e.g.*, *Aldon Homes, Inc.*, 33 T.C. 582 (1959).

These methods of control are uncoordinated: They contemplate different operative situations, different control relationships among multiple entities, and different burdens of proof. They have been used cumulatively or alternatively in shotgun approaches to multiple corporation problems. See, *e.g.*, *Kessmar Const. Co. v. Comm'r*, 336 F. 2d 865 (9th Cir. 1965); *Bush Hog Mfg. Co., supra; Samuel Napsky*, T.C.M. 284 (1965); *The Erensco Truck Co.*, T.C.M. 072 (1963). Thus, while the "evil" of improper or unrealistic multiplication of surtax exemption is readily grasped, the control devices, particularly when joined in a statutory broadside, are complex and most confusing.

Sections 1561 through 1563 were enacted in connection with the reduction of the rate of the normal corporate tax. The legislative history of the Revenue Act of 1964 indicates that modification of the corporate rate structure was intended to encourage small businesses which operate in corporate form. However, "while your Committee recognizes the importance to small business of reducing the tax on the first $25,000 of income from 30 to 22 percent, it also recognizes that this substantial tax reduction should not provide an added inducement to existing medium and large corporations to split up into multiple corporations." H. Rep. No. 749, 88th Cong. 1st Sess. 117 (1963).

Section 1561 provides for apportionment of a single surtax exemption between or among corporations which are "component members" of a "controlled group of corporations." Section 1563 contains definitions and special rules relating to control, stock ownership and constructive ownership of stock. These definitions and rules tend to narrow the application of section 1561 to situations more limited than those within the contemplation of prior statutory provisions affecting the surtax exemption. Section 1562 offers "controlled groups" the privilege to elect to enjoy multiple surtax exemptions upon payment of an additional tax of 6 percent on the first $25,000 of taxable income. The rule of section 1561 and the election of section 1562 do not prevent the application of other or further controls imposed under other statutory theories.

Unlike other statutory theories, the apportionment required by section 1561 is automatic: If related corporations constitute a "controlled group," section 1561 applies without regard to "tax avoidance purpose" or "clear reflection of income" or the like. Such an automatic rule facilitates administration, but in a particular case it may tend to undermine Congressional intent to encourage small business. Perhaps this explains the limitations of the section 1563 definition of a "controlled group," particularly in regard to brother-sister relationships where *one person* must enjoy the 80% control required. Perhaps this also explains the escape route of section 1562 which is likely to be chosen by all "controlled groups" which have total combined taxable income in excess of $32,500. See Bittker and Eustice, Federal Taxation of Corporations and Shareholders § 13.33 at 685 (2d ed. 1966).

The definitional limitations of section 1563 meliorate substantially the impact of section 1561 (particularly in the case of brother-sister corporations). The escape route of section 1562 undermines the attempt to curb improper multiplication of the exemption: Multiplication is made somewhat less advantageous, but the "inducement. . . to split up into multiple corporations" remains. Thus, real control of improper multiplication remains to be secured by pre-1964 provisions, *viz.*, sections 482, 269 and 1551.

The Council of the Section on Federal Taxation favors elimination of the multiple surtax exemption and the broadening of the group which may be subject to apportionment of the exemption. At the same time, it is concerned that an automatic rule may impose an inappropriate burden on developing small business in a particular case; it would prefer that controlled groups be allowed to demonstrate non-tax avoidance on non-tax motivated purpose, or, perhaps, even "small business purpose" which would be facilitated by and would justify multiple allowance. This might be accomplished by repealing sections 1561 and 1562 and by modifying section 1551 so as to: (1) broaden the application of sec-

tion 1551 beyond the operative situation where "the transferee corporation was created for the purpose of acquiring such property or was not actively engaged in business at the time of such acquisition," and (2) permit apportionment of the surtax exemption rather than complete disallowance to one or more related corporations.

The Council of the Section on Federal Taxation strongly favors review of all controls upon improper multiplication of the exemption to the end of simplifying the present complex of statutory theories.

STATEMENT PREPARED BY DUDLEY SWIM, CARMEL, CALIF.

PROCEDURAL RECOMMENDATION

Lay over tax revisions for another year to afford thorough, balanced study on behalf of taxpayers—not just government. "Reform" should also be from taxpayer's point of view—as well as government's. A staged emotional blitz is no background for major tax revision.

SUBSTANTIVE RECOMMENDATIONS

1. *Estate Taxes* (Give the widow a chance):

   (*a*) Levy only after death of second spouse.

   (*b*) Maintain present practice of establishing new capital gains cost base at market.

2. *Inflation Adjustments*:

   (*a*) Spread interval between tax brackets to reflect inflation (presently spreads should be doubled to adjust for less than 50¢ dollar).

   (*b*) Provide for adjusting cost base of capital assets (on sale) to reflect inflation—otherwise capital gains tax can become a capital levy (confiscation).

3. *Stock Options:* End special favor for few in this corporate pilfering device; instead establish less discriminatory upper tax brackets (maximum 40–50%);

4. *Capital Gains* (Encourage needed capital formation):

   Retain tax at 25% after a holding of one year, less one percentage point for each additional year of holding; if rate raised to 35%, then reduce by 2½ percentage points for each additional year of holding.

5. *Foundations:* Exempt only genuine charities—not those engaged in political activities. Continue to allow donor to deduct market value of donation, regardless of cost.

6. *Double Taxation on Corporate Earnings:* Eliminate this discriminatory practice by allowing stockholder, on dividends received, full credit for corporate tax paid.

7. *Universal Income Taxation:* If proposition that everyone should pay *some* income tax (regardless) is to be adopted, then let it apply at both ends of the income spectrum—not just to the few at the top but also to the many at the bottom, if only a token for latter.

I. PREFACE

POLITICS OR EQUITY

This 1969 Revenue Bill has been trumpeted as a measure of "reform"! But by what standards?

Apparently, the proposed radical changes are the product of a scheme carefully developed by a small clique over a period of years and sprung suddenly in a spirit of fanaticism. Credit must be given for the obvious success in making the *cunning schemes of a few appear as the righteous demands of the many.*

The key word in the build-up has been "reform." It is a well-worn political device to label one's objectives as "reforms"—an unctuous term implying virtue to the proponent and evil to the opponent. Likewise, the term "loophole" is applied to any provision not liked. As for "discrimination," let it be remembered that any "provision" in the Revenue Act is open to anyone who may choose to qualify thereunder.

BASIC POLICY

Tax policy should be motivated by a constructive approach toward generating revenue. It should not be a response to the emotions of the envious. It should not penalize the fortunate, nor punish the thrifty and hard-working. No one should be "soaked", neither the rich nor the "unrich".

The function of taxation is not to lock the door to financial success.

Unusual courage, talent, and application should be encouraged and rewarded—not thwarted. Our whole civilization, which benefits the many, is the creation of a relative few down through the ages. Our response should be gratitude and encouragement—not prejudice or hate—for outstanding, constructive achievement.

II. Procedural Recommendation

Consideration of a bill involving such a multitude of major changes in our tax laws should be laid over until at least January 1971 (only slightly more than one year) to enable broad, deep, and objective study for all concerned, to the mutual benefit of the government and taxpayers. Those who have concocted these "reform" schemes have obviously been engaged in the process for years. The taxpayers have really not had an opportunity to prepare and present their case.

An emotional blitz is no background for such a serious and far-reaching undertaking as restructuring our fundamental tax laws.

Reference is made to the penetrating and masterful analysis prepared by Dr. Raymond J. Saulnier for submission to this committee. The published summary was well entitled "Tax Reform: Exchanging Old Inequities for New".

III. Substantive Recommendations

ESTATE TAXES

Our system of taxing an estate on the death of the first spouse is cruel.

The breadwinner usually goes first. At the husband's death, the widow is confronted not only with the cessation of his earnings but also with a severe shrinkage in the estate caused by estate taxes and high probate costs. This reduced estate then becomes her sole source of income for the support of herself and her dependents.

As though all this were not enough, the widow soon finds her sharply reduced income taxed at the markedly higher income tax brackets of a single person.

Why not at least defer the estate tax until the second spouse dies?

The existing system of adjusting in an estate the decedent's cost base to market value at the time of death or one year later should be maintained. It is only fair in the face of the heavy burden of estate and inheritance taxes, which themselves constitute a capital levy at far higher rates.

Concocters of this proposed "reform", i.e., to levy capital gains taxes in addition to the severe burden of estate and inheritance taxes, apparently had not reached adulthood at the time of the 1929 crash. There were repeated and tragic instances of widows being left with estates that were bankrupted by the impact of the multiple tax load. That led to amendments to prevent the recurrence of such tragedies. Now should we start to turn back on this progress?

INFLATION ADJUSTMENTS

The present tax bill is silent on the glaring inequities produced by the major inflation that has been experienced in this country.

Such inflation has the effect of stepping up the severity of a graduated income tax. The between-bracket intervals in the presently prevailing rates should be doubled to afford relief from the automatic increase of the tax take caused by the arrival of a 50¢ dollar (or less).

Unless the tide of pseudo-liberalism that has been producing run-away governmental spending is reversed, inflation could reach the point where the effective over-all income tax levy under the present scale of graduated income tax rates would reach 50% or higher in the case of the average wage earner.

In the capital gains treatment, provision should be made for the adjustment of the cost base (on a sale) for the shrinkage in the value of the dollar. The sale today for $20,000 of an asset bought in 1946 for $10,000 would show no real gain—only a break-even after adjustment for the shrinkage of the dollar. Taxing such an unreal capital gain under our present tax system subjects one to a capital levy—i.e., confiscation of part of the property.

STOCK OPTIONS

The stock option device was developed as a deliberate tax loophole to circumbent in part for management the vastly increased tax burden that came with the emergence of big government in the United States.

Why should special and sheltered treatment be provided for the very few? (What is needed is a less harshly discriminatory top income tax bracket—such as 40–50%.)

Stock options have become the modern form of corporate pilfering. The abuse is snowballing. With options being granted in the amount of say 5% of the outstanding stock on each round, stockholders in not many years can find themselves diluted out of one-half of their ownership.

Philosophically, profit is the reward for the assumption of risk. Stock options, in this sense, are simply a betrayal of the private enterprise system. They offer a hit-and-run, riskless profit—a free ride.

There is no legitimate incentive that a stock option plan provides that cannot be better accomplished by a firmly committed stock purchase (carrying) plan with the stock being acquired in the open market, which eliminates the runaway dilution of stockholders' equity. There is in fact no dilution. Moreover, management acquires a continuing stock ownership—and must bet on itself as must the stockholders.

CAPITAL GAINS

Here again, are the proposed revisions in respect to capital gains really "reforms" or are they born of bias, prejudice, and lack of understanding of the role of capital?

Capital is derived from savings—the excess of one's income over expenditures. Sometimes it is defined as "stored up" labor.

Never has there been such need for capital as exists today. The amount of capital required to provide the average job in industry has risen sharply. Supersize airplanes, automation, the computer, and vast research programs pose especially heavy, still newer demands for capital. *Ever since the industrial revolution, made possible by the invention of the steam engine, the name of the game has been substituting capital for labor, thereby emancipating the workingman from drudgery and raising the standard of living opportunity for everyone.*

Yet, the provision of support capital has been substantially impeded by governmental action. Heavy and steeply graduated income taxes have retarded growth of available capital. More than 38 years of almost continuous, massive Federal deficits, largely since the emergence of big government, have absorbed vast amounts of private capital in competition with industry.

Inflation is tagged as our number one domestic problem. The more attractive saving is made, the greater will be the diversion of income from expenditure to savings, the less the inflationary pressure of spending, and the greater the development of capital for facilitating the increase of production.

Risk-bearing is a further role of capital.

Speciously it is sometimes argued that capital gains should not be treated differently from earned income. But who is contributing more to economic progress in our America—(a) a professional bureaucrat safely ensconced in the civil service with a job practically guaranteed for life, to say nothing of a very comfortable pension, and who spends his days concocting schemes further to restrict the individual, or (b) an electronics engineer imbued with a vision who musters his own savings and those of friends and courageously launches a new enterprise (with all its inherent risks) to provide our society with new or better products and more employment for an expanding labor force?

With ever more young people being brainwashed to seek "security", the more the inducements that should be offered to encourage the assumption of entrepreneurial risks. Enterprise provides the mainsprings of our economic society.

The bill as passed by the House increases from six months to one year the minimum holding period for long-term capital gains. This is reasonable. (I so advocated before the House Ways and Means Committee.) But there should be a scaling down of capital gains rates for longer holding. It is suggested that the maximum effective basic rate of 25% heretofore in effect be maintained and scaled down one percentage point for each additional year of holding beyond the one-year initial period. If the rate is to be increased to 35%, then it is recommended that the effective maximum rate be reduced 2½ percentage points for each additional year of holding beyond the first year. There is, in general, an obvious correlation between the length of holding and the extent of the economic contribution.

Moreover, provision should be made for adjusting the cost base on the sale of assets to offset the shrinkage in the dollar. (See section on "Inflation Adjustments", page 5.)

FOUNDATIONS

May you see fit to continue the present tax exemption for genuinely "charitable" foundations.

But foundations engaged in political activity, even though such activity masquerades as "do-goodism", should be taxed. The Ford Foundation and the octopus it has created may fall under this latter category.

To encourage private charity, the revenue act should continue to allow the donor to deduct the full market value of a donated asset regardless of the cost.

While private charity is offensive to those who are scheming to have all charity flow from government, i.e., a socialist state, the encouragement of private charity is essential to the maintenance of a free society in the finest traditions of our America.

DOUBLE TAXATION ON CORPORATE EARNINGS

This discriminatory practice of doubly taxing corporate earnings—first through the corporation and then through the individual stockholder on dividends received—should be eliminated by allowing an individual taxpayer to take full credit for corporate taxes paid with respect to the earnings distributed to him as dividends.

UNIVERSAL INCOME TAXATION

Great concern has been expressed that an infinitesimal few have been lawfully avoiding all taxes. Of what consequence is it that two hundred out of a population of two hundred million derive their income entirely from tax-free bonds? Who is wronged? They are legitimately lending to state and local governments at a reduced rate and, furthermore, are suffering a severe capital loss from the erosion of the dollar, to say nothing of incurring the extreme market depreciation currently prevailing in municipal bonds.

Investment in tax-free bonds is open to anyone.—If it is such a prize, why not more people taking full advantage of it?

While closing this alleged "loophole" to two hundred in the higher income groups, the bill would open a gigantic loophole to three million in the bottom income tax brackets by raising exemptions. The loss of revenue from this new loophole would be massive.

If we are to adopt the proposition that everyone directly pay some income tax, should it not apply at both ends of the income spectrum—to the many at the bottom, if only token, as well as to the few at the top? Or is the emotional rebuke to be expected from the demagogue to much to be braved by some?

STATEMENT OF JOHN P. MEEHAN ON BEHALF OF THE NATIONAL ASSOCIATION OF LIFE UNDERWRITERS

The following comments concerning the Tax Reform Act of 1969 (H.R. 13270) are made on behalf of the National Association of Life Underwriters (NALU). I am John P. Meehan of Boston, Massachusetts, a Trustee of NALU and Chairman of its Committee on Federal Law and Legislation.

The National Association of Life Underwriters (NALU) is a trade association composed of 949 state and local life underwriter associations representing a membership of over 100,000 life insurance agents, general agents and managers residing and doing business in virtually every locality in the United States.

While NALU, as a part of the business community, is generally interested in many of the proposals contained in H.R. 13270, it is particularly concerned with proposed reform in three areas:

(1) The proposed tax treatment of retirement plan contributions on behalf of shareholder-employees of Tax Option Corporations (Subchapter S Corporations);

(2) The proposed tax treatment of lump-sum distributions from pension or profit-sharing plans, and

(3) The reorientation of the application of the unrelated business income tax.

The comments following are confined to these areas.

On the subject of Subchapter S Corporations I am pleased to be able to tell your Committee that we are also speaking for the National Small Business

Association which, as your Committee knows, is made up of over 36,000 small businesses in this country, which are vitally concerned with this aspect of the tax reform bill.

I would like to note at this point that NALU is also concerned with the proposed reform in the areas of deferred compensation, stock dividends, and multiple and accumulation trusts. With a view to consolidating testimony, NALU is not commenting on these sections, but would like to associate itself with the statement presented to this Committee by James B. Irvine, CLU, President of the Association for Advanced Life Underwriting (AALU) and Vice Chairman of our Committee on Federal Law and Legislation on these subjects. The AALU is a conference of NALU.

I. TAX OPTION (SUBCHAPTER S) CORPORATIONS

Section 541 of H.R. 13270 proposes to amend Subchapter S of the Income Tax Chapter of the Internal Revenue Code by adding a new section 1379 which would require a shareholder-employee of a Subchapter S corporation who also owns more than 5% of the corporation's stock to include in his gross income contributions made by the corporation on his behalf under a qualified retirement income plan to the extent such contributions exceed 10% of his salary or $2500, whichever is less. These proposed limitations are similar to those contained in the Self-Employed Individuals Tax Retirement Act of 1962 (the Keogh Act).

In reporting the bill, the Ways and Means Committee explained its rationale in recommending this provision by emphasizing the similarity between this kind of a corporation and a partnership or proprietorship. The Committee felt that a tax avoidance device had been created to the extent that partnerships and proprietorships could incorporate and elect Subchapter S status to escape the restrictions imposed on retirement programs for these unincorporated organizations. The Committee rationalized that an organization seeking to be taxed in a manner similar to a partnership should be subject to the same H.R. 10 limitations as a partnership.

While the Committee makes it quite clear that the target of the provision is tax avoidance, no probative evidence of tax abuse or intent to avoid taxes by Subchapter S corporations is offered or even discussed. Indeed, the calculations of the Committee itself indicate that the Treasury's loss of revenue with respect to this particular device is quite small. Although there are approximately 200,000 Subchapter S corporations today, the committee notes in chart 6 of its report (H. Rept. 91–413 (Pt. 1)) that this change in the law will produce less than $2.5 million additional revenue by 1979. This is only about four-hundredths of one percent of the additional revenue expected to be raised by H.R. 13270 by that year.

NALU realizes that revenue neutrality is a goal of this bill and that it is not intended as a revenue raising device. However, if tax avoidance is the problem to which section 541 is directed, then surely the problem could not have been great or even significant if less than $2.5 million can be gained by halting this alleged tax avoidance practice.

Even if the tax avoidance allegation were valid, this would form no basis for taxing these corporations like partnerships. Nor can NALU agree that partnerships and Subchapter S corporations are so similar in organization or operation to warrant this change.

This very point is stressed by Professor Boris Z. Bittker of the Yale University Law School in his book *Federal Income Taxation of Corporations and Shareholders*. Professor Bittker notes, "More important than labels, however, is the fact that an electing corporation remains a corporation—not only as a matter of state law, but also for many federal income tax purposes. This point cannot be overemphasized, because it is often erroneously said that Subchapter S permits corporations to be treated as partnerships. In point of fact, there are many differences between a partnership and an 'electing small business corporations.' Even while the election is in effect, corporate redemptions, liquidations, reorganizations, and many other transactions are governed by the tax law applicable to corporations, rather than by the law the partnerships; and if the election is terminated, the corporate income tax will once again become fully applicable. Recognizing these facts, some commentators have sought to sum them up in a label—'pseudo-corporation,' 'conduit-corporation,' and 'hybrid corporation,' to say nothing of more barbarous coinages like 'corpnership' and 'pseudo-type corporation.' The author prefers the more neutral terms 'electing corporation' or 'Subchapter S corporation,' however, because they serve as a constant

reminder that the corporation does not cease to be a corporation by electing to come under Subchapter S."

In making the election, the only significant change from a regular corporation which a small business undergoes is that corporate income and losses are passed directly to the shareholders and cease to have consequence to the corporate entity itself. To treat the pension plans of Tax Option Corporations differently from those of other corporations would only complicate the operation of small businesses seeking Subchapter S status for other sound business purposes.

If the owners of an established small business decide that in the interest of sound financial operation it is wise to elect Subchapter S status, they will find, if this provision of H.R. 13270 is enacted, that they are confronted with an alarming array of major and very complicated decisions. The retirement program of every shareholder-employee may have to be revised to compensate for the 10%—$2500 limitation. The corporation will also have to determine to what extent any restructuring of the retirement program for shareholder-employees may require or make desirable the restructuring of the retirement program for other employees. Any change of this nature of course must consider the possible consequences to employee-employer relations, particularly if the restructuring results in smaller retirement contributions for long-time employees.

If restructuring of a retirement program is thought desirable, consideration must be given to the disposition of long-term contractual obligations designed to meet the company's obligation under the old plan but which may not be appropriate to the needs of the revised retirement program. If, for example, the original program is funded by life insurance, it may be necessary to lapse some policies, the premiums for which do not meet the requirements of the new plan, and acquire others at considerable additional cost.

If the small business corporation is capable and willing to surmount these difficulties, the shareholder-employees will discover that the retirement program available to them as shareholder-employees of a tax option corporation is substantially smaller than that of any other corporation. The retirement programs available to corporate employees, of course, contain none of the H.R. 10 restrictions. The H.R. 10 limitations applicable to owner-employees in a proprietorship or partnership do not limit the retirement program available to owner-employees with less than 10% ownership in the organization. However, the limitations which would be applicable to Subchapter S corporations would include all shareholder-employees with more than 5% ownership in a corporation. This particular discrimination against small business corporations is entirely unexplained in the Ways and Means Committee report on H.R. 17230.

The net result of all this is to inject federal income tax back into the picture as a primary consideration in choosing a form of business operation. This is the very problem Subchapter S was created to prevent.

NALU feels there is no need for new restrictions on small business corporations and urges this Committee to recommend that Section 541 of H.R. 13270 be deleted in the final version of the Tax Reform Act of 1969. As I said earlier, we are joined in this request by the National Small Business Association.

II. TOTAL DISTRIBUTIONS FROM QUALIFIED PENSION AND PROFIT-SHARING PLANS

Section 515 of H.R. 13270 proposes to revise Secs. 402(a), 403(a) and 72(n) of the Internal Revenue Code to the extent that total distributions of the funds accumulated in qualified pension and profit-sharing plans taking place within one year of the employee's death, separation from the employer's service, or death after retirement shall be eligible for capital gains treatment only as to the net taxable portion of the contribution made by the employer.

The Ways and Means Committee in recommending this element of tax reform notes as its reason for change that the present treatment enables highly compensated employees to convert substantial amounts of deferred compensation from its regular ordinary income treatment to capital gains and that the Committee considers it appropriate to restrict the extent to which lump-sum pension distributions receive more favorable capital gains treatment than pension income received over a period of retirement years.

NALU questions whether the objective here sought by the Ways and Means Committee is most appropriately achieved by this change in tax treatment.

On page 154 of the report accompanying H.R. 13270, the Committee has set forth an example of the treatment afforded lump-sum distributions under present law as compared to the treatment for those same distributions under the proposed

law. In the example given, the Committee notes that an effective tax rate of 25% is now paid on lump-sum distributions of qualified pension and profit-sharing plans, whereas under the House proposal an effective rate of 66% would be paid. The report points out that the special capital gains rule of Section 402(a)(2) presently results in a tax differential of 41%. It goes on to say that if the special five-year forward averaging provision of the proposed law is used, the effective tax rate will be 57%, or a tax differential of 32%.

In making these comparisons, however, the report does not discuss the rate differentials produced by this same suggested change if Section 511 of H.R. 13270 also becomes law. Section 511 proposes to repeal the alternate capital gains tax for individuals. In discussing the effects of enactment of Section 511, the Ways and Means Committee indicates that the capital gains tax rate would be increased from 25% to an effective rate of 32.5% after 1971. If we use the same example as cited in the House Report but assume an effective capital gains tax rate of 32.5% rather than 25%, the rate differential will be 33.5% and 24.5%, rather than 41% and 37%, respectively. Thus, whatever "abuse" or "loophole" the House is concerned with will already be substantially restricted, without changing the tax treatment of lump-sum distributions.

If we add to this the proposed adjustment in the individual tax burden as set forth in Sections 802 and 804 of the bill which sets the maximum income tax rate for individuals at fifty percent, it can readily be seen that whatever objective is sought by the amendments contained in Section 515 are to a large extent achieved by reform measures in other sections of the bill.

The Ways and Means Committee is concerned that present law unduly benefits highly compensated employees. At page 154 of the Report, the Committee states that presently ". . . the more significant benefits accrue to taxpayers with adjusted gross incomes in excess of $50,000." However, as the bill is written, the adoption of the provision relating to lump-sum distributions would only penalize employees who are not highly compensated and would not have the sweeping effect on highly compensated employees that is visualized by the Ways and Means Committee.

Under Section 802 of the bill, the maximum tax rate would be 50% and this, taken together with the increase in the capital gains tax rate from 25% to 32.5% would mean that the future differential in the tax treatment of lump-sum distributions would be only 17.5%, rather than the 41% suggested in the example given in the House Committee's Report.

Any undue tax advantage a highly compensated employee might have under present law will have been curbed without the necessity of touching this particular and highly desirable provision of the Code. Increasing the tax on lump-sum distributions would adversely affect all employees who need and deserve the present tax treatment of lump-sum distributions from their pension or profit-sharing plans. For example, consider the employee who is retiring because of a total and permanent disability and who wants to purchase a joint and last survivor annuity for himself and his wife. The enactment of Section 515 of H.R. 13270 would sharply increase the tax he would have to pay on his distribution and would therefore substantially reduce the annuity available to this individual and thereby his monthly income and that of his wife for the rest of their lives. Also consider the situation of a widow, who because of the untimely death of her husband, is faced with the necessity of receiving his deferred compensation in lump-sum, if she is to keep the children in college, pay the mortgage on the home and still have enough to pay the expenses of her late husband's estate. Unless her independent income is substantial, this provision will weigh substantially on her ability to maintain her household.

We think the House has placed too much emphasis on "highly compensated employees" in this regard. Consideration should be given to employees as a class. The millions of employees in this class are not highly compensated and they should not be penalized by the enactment of this provision of the bill.

III. ADVERTISING INCOME

In December 1967, the Internal Revenue Service amended Income Tax Regulations Sections 1.511, 1,512 and 1.513 to permit the taxation of advertising income which tax exempt organizations derive from magazines, journals and similar publications. In Section 121 of H.R. 13270, the House Ways and Means Committee agrees with the Service position. NALU feels that this reorientation of this rule is unnecessary and unduly restricts vital functions of exempt organizations.

As enacted in 1950, the unrelated business tax was to be a tax confined to income from a trade or business regularly carried on by a tax exempt organization, but which was not substantially related to the purpose for which the organization was granted its income tax exemption.

The law did not propose to tax the income from every trade or business regularly carried on by a tax exempt organization. So much of the income from a trade or business regularly carried on by the exempt organization which was related to the organization's exempt function was to continue to be exempt, even though competition between the exempt organization and non-exempt corporations would result. It was recognized that a trade or business might form an integral part of the function of a tax exempt organization.

The concept embodied in the Treasury position and approved by the House Ways and Means Committee in effect eliminates from the requirements for taxation that an operation be a trade or business and that it be unrelated.

The amended regulations, in clarifying the term "trade or business," provide that the term includes "any activity" carried on for the production of income from the sale of goods or performance of services. The phrase "substantially related" has been clarified to mean "contribute importantly."

Since every exempt organization has several trade or business activities, by breaking the exempt organization into several activities and requiring each to stand the "contribute importantly" test, the Internal Revenue Service can virtually destroy the tax exempt status of any organization subject to these provisions of the code. Any exempt organization which tries to divorce itself of all business activities which may result in taxation under the amended regulations, as a practical matter, will so divorce itself of activity as to be almost dormant. This is particularly so if we consider that an activity may become taxable without regard to its relationship to the exempt purposes of the organization.

In this instance, the Service ruled and the Ways and Means Committee agreed that all advertising is to be considered unrelated, ergo, that no advertising can in any way be related to any tax exempt purpose of any exempt organization.

But, in fact, the publication of a magazine or other journal, with accompanying advertisements, is an essential function of most exempt organizations. One of the basic reasons individuals or corporations associate in the form of a trade or professional association is to facilitate the free exchange of ideas and products of mutual interest to a particular trade or profession. For this function to be meaningful and useful, the exchange must be frequent, the information disseminated must be comprehensive and the process of dissemination must not be prohibitively expensive. A magazine, circular or similar publication is a perfect tool for this purpose.

A magazine or other similar publication enables an association to collect, at any one point in time, the ideas and products of a variety of experts that would be impossible in any other forum. At the same time, by charging some of the contributors a fee for the use of the publication as a forum for the presentation of their products and ideas, the expense to the association is kept to a minimum. In many cases, these activities provide the association with extra revenues to apply to the general enhancement of association activities. Some of the ideas and products presented in association publications are presented in the form of commercial advertising, which is a universally accepted and effective method of disseminating this type of information. If this basic tool of communication is to be curtailed by taxing the revenues it produces, a vital function of the association will be imperiled.

Life Association News, the official publication of The National Association of Life Underwriters, is a monthly publication averaging approximately 130 pages of which about 50 percent is advertising. The magazine will accept only advertising which describes a service or a product that is of value to the life insurance agent in his capacity as an agent. This includes advertisements of the availability of newsletters and/or books containing information of concern to the life insurance industry and advertising concerning new insurance products and/or services available to the agent from various sources. This advertising is an extremely valuable and effective tool in any Association's performance of its obligation to keep its membership informed. While it is not our purpose to suggest that all advertising in a publication of a tax exempt organization is related to the organization's exempt purpose or any other tax exempt purpose, we feel that it is totally arbitrary and illogical to conclude that all advertising is unrelated to tax exempt purposes.

When Congress recognized that certain activities in our society made such important social contributions that their development should be encouraged by exempting them from federal taxation, it recognized to a certain degree a competitive advantage was being afforded these associations over the business operations of other non-exempt organizations. However, it was felt that this was an acceptable price to pay for the promotion of the socially desirable activities involved. Unless Congress is going to retreat from this policy, so much of Section 121 of H.R. 13270 as relates to the taxation of advertising income of exempt organizations should be deleted.

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APPENDIX B

WRITTEN TESTIMONY RECEIVED BY THE COMMITTEE EXPRESSING AN INTEREST IN THE SUBJECT OF TAX-EXEMPT ORGANIZATIONS

Written Testimony Received by the Committee Expressing an Interest in the Subject of Tax-Exempt Organizations

STATEMENT OF THE SISTERS OF MERCY OF THE UNION IN THE UNITED STATES OF AMERICA, SUBMITTED BY, SISTER MARY REGINA CUNNINGHAM, R.S.M., SUPERIOR GENERAL, SISTERS OF MERCY OF THE UNION, BETHESDA, MD.; MR. JOHN H. RHUDE, VICE PRESIDENT, SISTERS OF MERCY; AND MR. RONALD E. HEINLEN, FROST AND JACOBS, ATTORNEYS AT LAW

This statement is submitted to express the views of the Sisters of Mercy of the Union in the United States who render service to the sick, uneducated and the poor in 84 hospitals, 433 elementary schools, 98 high schools, 17 child-caring homes, 14 homes for the aged, and 43 schools of nursing throughout the United States. These institutions are non-profit, tax-exempt institutions under 501(c) 3 of the Internal Revenue Code.

The Sisters of Mercy have been active in the United States since 1843 and while a Catholic Community of Religious Sisters, neither they individually nor their numerous institutions receive any financial support from the Catholic Church. They are solely dependent upon revenues generated by their works in health, education and welfare and upon charitable donations from friends and benefactors.

The Sisters of Mercy of the Union are not opposed to equitable tax reform. However, owing to the expanding nature of our services to a burgeoning public in the areas of health, education and welfare, with the concomitant spiraling costs and other mounting needs to upgrade the quantity and quality of hospital care and education, we are opposed to any measures that will thwart the incentive to make charitable gifts to our institutions and ultimately limit our capability to serve those in need. Presently our institutions are facing a serious financial crisis in terms of escalating costs. To remove these traditional incentives for charitable giving which our hospitals, colleges, schools and homes depend upon heavily for operational needs and capital expansion could jeopardize our institutions to the point where many much-needed works we perform will be severely cut back and/or abandoned. In our past experience private philanthropy has shown concern and imagination in helping us render service to the public. A lessening of this assistance and stimulus from the private sector, to our way of thinking, will result ultimately in the necessity of increased government funding to maintain our works. The cost of education and hospital care will soar to greater heights without traditional forms of tax-incentive gifts.

For instance, in our hospitals, income from endowment funds or gifts restricted by donors to provide services for designated patients in effect reduces the payment for those services. Thus such gifts can lessen the total valid needs of the hospital to provide services. This lowers the third party reimbursement formula to hospitals (such as Blue Cross), resulting in lower hospital costs to the patient.[1] Curtailing charitable giving to hospitals, homes for aged, schools and colleges would do more than close the doors of a number of our institutions; it could also close the door on a long-standing virtue of this country: charity.

Donors to the Sisters of Mercy have made gifts primarily out of charity . . . the desire to assist and perpetuate our services. However tax incentives have served as a catalyst to such giving, often enabling the donor to contribute in excess of what he originally anticipated. Thus such tax incentives are a "compel to action" and a means whereby funds can be given by not just an affluent few, but by many who are often in middle income groups, thus enlarging the charitable support base. This is especially true of charitable gift annuity and life income agreements. (See page 5).

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[1] *Statement on Financial Requirements of Health Care Institutions and Services*, American Hospital Association, 1969.

The complexity of H.R. 13270 as it relates to charitable giving is of great concern to us. We feel such complexity of itself will lessen the incentive to give to charity. Definitions differ considerably, making it increasingly difficult for the average donor who cannot retain sophisticated gift and estate tax counsel to assess his charitable gift potential.

H.R. 13270 contains several provisions which are designed to correct certain alleged "abuses" in the area of charitable deductions. The net effect of these provisions, if enacted, could be to reduce the total number of dollars given to support worthwhile charitable activities. Because the Sisters of Mercy are so heavily dependent on the financial support of private donors, we are vitally concerned about this legislation and believe that certain of its provisions would pose a serious threat to the Sisters in carrying out their charitable activities.

We are particularly concerned about the proposed treatment of gifts of appreciated property and of charitable remainder trusts.

APPRECIATED PROPERTY

H.R. 13270 would introduce a set of complex and arbitrary rules governing the contribution of appreciated property. These rules could very materially reduce the private support given to charitable organizations such as the Sisters of Mercy. While H.R. 13270 continues present law with respect to contributions of securities so that there is a deduction for the full fair market value of the securities without a capital gain on the appreciation, other provisions of the Bill go far toward emasculation of this important provision.

Under section 302 of the Bill, individuals would be required to allocate certain personal deductions (including charitable contributions) proportionately between their taxable income and their so-called tax preference amounts to the extent they exceed $10,000. Included among tax preference amounts is the appreciation in the value of property donated to charity to the extent the appreciation was deducted and not included in income. Thus, while the Bill purports to continue the incentive under present law for making gifts of appreciated securities, it at the same time in part removes that incentive by its complicated provisions governing the allocation of deductions.

For example, if a taxpayer with $100,000 income makes a gift of securities worth $30,000, with a zero basis, he would have ⅙th of his charitable deduction disallowed. And the more tax preferences the taxpayer has the greater the disallowance would be. Thus, if a taxpayer has $100,000 taxable income, plus $50,000 in untaxed capital gains (a tax reference amount) and he makes a gift of securities worth $30,000, with a zero basis, he would have 7/17ths, or almost one-half, of his contribution disallowed.

Under these circumstances a donor may understandably be more reluctant to make a charitable contribution, or may defer a contribution which he otherwise would have made because of a substantial capital gain or other tax preference amount in the current year.

Accordingly, we urge that the untaxed gain on gifts of appreciated property be eliminated as a tax preference amount and that charitable contributions be eliminated as one of the deductions which must be allocated between taxable income and tax preference amounts.

Secondly, we strongly urge that H.R. 13270 be amended so as to eliminate the provisions which would either impose a tax on or deny a deduction for the appreciation in value of gifts of so-called "ordinary income property", tangible personal property, and future interests. These provisions, if enacted, could effectively curtail the making of many gifts (such as inventory) now received by The Sisters of Mercy. If it is valid to provide an incentive for making gifts of appreciated securities, there is no reason to deny similar treatment to gifts of other types of property. The exceptions of H.R. 13270 would introduce a needless complexity into the Code and could deprive charitable organizations of desirable private support.

Thirdly, we wish to express our concern over the provisions of H.R. 13270 governing bargain sales of appreciated property. Under present law, bargain sales are encouraged, and the possibility of obtaining a gift by bargain sale where an outright gift cannot be obtained, is a valuable alternative. H.R. 13270 would reduce the attractiveness of the bargain sale alternative and would hamper fund raisers in their efforts to raise money.

In addition, the bargain sale provisions of H.R. 13270 could undermine a method of fund raising which some of the institutions of The Sisters of Mercy have embarked upon and which has become increasingly popular among charita-

ble organizations in recent years, namely, the use of gift annuities. A gift annuity provides a means by which a donor can make a contribution to a charity in return for the charity's agreement to pay the donor a fixed annual sum each year for the rest of his life. Under present law part of the amount contributed is considered as the cost of acquiring the annuity, and the remainder is deductible as a charitable contribution.

Under H.R. 13270 a transfer of appreciated property for a gift annuity could be construed as a bargain sale on which the donor would be required to pay an immediate capital gains tax, even though he has received no cash payment, but only the promise of the charity to pay him a fixed sum each year. To treat the "purchase" of a gift annuity as a bargain sale could hinder charitable organizations, such as The Sisters of Mercy, that are utilizing a gift annuity program as a fund raising tool.

We, therefore, urge that if the bargain sale provisions of H.R. 13270 are to be retained, it be made clear that they do not apply to gift annuity programs.

CHARITABLE REMAINDER TRUSTS

Under present law a donor who sets up a trust providing that the income is to be paid to a named beneficiary and the remainder is to pass to a charity is entitled to a deduction for the commuted value of the remainder interest. H.R. 13270 would deny a deduction for this common form of charitable giving by providing that a deduction would be allowable only if the trust was a "unitrust" or an "annuity trust" (i.e., a trust which pays either a fixed amount or percentage of income to the life beneficiary).

The alleged "abuses" of the charitable remainder trust under present law hardly seem to justify the elimination of this important means of charitable giving.

We are particularly concerned about the effect of these provisions because they could eliminate a very substantial source of financial support under a program of deferred giving which some of the institutions of The Sisters of Mercy have adopted, namely, the use of so-called life income plans. Under these plans a donor makes a contribution to a charity, and, in return, the charity agrees to hold the amount contributed and to pay the donor for his life the equivalent of the income earned on this amount. With respect to this type of program, the "abuses" at which the provisions of H.R. 13270 are directed are virtually non-existent. The "trustees" of the life income fund typically are persons friendly to the charity and not to the donor; thus there would be no tendency to favor the life income beneficiary over the charitable remainderman.

We, therefore, urge that the provisions of H.R. 13270 limiting the benefits of charitable remainder trusts be stricken. If this is not considered appropriate, then these provisions should exempt transfers made pursuant to life income programs sponsored by the charity itself.

SUMMARY SHEET—WORKS OF THE SISTERS OF MERCY OF THE UNION IN THE UNITED STATES OF AMERICA

We have 84 hospitals; 17,000 beds; 360,000 inpatients; and 2,500,000 outpatients; 43 schools of nursing, 3,100 students; 10 colleges, 7,500 students; 433 elementary schools, 165,000 students; 98 high schools, 50,000 students; 14 homes for aged, 3,000 residents; and 17 child caring homes, 2,500 children.

COMMUNITY-OWNED INSTITUTIONS OF THE SISTERS OF MERCY OF THE UNION

BALTIMORE PROVINCE

Villa Mercy, Daphne, Alabama
Convent of Mercy, Mobile, Alabama
Martin de Porres Hospital, Mobile, Alabama
St. Joseph's Infirmary, Inc., Atlanta, Georgia
Mount de Sales Academy, Macon, Georgia
St. Joseph's Hospital, Savannah, Georgia
St. Vincent's Academy, Savannah, Georgia
Mercy High School, Baltimore, Maryland
Mercy Hospital, Baltimore, Maryland
Mercy Villa, Baltimore, Maryland
Mt. Saint Agnes College, Baltimore, Maryland
Mount Washington Country School for Boys (Mount Mercy Convent), Baltimore, Maryland
Sisters of Mercy Provincialate, Baltimore, Maryland

COMMUNITY-OWNED INSTITUTIONS OF THE SISTERS OF MERCY OF THE UNION—Con.

CHICAGO PROVINCE

St. Joseph Mercy Hospital, Aurora, Illinois
Mercyville Institute of Mental Health, Aurora, Illinois
Mercy High School, Chicago, Illinois
Mercy Hospital and Medical Center, Chicago, Illinois
Mother McAuley High School, Chicago, Illinois
Our Lady of Mercy Convent, Chicago, Illinois
St. Patrick Academy, Chicago, Illinois
Sisters of Mercy Provincialate, Chicago, Illinois
Siena High School, Chicago, Illinois
St. Xavier College, Chicago, Illinois
McAuley Residence, DeKalb, Illinois
Marquette High School, Ottawa, Illinois
Mercy Hospital of Davenport, Davenport, Iowa
Mercy Hospital, Iowa City, Iowa
Mercy Hospital, Marshalltown, Iowa
Mercy Hospital, Janesville, Wisconsin
St. Catherine Residence for Young Women, Milwaukee, Wisconsin
Mercy High School, (Our Lady of Mercy Convent), Milwaukee, Wisconsin

CINCINNATI PROVINCE

Sisters of Mercy Provincialate, Cincinnati, Ohio
Lake St. Joseph, Crestwood, Kentucky
Academy of Our Lady of Mercy, Louisville, Kentucky
Assumption High School, Louisville, Kentucky
The McAuley, Louisville, Kentucky
Mount Mercy Convent, Pewee Valley, Kentucky
Our Lady of Mercy Hospital, Morganfield, Kentucky
Our Lady of Mercy Hospital, Owensboro, Kentucky
Convent of the Divine Will, Cincinnati, Ohio
McAuley High School, Cincinnati, Ohio
Mother of Mercy High School and Academy, Cincinnati, Ohio
Edgecliff College, Cincinnati, Ohio
Our Lady of Mercy Hospital, Cincinnati, Ohio
Our Lady of Mercy Hospital, Coldwater, Ohio
The Siena Home, Dayton, Ohio
Our Lady of the Pines, Fremont, Ohio
Mercy Hospital, Hamilton, Ohio
St. Rita's Hospital, Lima, Ohio
Mercycrest, Springfield, Ohio
Mercy Hospital, Springfield, Ohio
Mercy Hospital, Tiffin, Ohio
McAuley High School, Toledo, Ohio
Mercy Hospital, Toledo, Ohio
St. Charles Hospital, Toledo, Ohio
Mercy Memorial Hospital, Urbana, Ohio
St. Bernard Convent and Academy, Nashville, Tennessee
St. Mary's Memorial Hospital, Knoxville, Tennessee
Mother of Mercy Novitiate, Kingston, Jamaica
Mount Claver Convent, Manchester, Jamaica
Convent of Mercy, Alpha, Kingston, Jamaica, West Indies
Mount St. Joseph Convent and Academy, Mandeville, Jamaica, West Indies

DETROIT PROVINCE

Mercy Hospital, Bay City, Michigan
Mercy Hospital, Cadillac, Michigan
Mount Mercy Academy, Grand Rapids, Michigan
St. Gertrude Convent, Grand Rapids, Michigan
St. Mary's Hospital, Grand Rapids, Michigan
Mercy Hospital, Grayling, Michigan
Mercy Hospital, Muskegon, Michigan
Mercy College of Detroit, Detroit, Michigan
Our Lady of Mercy Hospital, Dyer, Indiana
Sisters of Mercy Provincialate, Farmington, Michigan
Our Lady of Mercy High School, Farmington, Michigan
Mercywood Hospital, Ann Arbor, Michigan
St. Joseph Mercy Hospital, Ann Arbor, Michigan
Leila Y. Post Montgomery Hospital, Battle Creek, Michigan
Mount Carmel Mercy Hospital, Detroit, Michigan
St. Joseph Mercy Hospital, Detroit, Michigan
St. Joseph Mercy Hospital, Pontiac, Michigan
Mercy Hospital, Port Huron, Michigan
St. Joseph Mercy Hospital, Clinton, Iowa
St. Joseph Mercy Hospital, Cresco, Iowa
Mercy Medical Center, Dubuque, Iowa
St. Joseph Mercy Hospital, Fort Dodge, Iowa
St. Joseph Mercy Hospital, Mason City, Iowa
St. Joseph Mercy Hospital, Sioux City, Iowa
St. Joseph Mercy Hospital, Waverly, Iowa
Mercy Hospital, Jackson, Michigan

St. Lawrence Hospital, Lansing, Michigan
Saint Ethnea, Bella Vista, Argentina, South America
Mater Misericordiae, Buenos Aires, Argentina, South America
Saint Mary's, San Antonio de Areco, Buenos Aires, Argentina, South America

NEW YORK PROVINCE

Mercy College, Mt. Mercy-on-Hudson, Dobbs Ferry, New York
Sisters of Mercy Provincialate, Mount Mercy, Dobbs Ferry, New York
Madonna Home of Mercy Hospital of Watertown, Watertown, New York
Mercy Hospital of Watertown, Watertown, New York
Mercy General Hospital, Tupper Lake, New York
St. Francis Hospital of Port Jervis, Port Jervis, New York
The Uihlein Mercy Center, Inc., Lake Placid, New York
Our Lady of Victory Academy, Mount Mercy-on-the Hudson, Dobbs Ferry, New York
St. Cathernie Acadamy, Bronx, New York
Susan Devin Residence, Bronx, New York

OMAHA PROVINCE

Mount St. Mary Academy, Grass Valley, California
St. Elizabeth Hospital, (Convent of Mercy), Red Bluff, California
Mercy Hospital, Denver, Colorado
Mercy Hospital, Durango, Colorado
Mercy Hospital, Nampa, Idaho
Saint Anthony Community Hospital, Pocatello, Idaho
St. Joseph's Mercy Hospital, Centerville, Iowa
Mercy Hospital, Council Bluffs, Iowa
Bishop Drumm Home, Des Moines, Iowa
Mercy Hospital, Des Moines, Iowa
St. John's Medical Center, Joplin, Missouri
St. Peter's Convent of Mercy, Joplin, Missouri
Sisters of Mercy Faculty Residence, Kansas City, Missouri
Archbishop Bergen Mercy Hospital, Omaha, Nebraska
College of Saint Mary, Omaha, Nebraska
Maryview Convent, Omaha, Nebraska
Mercy High School, Omaha, Nebraska
St. Catherine's Hospital, Omaha, Nebraska
St. Vincent's Home, Omaha, Nebraska
Sisters of Mercy Provincialate, Omaha, Nebraska
Mercy Hospital, Devils Lake, North Dakota
Mercy Hospital, Valley City, North Dakota
Mercy Hospital, Williston, North Dakota
St. Catherine's Residence and Nursing Center, North Bend, Oregon
Mount St. Joseph's Residence and Extended Care Center, Portland, Oregon
Mercy Hospital, Roseburg, Oregon

PROVINCE OF PROVIDENCE

Salve Regina College, Newport, Rhode Island
St. Mary Convent and Academy—Bay View, Riverside, Rhode Island
St. Joseph Convent and School, Pine Harbor, Pascoag, Rhode Island
St. Francis Xavier Convent and Academy, Providence, Rhode Island
Mt. Saint Mary Convent and Academy, Fall River, Massachusetts
Sisters of Mercy Provincialate, Cumberland, Rhode Island
Mt. St. Rita Convent, Cumberland, Rhode Island
Convento San Vincente de Paul, San Pedro Sula, Honduras, Central America
Convento Maria Regina, La Ceiba, Honduras, Central America
Convent of Our Lady of Orange Walk, Orange Walk Town, British Honduras, Central America
St. Catherine Convent and Academy, Belize City, British Honduras, Central America

ST. LOUIS PROVINCE

Sisters of Mercy Provincialate, St. Louis, Missouri
Mercy Junior College, St. Louis, Missouri
Warner Brown Hospital, El Dorado, Arkansas
St. Anne's Academy, Fort Smith, Arkansas
St. Edward Mercy Hospital, Fort Smith, Arkansas
Mount St. Mary Academy, Little Rock, Arkansas
Mercy Hospital, Fort Scott, Kansas
St. Margaret's Mercy Hospital, Fredonia, Kansas
St. Elizabeth's Mercy Hospital, Hutchinson, Kansas
Mercy Hospital, Independence, Kansas

Holy Name of Jesus Convent and Academy, New Orleans, Louisiana
Mercy Hospital, New Orleans, Louisiana
St. Martin Convent of Mercy, St. Martinville, Louisiana
Mercy Hospital-Street Memorial, Vicksburg, Mississippi
St. Francis Xavier Academy, Vicksburg, Mississippi
McAuley Hall, St. Louis, Missouri
St. John's Mercy Hospital, St. Louis, Missouri
Mercy Villa, Springfield, Missouri
St. John's Hospital, Springfield, Missouri
St. Joseph Convent of Mercy, Webster Groves, Missouri
Mercy Hospital, (Oklahoma City General), Oklahoma City, Oklahoma
Mt. St. Mary, Oklahoma City, Oklahoma
Convent of Mercy, Shawnee, Oklahoma
Mercy Hospital, Brownsville, Texas
Luearlam Manor, Brownsville, Texas
Mercy Hospital of Laredo, Laredo, Texas
Mercy Hospital, Slaton, Texas
St. Joseph's Hospital, Hot Springs, Arkansas

SCRANTON PROVINCE

College Misercordia, Dallas, Pennsylvania
Mount Aloysius Junior College, Cresson, Pennsylvania
Sister of Mercy Provincialate, Dallas, Pennsylvania
Mercycrest Convent, Harrisburg, Pennsylvania
The Mercy Hospital of Johnstown, Johnstown, Pennsylvania
Mercy Hospital, Scranton, Pennsylvania
Mercy Heights Hospital, Scranton, Pennsylvania
The Mercy Hospital of Wilkes-Barre, Wilkes-Barre, Pennsylvania
St. Mary's Convent, Wilkes-Barre, Pennsylvania
Sacred Heart Convent, Georgetown, Guyana, South America

AMERICAN CHEMICAL SOCIETY,
Washington, D.C., September 11, 1969.

Hon. RUSSELL B. LONG,
Chairman, Finance Committee of the U.S. Senate,
New Senate Office Building, Washington, D.C.

DEAR MR. CHAIRMAN: I am availing myself of the opportunity of addressing this communication to you in this form rather than requesting an appearance before the Committee, as I did in the House of Representatives before Chairman Mills' Committee, for several reasons.

You no doubt are aware of the fact, Mr. Chairman, that the American Chemical Society, which was organized in 1876, was given its present corporate life by the Congress of the United States in Public No. 358, Chapter 762, First Session of the 75th Congress; signed into law by Franklin D. Roosevelt on August 25, 1937. It also should be noted that the Society numbered in excess of 116,000 members, nation-wide, as of August 31 this year. It is the largest scientific and educational society in the world devoted to a single discipline.

Now as to my reasons for not seeking an appearance; first, it would appear that the House Ways and Means Committee, by and large, with the single exeception of its handling of the unrelated business revenue tax, handled the problems involving the American Chemical Society, of which I am President, in appropriate fashion.

Secondly, I am leaving for Germany today to be gone for a number of weeks on matters which are most important to both the American Chemical Society and to chemistry in the United States generally.

And third, it is obvious to us that your Committee will have number of witnesses from Government and many from various areas in the private sector on the many subjects cc. red by the Tax Reform Bill which are more controversial than the items in which we are interested. Accordingly, we believe that the Committee should not have witnesses piled upon it just for the sake of making a record. Thus we respectfully ask that our remarks be incorporated in the record for purposes of review and markup when the tax bill takes its final form.

I appeared before the House Ways and Means Committee on February 25, 1969, and presented a statement in behalf of the Society, a copy of which I attach hereto along with the Appendices which were attached to that statement.* I

*The appendices were made a part of the official files of the committee.

would ask that my letter to you, Mr. Chairman, and the statement submitted to the House of Representatives be made a part of the record of the hearings of this Committee relating to the Tax Reform Act of 1969.

The one area which we wish to call particularly to your attention is that of the definition of a private foundation as it relates to the definition of a scientific, educational and literary society in the proposed amendments to the Act. We believe from the Act, as passed by the House of Representatives and we are convinced from the wording of the report accompanying same, that the American Chemical Society and like organizations are not affected by its amendments concerning private foundations. We do earnestly believe and hope that your Committee will clarify this language so that all can clearly delineate between the private foundations which have admittedly been the subject of considerable controversy, and organizations of the nature of the American Chemical Society which clearly serve the public interest in the fullest sense of the word.

The primary point in which we differ with the House Committee is in its proposed treatment of unrelated business income which is discussed beginning at page 44 of the report accompanying H.R. 13270 and continuing on through the middle of page 51. We disagree with the position of the House of Representatives both as to its interpretation of the present law and its support of the regulations advanced by the Internal Revenue Service in December, 1967, and in the House effort to make the law applicable to a segment of the activities of an organization which are not separately incorporated but are an integral part of the carrying out of the exempt functions of the organization.

The very fact that the House admits that the maximum revenues estimated from these sources is $5,000,000 a year in the first five years of the proposed imposition of the tax is evidence enough of the de minimis approach from a tax standpoint which can only result in harm to many organizations such as our Society. These dollars are highly important to the carrying out of our related functions and miniscule in the total tax consequences to the public of the United States. It should be noted that the Society filed a return this year in accord with the 1967 regulations and no tax was due because of a loss on our publications.

We further are of the firm opinion that the tax laws are not the appropriate areas to decide what is or isn't unfair competition in a business sense. It has been our view that unfair competition lay in a trade regulation atmosphere and is also better reviewed by the Federal Trade Commission and the Acts relating thereto, or the Department of Justice in the Antitrust Division. We believe it a dangerous precedent to have the tax laws commingled with this concept. Accordingly, we strongly urge the Senate to review this proposed provision in the Tax Reform Law and ask that you oppose the position of the House in this field.

In conclusion, I again urge that you and your staff pay particular attention to the statement which I delivered before the House on February 25, 1969, and the attachments thereto.

I sincerely believe that the best interest of our country would be better served by following the approach we have outlined in relation to this area of the tax law.

Again, I sincerely believe that the House of Representatives has agreed with us in all major fields except the unrelated business income area, and we do ask once again that the Senate clarify the definition of private foundations vis-a-vis quasi public bodies such as the American Chemical Society.

Cordially,

WALLACE R. BRODE, *President.*

STATEMENT OF DR. WALLACE R. BRODE, PRESIDENT, AMERICAN CHEMICAL SOCIETY, BEFORE THE WAYS AND MEANS COMMITTEE

In Relation to Paragraph 1(4) of the Notice of Hearings Issued by the Committee on Ways and Means of the House of Representatives in Relation "to whether advertising income should be characterized as unrelated in the case of magazines and other periodicals published by exempt organizations where the editorial matter of the publication is related to its exempt function."

Chairman Mills and gentlemen, I am Doctor Wallace R. Brode, President of the American Chemical Society, an organization founded in 1876 and reincorporated by an Act of the Federal Congress in 1937, which represents the largest scientific and educational organization in the United States, devoted to a single science.

I wish to express to you my appreciation for the privilege afforded me to represent my Society and its 113,000 members on this important matter. To conserve the Committee's time, I have attached five appendices to this statement. I am accompanied by the Society's General Counsel, Arthur B. Hanson, and Dr. B. R. Stanerson, the Society's Executive Secretary.

I support fully the statement submitted by Mr. Hanson before the Internal Revenue Service in 1967 when unrelated business taxable income was the subject of hearings upon proposed regulations which the Internal Revenue Service was desirous of imposing.

Subsequent to these hearings, the Service did impose these regulations in December, 1967, to become effective upon the taxable year 1968. As a consequence the Society will file a return this year for the year 1968 insofar as its revenues from advertising are concerned. I might add, that preliminary reports indicate that our Society, due to a deficit, will be subject to little or no tax for the year 1968, but this in no way negates the importance of our appearing before you and our request to this Committee that the entire matter be reviewed by the Federal Congress and not be done by administrative fiat in contravention of the clear intent of Congress as indicated in the 1950, 1952, and 1954 amendments to the Federal Internal Revenue Code relating to exempt organizations.

If in the wisdom of the Congress, it should be decided that tax exempt scientific and educational organizations of the nature of the American Chemical Society should be taxed on their revenues, from any sources, we would submit two major items. First, this determination is one for the Congress and the Congress alone, and, secondly, should such a determination be made, we are firmly convinced that it would be contrary to law to endeavor to impose such a tax in the fashion in which it has been suggested by the Internal Revenue Service under the regulations to which we object.

Under the landmark case of *Grosjean* v. *American Press*, decided unanimously by the Supreme Court of the United States in 1936, it is the clear intent of the United States Supreme Court that advertising cannot be separated from other editorial content in a publication and singled out for the imposition of a tax. This was found to be an abrogation of the First Amendment of the Constitution.

We do not believe that this Committee or the Congress has any desire to do other than to support this decision of the Court which has been upheld from time to time subsequent thereto. We urge that the Committee counsel review this case in detail, for although the case involved daily newspapers, the briefs submitted with the case and the decision itself make no differentiation as to the fact that one cannot take a publication and make it into a piecemeal subject of taxation. In saying this, I want to make it clear that we do not contend that the Congress could not take away tax exemption from exempt organizations and make them liable for income taxes in accord with the normal tax structure in the corporate business tax laws of our country. In that event a levy would be made on the business of the Society as a whole just as is done with a normal business for profit. It would not be a levy against an inseparable part of an exempt function as is endeavored to be done in the regulations adopted by the Internal Revenue Service in December, 1967. Thus, these regulations suffer from the further defect of discriminatory treatment of the taxpayer.

We feel that the example just given should not be the subject of these hearings for we know of no one in this country who would desire to take away the exemptions granted by this Congress to organizations such as the American Chemical Society.

Now to my second point: can one separate a segment of a publication from the remainder of the publication for tax purposes? It should be clear that the regulations adopted by the Internal Revenue Service in December, 1967, are inappropriate in their effort to declare a part of a journal as separate from its remainder for purposes to taxation. I have submitted as Appendix D copies of the February 17 issue of *Chemical & Engineering News*, the official journal of the Society. The advertising content of the magazine is as much a part of the editorial content as is the news commentary and the scientific feature articles which are contained therein. The magazine is a whole, it should not be broken down into parts. Looking at this in another way, were the Society to go out and buy a publishing business devoted to manufacturing, not science, but in the broad field of reports on what industries which use chemicals are doing, then it might rightly be argued that the operation of such a business would be taxable.

Our Society publishes twenty journals, all of which are clearly devoted to one or another segment of the scientific and teaching aspects of the discipline of chemistry and in the case of the weekly *Chemical & Engineering News*, the

official organ of the Society, it is devoted to broad chemical and scientific interests. The advertising carried in some of these journals is merely an incidential extension of these Journals which helps in a small way to defray the over-all costs of publication and to assist the Society in carrying out the very exempt functions which this Congress gave to it in its Charter in 1937. See Appendix C.

To tax unrelated business income, I suggest that you must have an unrelated business. The business of the American Chemical Society—the promotion of the science of chemistry—has, by charter and rulings been declared tax exempt. The fact that incidental advertising revenue comes to a part of its business as a non-substantial portion thereof, should not open the door for the tax collector to harrass the Society in its exempt functions.

The argument advanced by the Internal Revenue Service that by taxing this income as unrelated business income it will provide a fairer means for business publications to compete with the Society is inapt. Figures which became available only this past week from McCann-Erickson's annual report, report that newspapers in the United States during the year 1968 grossed $5,237,000,000 in advertising revenue; television $3,142,000,000; magazines generally $1,318,000,000; radio $1,145,000,000; direct mail advertising $2,612,000,000; and so-called business papers and magazines $718,000,000. There are no accurate figures as to what the tax-exempt organizations' publications grossed in advertising revenue in this field, but the best estimate we have been able to develop is less than $30,000,000.

Appendix C shows the circulation and advertising revenue attributed to *Chemical & Engineering News*, a copy of which is attached as Appendix D. This magazine is not strictly in competition with any others in this field. It is devoted principally to the Society's operation and exempt purposes and its gross advertising revenue to the Society for the year 1968 came to less than $3,000,000. It is obvious from an examination of Appendix C that the other journals listed do not compete with commercial publications, and certainly the advertising revenue from our combined journals of a little over 4 million dollars present a miniscule factor in the Society total business of about 25 million dollars in 1968. Half of this total of 25 million dollars represents direct subscriptions to publications. In 1968 we had a deficit of more than half a million dollars and had to draw on our reserves to balance our annual budget. We feel that these figures, by their very nature, show that this problem of a relative minor advertising income to our total operation and the deficit or non-profit character of our budget does not merit the intensive consideration given to it by the Internal Revenue Service.

I would like to make an additional comment. If this Committee does not direct the Internal Revenue Service to repeal the regulations we have noted then we would ask that the committee consider introducing as one of the amendments in your proposed tax revision bill, language similar to that introduced by Representatives Watts of Kentucky and former Congressman Curtis of Missouri, or Congressman Battin of Montana, just this January 6, in the form of H.R. 2057, which would make it clear that the Internal Revenue Service is not to declare as unrelated business income, that advertising income generated by advertising in magazines which is clearly related to the exempt functions of the organization in question.

In conclusion let me again thank this Committee and you, Mr. Chairman, for this opportunity to appear before you today to express these views.

Respectfully submitted.

AMERICAN CHEMICAL SOCIETY,
By WALLACE R. BRODIE, *President.*

COUNCIL ON LAW-RELATED STUDIES,
Cambridge, Mass., September 30, 1969.

Hon. RUSSELL B. LONG,
Chairman, Committee on Finance,
U.S. Senate, Washington, D.C.

DEAR SENATOR LONG: I am submitting this letter commenting on H.R. 13270, Title I, "Tax Exempt Organizations", for inclusion in the record of the hearing on that bill before the Committee on Finance.

I write as president of a newly-created foundation, the Council on Law-Related Studies, and also as Fessenden Professor of Law Emeritus in the Harvard Law School. The Council is financed by a grant by the Walter E. Meyer Research Institute of Law, which has been the only grant-giving foundation having the advancement of justice through law as its primary purpose. The functions of

the Council are to plan, encourage, support, and, on occasion, conduct research on problems of contemporary social importance with significant legal aspects, drawing chiefly for this purpose on members of faculties of law and of the social and behavioral sciences.

I foresee a short and seriously restricted existence for the new Council if the House Tax Reform Bill should become law. Like that of any new foundation created by another, our prospect of achieving "operating" status, as defined in the Bill, is dim indeed. It is ironic that the compliment paid in the House Committee Report to the usefulness of intermediary foundations should have been accompanied by tests for their survival that endanger many established institutions of this type and, as a practical matter, preclude the creation of new ones.

If the Committee on Finance were to develop, and the Congress to adopt, a concept of a foundation engaged in the conduct, support, or encouragement of research which would place foundations so engaged in the same tax category as colleges and universities, many of the perverse effects of the House Bill would be removed. I strongly urge the favorable consideration of amendments proposed with this in view. However, if this solution were unacceptable, a helpful though a less beneficial solution could be achieved by broadening the category of "operating foundation." This would reduce the damage that the restrictive tests for an "operating foundation" would wreak. At the same time, it could preserve the Committee's objective of assuring prompt application of a foundation's funds to the objects of its bounty. This solution would require a provision modifying the alternative test of an "operating foundation" found in § 4942(j)(3)(B)(i).

Enlarging the Concept of "Operating Foundations". The test in subparagraph (B)(i) prescribes that substantially more than half the "assets" of the foundation be "directly devoted" to activities constituting its purpose. "Assets" is a concept broad enough to cover money received and expended currently. Thus, a foundation receiving gifts or grants amounting to $1,000,000 in a taxable year and expending $700,000 of that amount in that period directly in support of its activities would seem to satisfy the language of the subparagraph. However, the subparagraph is widely viewed as limited to physical assets.

Accordingly, to make it clear that monetary assets expended each year would satisy (B)(i), a clarifying addition would seem called for. Thus, there might be inserted after "devoted directly to" in line 5 on p. 34 the following: "*or, before the first day of second (or succeeding) taxable year after the assets' receipt, are expended directly for the active conduct of,*." This would permit support from a narrower source than that required by (B)(ii), but, unlike (B)(ii), it would not permit the foundation to accumulate more than 35% of the support it received.

In view of the importance of the question to many foundations, the Report, if not the provision, should make clear whether the making of grants by a foundation created for the purpose of making grants constitutes the devotion of its assets "directly" for activities constituting its purpose.

Broadening the Concept of "Qualifying Distributions". The chief reason a new foundation must struggle to become an "operating foundation" if it is to survive is the Tax Reform Bill's concept of "qualifyng distributions." The tax compulsion that all distributions to nonoperating foundations be paid out of capital which the Bill would impose on all private foundations would certainly deter most of them from contributing to such grantees. As a consequence, the new foundation could not secure all its support from five or more "exempt organizations", none of which gave it more than 25% of its total support—a rule that I have termed the "5-and-25 test."

Ths discrimination against new foundations could be eliminated without serious sacrifice of the Bill's objectives by the adoption of either one of two amendments to § 4942(g)(1)(A)(ii) defining "qualifying distributions." The first of these alternatives would amend the section by adding the underlined words to subparagraph (ii) so that the provision would read in part as follows:

(1) IN GENERAL.—For purposes of this section, the term "qualifying distribution" means

(A) any amount paid out to accomplish one or more purposes described in section 170(c)(2)(B), other than any contribution to . . . (ii) a private foundation which is not an operating foundation (as defined in subsection (j)(3)), *unless it distributes substantially all the support it receives to persons other than private foundations before the first day of the second (or any succeeding) taxable year following its receipt.*

Another alternative might be stated as follows, substituting the following language for that underlined in the preceding version: *unless it distributes all of each such contribution to persons other than private foundations before the first day*, etc.

These provisions would permit gifts to non-operating foundations to be "qualifying" while leaving the grantees subject to "expenditure responsibility." The former version is more restrictive in that it applies to all of the grantee's support whereas the latter operates on a gift-by-gift basis. However, the former uses "substantially all" rather than "all."

Bugs in the 5-and-25 Test. There is a serious ambiguity in the much-discussed 5-and-25 test in subparagraph (B)(ii) that I have not seen commented on. Suppose a private foundation receives 40% of its support from grants and contracts by one federal government department or agency and 60% from grants by five private foundations, the largest grant from any of the five being 20% of the total. Is the federal government or each granting agency an "exempt organization" within the meaning of subparagraph (B)(ii)? If so, then the foundation may not qualify as an "operating foundation" because one of the "exempt organizations" supporting it gives it over 25% of its support, despite the fact that that support is received by the foundation for performing public services, advancing government objectives. If, on the other hand, government sources do not constitute "exempt organizations," then the foundation is equally barred because its support (other than gross investment income) does not all come from five or more exempt organizations.

Governmental bodies (governmental corporations excepted) are not included in the long list of "exempt organizations" in § 501(c), even though gifts to governmental bodies are tax deductible. I assume that the governmental bodies do not fall within the term "general public" in (B)(ii). However, if that construction were placed on the latter term, the test in (B)(ii) still would not make sense. Thus, though 80% of a foundation's support came for the government (*qua* "general public"), the foundation would fail to qualify as an "operating foundation" if it received the balance of its support from only four foundations.

Still another uncertainty in the 5-and-25 test is whether gifts for endowment are "support." Suppose normally 20% of the contributions received by a private foundation came in the form of bequests for endowment; the rest of the funds it receives come from five foundations, none of which give 25% of the 80%. Would the endowment gift be "support" and so preclude the legatee foundation from qualifying since all of its support does not come from "exempt organizations" or the "general public"? Existing foundations may have endowment and still qualify. To deny new foundations the right to acquire endowment unless all the gifts creating it meet the 5-and-25 test seems arbitrary. On the other hand, to exclude gifts for endowment from "support" is also anomalous. To do this would allow a foundation to qualify as "operating" by reason of five small grants from foundations where nearly all its funds take the form of gifts for endowment and investment income. The 5-and-25 test is basically unsound.

Grants to Individuals.—The substance of this provision (§ 4945(e)) does not seem objectionable, but the requirement that it be "demonstrated to the satisfaction of the Secretary or his delegate" that each grant falls within the approved categories or purposes strongly suggested that advance clearance at the Treasury would be required. This would almost certainly be productive of delays which would surely disrupt the plans not only of most of the individuals involved but also of the institutions at which they were planning to study. The volume of applications to be cleared would be great, and one can readily envisage them mounting on officials' desks.

Post-audit seems a much better means of handling this problem—if it really is a problem and not simply an uncertainty caused by ambiguous language. To obviate the question, the clause beginning "if it is demonstrated . . ." on line 24 of p. 47 through "it" in line 1 on p. 47 should be stricken. In its place might be substituted: "*unless the Secretary or his delegate finds that is neither* . . ." In line 3 on p. 47 "nor" should then be substituted for "or." This language would seem consistent with the post-audit handling of the grants.

Influencing Legislation. The chief concern which § 4945(b)(1) and (c) have created among foundations supporting studies dealing with controversial public affairs springs from uncertainty as to the meaning of "nonpartisan research and analysis." However, underlying this question is another one which may be still more important for grant-giving foundations. Where a foundation conducts

and publishes studies itself or engages in demonstration or action programs, it will, of course, be subject to the limitations the provisions impose. But what is the responsibility of a foundation that gives a grant to a university to enable a professor to conduct research or a demonstration or action program—or makes the grant directly to the individual scholar? If the purpose of the grant as presented in the application to the foundation contemplates an objective program of research or experimentation to ascertain social facts or to test a social program and if the grantor foundation has no knowledge of an improper intention, surely the foundation should not be subjected to strict liability for the tax because of the professor's subsequent partisan behavior or his "private communication" with legislators. The foundation's purpose in making the grant, not the grantee's behavior after receiving it, should be the test of tax liability.

If a grant had not been fully paid when the grantor foundation learned that the grant's terms had been departed from and that the grant was being used to influence legislation improperly, the foundation might be taxable for subsequent payments. Surely, however, a grantor foundation should not be expected to keep its grantees under continuous surveillance. Even the provision for penditure responsibility" does not seem to require that, and it applies only grants by one foundation to another.

Though I am confident that, properly interpreted, the provision does not impose strict liability on grant-making foundations, I doubt that this is widely understood. Therefore, a clarifying explanation in the Committee's report would be desirable. The explanation should make it plain that, subject to subsection (f) imposing "expenditure responsibility", a grant paid in good faith by a private foundation to support a nonpartisan study of a subject relating to existing or proposed legislation would not constitute a taxable expenditure even though the independent recipient used the product of his research or experiment in an improper attempt to influence legislation.

"*Nonpartisan research or analysis.*" This phrase has surely been questioned by many others, but it has special importance for foundations such as the Council on Law-Related Studies which contemplates studies in area where there may be need for law reform. However, as the previous point indicates, it would appear relevant only where action alleged to give rise to a taxable expenditure is taken by the foundation's own staff or by others with its connivance. If the foundation denies liability for such action, its defense will turn on the meaning of the quoted phrase.

"Nonpartisan" ordinarily suggests "not related to a political party's position." However, it is sheer chance whether political parties have taken positions on any given law reform proposal. In any event, the taxable character of a research expenditure should not turn on the relation of a researcher's conclusions to a party's position. It seems equally clear that a researcher should not have to be neutral or silent on controversial issues that he has studied lest the foundation employing or supporting him be subjected to a heavy tax. Presumably what is intended is that an objective statement based on the research or experiment shall not subject the foundation employing or supporting the researcher to taxation. If so, I suggest the substitution for "the results of nonpartisan analysis and research" in subsection (c) the following: "*a statement of the results of objective analysis or the findings and conclusions of objective research.*"

Though lacking the political flavor of "nonpartisan", "objective" is not crystal clear. Its use should be accompanied by a gloss in the Committee's report making plain that analysis and research may be "objective" even though they lead to a position on one side or the other of a controversial issue. The question goes basically to the fairness of an analysis or of a study's findings and the conclusions drawn from them.

"*Expenditure Responsibility*". Though subsection (f) requires a private foundation making a grant to another foundation "to see that the grant is spent for the purpose for which made," it is not clear what the effect would be of the grantee foundation's departure from the terms of the grant. Is strictly liability to be imposed on the grantor, requiring it to pay a dollar's tax for every dollar it discovers has been diverted from the grant's terms? This would deter any foundation from making grants to any other foundation unless the grantor exercised strict control over the grantee and thereby extended the power it enjoyed by reason of its superior resources. Surely this drastic, untoward consequence is not intended. Paragraph (1) in subsection (f) is unwise and impracticable and should be eliminated.

The problem posed by paragraph (1) is accentuated by the fact that the terms and conditions of grants can seldom be drawn with specificity. Research is constantly encountering the unexpected; adaptation is essential. If a major departure from the original plan seems called for, the grantee will apply to the grantor and will ordinarily be granted permission to change his research plan. This procedure, coupled with the reports required by subsection (f), should afford sufficient expenditure control. If it were thought necessary, a new paragraph (1) could be substituted for that in the Bill, reading as follows:

(1) *to include in each grant a condition that no substantial departure be made from the purpose of the grant unless the grantee shall have obtained the approval of the grantor.*

The amendments and clarifying additions to the Committee report that I have proposed would diminish the deterrent to needed research that § 4945 now constitutes. However, as applied to foundations designed to conduct, support, or encourage research, its benefits would not be proportionate to the handicaps it would impose. I wish therefore to reiterate my support of proposed amendments which would place foundations having responsible research objectives in the same category as colleges and universities.

Very truly yours,

DAVID F. CAVERS.

THE AMERICAN ASSOCIATION OF PETROLEUM GEOLOGISTS,
Tulsa, Okla., 74101, September 15, 1969.

Hon. RUSSELL B. LONG,
Chairman, Senate Finance Committee,
U.S. Senate Office Building,
Washington, D.C.

DEAR SENATOR LONG: The American Association of Petroleum Geologists, Inc., headquartered in Tulsa, Oklahoma, is a scientific organization of 15,000 petroleum geologists, exempt under Section 501(c)6 of the Internal Revenue Code. The Association is deeply concerned about the tax reform bill (HR 13270), which is now before your Senate Finance Committee.

We are especially concerned about the proposed section regarding advertising income, which would have the effect of legislating an inseparable portion of a non-profit organization into a distinctly separate, unrelated, taxable business:

"(c) Advertising, etc., Activities.—For the purpose of this section, the term 'trade or business' includes any activity which is carried on for the production of income from the sale of goods or the performance of services. For purposes of the preceding sentence, an activity does not lose identity as a trade or business merely because it is carried on within a larger complex of other endeavors which may, or may not, be related to the exempt purposes of the organization."

We maintain the position as stated in our brief, filed with the House Committee on Ways and Means (pages 1379–1386, Tax Reform, 1969, Part IV of 15, Hearings Before the Committee on Ways and Means, House of Representatives, 91st Congress, 1st Session on the Subject of Tax Reform) that the advertisements carried in the Association's monthly scientific Bulletin are "related" to the exempt purposes of the Association. We would also state that the advertising function is not a separate business, and income from advertisers is, in fact, vital financial support of an essential scientific journal. In many cases, advertisers consider the purchase of an ad in our journal as a "charitable" contribution.

We also wish to point out that, except for a possible loss of exemption, there is now no civil penalty for failure to file, or for lateness in filing, an exempt organization return. Under HR 13270, as reported out of the House, there will be a sanction of $10 per day up to a maximum of $5,000 imposed upon an organization which fails to file, or is late in filing, the forms. Many organizations such as AAPG, may have difficulty in complying with these requirements, and there is a reasonable expectation that enforcement will be impossible.

Many of the Association's fifty-two affiliated geological societies, being autonomous organizations of volunteers, suffer an innate, unavoidable, and perennial discontinuity between successive administrations. The breaks do not hinder the fulfillment of these societies' fundamental purpose to bring stimulating programs of scientific interest to their professional members, but the hiatus in administrative continuity renders them incapable of responding to a requirement

that they behave like nonexempt business organizations. These organizations and their thousands of counterparts in other scientific disciplines deserve to be nourished for the good of the nation's economic future, rather than to be taxed and penalized, possibly to the extent of ultimate, if not immediate, destruction.

For these reasons, we believe that the sanctions now included in HR 13270 are arbitrary, unreasonable, and fundamentally unsound. We therefore respectfully request that consideration be given to our earnest position.

Very truly yours,

KENNETH H. CRANDALL, *AAPG President.*

STATEMENT OF THE AMERICAN ASSOCIATION OF PETROLEUM GEOLOGISTS BEFORE THE HOUSE COMMITTEE ON WAYS AND MEANS

SUMMARY OF STATEMENT

Gentlemen of the committee, the American Association of Petroleum Geologists, Inc., a tax exempt organization under section 501(c)(6) of the Internal Revenue Code of 1954, and its 15,082 members are unalterably opposed to the taxation of income received from the sale of advertising in journals published by tax-exempt organizations. The American Association of Petroleum Geologists is particularly disturbed by the Treasury Department's issuance of Regulations proclaiming such advertising income to be taxable as unrelated business income under section 511 through 513 of the Internal Revenue Code of 1954.

The American Association of Petroleum Geologists publishes The American Association of Petroleum Geologists *Bulletin* in which appear scholarly scientific articles for the education of its members. To help defray publication expenses a certain amount of advertising is sold. Advertisers, however, are carefully screened so that only advertisements which will update members' knowledge of materials and services related to petroleum geology are included. The American Association of Petroleum Geologists does not actively compete with magazines of general distribution for advertisers.

Actually, it is probably incorrect to refer to much of the "advertising" in the *Bulletin* as advertising at all. Certainly in many cases it is not "advertising" in the usual commercial sense of the word. Rather, it is support of a scientific and educational journal by companies and persons interested in the advancement of the science of petroleum geology. It would be more accurate to refer to them as contributors than as advertisers.

However, after 17 years of settled interpretation to the contrary, the Treasury Department has usurped the legislative function by declaring that all such advertising income is, *per se*, unrelated business income. The Treasury Department Regulations, sections 1.512(a)-1 Example (2) and 1.513-1(d)(4)(iv) Example (7), are not supported by the words of the statute or by the legislative history of the statute. In fact, the Treasury Department appears to have totally disregarded the legislative history and purpose of the unrelated trade and business income statute. These Regulations represent what someone in the Treasury Department thinks the law ought to be, not what Congress has said the law is, and they do not, therefore, respect the legislative process.

The effect of taxing such income will be to curtail, and in some cases to prohibit, the publication of scientific and educational papers which ultimately and directly benefit all mankind. The American Association of Petroleum Geologists, therefore, urges this Committee to take positive steps to insure that such income is not taxed, by recommending to the Congress that legislation be enacted specifically exempting advertising income derived from the publication of a journal which is related to the purpose or function constituting the basis for an organization's tax-exempt status.

I. THE AMERICAN ASSOCIATION OF PETROLEUM GEOLOGISTS, ITS PURPOSES, OBJECTIVES, AND MEMBERS

The American Association of Petroleum Geologists, Inc., is a Colorado corporation with national headquarters at the AAPG Building, 1444 South Boulder Avenue, Tulsa, Oklahoma. The Association is a tax-exempt organization under section 501(c)(6) of the Internal Revenue Code of 1954. The American Association of Petroleum Geologists has an Eastern Section, a Gulf Coast Section, a Mid-Continent Section, a Pacific Section, a Rocky Mountain Section, a Southwest Section, a Division of Paleontology and Mineralogy, and sixty affiliated

societies throughout the United States.[1] Presently there are some 15,082 members of the AAPG who are located in all 50 states and many foreign countries.[2] The Association has stringet educational and moral character requirements for membership.

The American Association of Petroleum Geologists was organized in 1917 to promote the science of geology, especially as it relates to petroleum and natural gas; to promote the technology of petroleum and natural gas and improvements in the methods of winning these materials from the earth; to foster the spirit of scientific research among its members and to disseminate facts relating to geology and technology of petroleum and natural gas.

Each month the Association publishes The American Association of Petroleum Geologists *BULLETIN* which is the principal method by which knowledge is disseminated among the Association's members. The format of the *BULLETIN* is that of a scientific and educational journal. The articles are written in a scholarly manner, are highly technical and would not generally be read by laymen. The *BULLETIN* is distributed by mail to AAPG members and to a limited number of interested subscribers, principally public and university libraries. It is not marketed generally, nor is it sold on newsstands. The *BULLETIN* serves a very important purpose and the Association is justifiably pround of the contributions to the science of geology and to the art of technical writing and publishing which the *BULLETIN* has made throughout the years.

II. THE AMERICAN ASSOCIATION OF PETROLEUM GEOLOGISTS BULLETIN, ITS FUNCTION, NATURE OF ARTICLES AND ADVERTISING CONTAINED THEREIN

To help defray publication expenses The American Association of Petroleum Geologists sells a limited amount of advertising in the *BULLETIN*. Advertising is not, however, indiscriminately sold. No cigaret, soft drink or similar advertisements will be found in The American Association of Petroleum Geologists *BULLETIN*. The advertisers in the *BULLETIN* are carefully screened and only those advertisements which will update members' knowledge of materials and services related to petroleum geology are selected for inclusion. The *BULLETIN* generally does not actively compete with magazines of general distribution for advertisers.

An analysis of the nature of the advertising contained in the *BULLETIN* shows that to a large extent it is institutional type advertising, that is, the company purchasing the space does not attempt to use the space to sell a particular product, but merely to advertise the corporate name. This is "good will" type advertising. Actually, it is probably incorrect to refer to it as advertising at all. Certainly it is not "advertising" in the usual commercial sense of the word. Rather, it is support of a scientific and educational journal by companies and persons interested in the advancement of petroleum geology. It would be more accurate to refer to them as contributors than as advertisers.

This Committee is aware of the kind of "advertisement" about which we are speaking. Often a company will purchase a full page in a scientific journal and merely have its name printed thereon. It cannot be said that by its action the company is actively trying to sell the reader of the journal a patricular product. What the company has done is to contribute to the journal the price of the page to help defray the cost of publication. It usually does so because it wishes to encourage the continued publication of technical articles which are highly instructive, and essential to the professional practice of geologists on its exploration staff.

The American Association of Petroleum Geologists invites the members of this Committee at their convenience to thumb through a copy of the *BULLETIN* to determine for themselves the nature of the advertising contained therein.

Despite the fact that the advertising contained in the *BULLETIN* is related to geology and the Association's exempt purpose, and despite the fact that the Association does not actively compete with commercial publishers for advertising in general, the Treasury Department has taken the position by recently issued Regulations that such advertising income is taxable as income from an unrelated trade or business under sections 511 through 513 of the Internal Revenue Code of 1954.

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[1] The AAPG affiliated societies are listed in the Appendix attached hereto.
[2] See Appendix.

In Example (2) of Regulations section 1.512(a)-1 it is provided that:

> Z, an exempt business league, publishes a monthly journal which it sells by subscription to members and others. The articles and other editorial content contribute importantly to the accomplishment of Z's exempt purposes. Therefore, the income attributable to journal subscriptions does not constitute gross income from unrelated trade or business. In connection with the publication of the journal, Z derives income from the regular sale of advertising space and services to commercial advertisers. Since the provision of commercial advertising space and service does not contribute importantly to the accomplishment of Z's exempt purposes, Z's income from advertising constitutes gross income from unrelated trade or business. . . .

And in Example (7) of Regulations section 1.513-1(d)(4)(iv), it is provided that:

> . . . (T)he advertising in Z's journal promotes only products which are within the general area of professional interest of its members. Following a practice common among taxable magazines which publish advertising, Z requires its advertising to comply with certain general standards of taste, fairness, and accuracy; but within those limits the form, content, and manner of presentation of the advertising messages are governed by the basic objective of the advertisers to promote the sale of the advertised products. While the advertisements contain certain information, the informational function of the advertising is incidental to the controlling aim of stimulating demand for the advertised products and differs in no essential respect from the informational function of any commercial advertising. Like taxable publishers of advertising, Z accepts advertising only from those who are willing to pay its prescribed rates. Although continuing education of its members in matters pertaining to their profession is one of the purposes for which Z is granted exemption, the publication of advertising designed and selected in the manner of ordinary commercial advertising is not an educational activity of the kind contemplated by the exemption statute; it differs fundamentally from such activity both in its governing objective and in its method.
>
> Accordingly, Z's publication of advertising does not contribute importantly to the accomplishment of its exempt purposes; and the income which it derives from advertising constitutes gross income from unrelated trade or business.

The American Association of Petroleum Geologists, its members and affiliated societies find this position taken by the Treasury Department to be very alarming and potentially stultifying. The position stated in the Regulations is that all advertising income is, *per se*, unrelated to an organization's exempt purpose. As will be demonstrated, *infra*, this conclusion is wholly without support in the statute enacted by Congress concerning unrelated business income and we urge this Committee to recommend legislation specifically exempting advertising income derived from the publication of a journal which is related to the purpose or function constituting the basis for the organization's tax-exempt status.

III. THE TREASURY DEPARTMENT'S POSITION ON ADVERTISING INCOME IS ARBITRARY AND IS NOT SUPPORTED BY STATUTE OR BY REASON

For a period of over 17 years after the enactment in 1950 of the Unrelated Business Income Tax Statute, the Internal Revenue Service correctly interpreted the statute as excluding income derived from the sale of advertising in journals published by tax-exempt organizations, such as The American Association of Petroleum Geologists.

In 1952 the Treasury Department issued Regulations interpreting the statute and defining the term "unrelated trade or business." For an activity to come within the unrelated business income section it was said that there must be a "trade or business" which is "regularly carried on" and which is not "substantially related" to the organization's exempt purpose. This was the test as developed by the Internal Revenue Service for the determination of whether or not activity was, in fact, an unrelated trade or business.

This was the test in effect in 1954 when the entire Internal Revenue Code was revised and reenacted. No change was made in the unrelated business income sections by the Congress in 1954. The Treasury Department has in effect, however, after over 17 years, redefined what it considers unrelated trade or business income and specifically included in the Treasury Department's definition is income received from the sale of advertising in scientific and educational jour-

nals, such as The American Association of Petroleum Geologists *BULLETIN*. Income from *all* advertising in such journals is, under the new Regulations, automatically included as unrelated business income. No analysis of the nature of the advertising to determine whether it is related to the exempt organization's purpose is provided for. Indeed, under the new Regulations the nature of the advertising is totally irrelevant since it is provided that no advertisement could ever be related to an exempt purpose. Under the Regulations, if it is advertising it is unrelated and income derived therefrom is taxable as unrelated business income.

The Treasury Department's position in this regard is totally without rationale. The new Regulations, as they apply to advertising income, have no basis in, and are not supported by the statute on unrelated business income as enacted by Congress. The issuance of these Regulations represents an usurpation of the legislative function by the Treasury Department. They represent what someone in the Treasury Department thinks the law ought to be, not what the law is as enacted by the Congress.

The Treasury Department attempts to justify its position by the argument that the unrelated trade or business provision was enacted for the purpose of eliminating the competitive advantage of exempt organizations engaged in businesses not related to their exempt purposes over non-exempt organizations engaged in similar businesses. The premise of the Treasury Department's argument is, of course, true. As this Committee well knows, the unrelated trade or business statute was enacted to correct abuses by some exempt organizations of their status. Certain exempt organizations had extended their operations into areas of competition with private, non-exempt organizations. The highly publicized acquisition by New York University of the Mueller Spaghetti Company is one example of the abuse sought to be remedied by the unrelated trade or business statute. But the extension of this statute by interpretation to cover income from the sale of advertising in a journal directly related to the exempt organization's purpose is without reason or justification.

All the legislative history leading up to the enactment of the unrelated trade or business statute indicates that the Congress realized that an exempt organization might properly have income from a source with some commercial aspects. Congress knew perfectly well that organizations such as The American Association of Petroleum Geologists published scientific and educational journals which contain advertising and there is not one shred of evidence that indicates an intent that income from this advertising would be covered by the legislation enacted in 1950. Indeed, there is substantial evidence to support the conclusion that such income was not considered to be unrelated business income.

When this statute was under consideration, Representative Mason introduced a bill which would have made taxable "income from any activity of a kind which is recognized as an ordinary trade or business activity commonly engaged in by persons for profit. . . ." This bill was rejected in favor of the bill enacted which taxes income derived from an "unrelated trade or business" which is not "substantially related" to the exempt purposes of the organization.

It is the failure of the Treasury Department to recognize the distinction between income derived from an exempt related activity which has commercial aspects from income from an unrelated activity that has led to the issuance of the regulations making all advertising income includible as unrelated business income.

Even if it is assumed that journals, such as The American Association of Petroleum Geologists *BULLETIN*, have a competitive advantage in selling advertising (and in view of the highly technical nature of the advertising in most such journals, this would seem to be a highly arguable assumption), this would not lead to the conclusion that all such income is from an unrelated trade or business. It was not the intent of Congress to tax income from unrelated activities, such as the publication of a scientific journal, even though there *may* be some competition with non-exempt organizations. Where the publication of a journal is related to the tax-exempt purpose, the income derived from the advertising therein should not be taxable, and is not under any reasonable interpretation of the statute enacted by the Congress. By no stretch of the imagination can advertising be described as a trade or business engaged in by AAPG; and to the extent that "engagement" could be substantiated, it is certainly not substantial.

IV. TAXATION OF ADVERTISING INCOME WILL RESULT IN THE CURTAILMENT AND IN SOME CASES WILL PROHIBIT THE PUBLICATION OF SCIENTIFIC AND EDUCATIONAL PAPERS

The effect of taxing the advertising income of exempt organizations will be in many cases to inhibit the organization. Many such organizations, especially the smaller ones, exist only because it is possible to communicate and educate by way of the organization's publication. But if advertising revenues are taxed, these organizations will find it difficult, if not impossible, to continue.

The American Association of Petroleum Geologists and similar organizations are not charitable organizations. They are, however, scientific, educational and benevolent oragnizations incorrectly designated by Internal Revenue Service as "business leagues." They are not organized for profit. All of the people in the United States, indeed all of the people of the world, benefit as a result of The American Association of Petroleum Geologists' work. And the very thing that benefits society the most is the research and scientific work that finds an outlet in journals such as The American Association of Petroleum Geologists *BULLETIN*.

The American Association of Petroleum Geologists does not, of course, question the power of Congress to tax income derived from the sale of advertising in the Association's journal. The American Association of Petroleum Geologists would, however, question the wisdom of such a tax even if it were to be imposed by legislation.

It is assumed that this Committee will carefully consider the possibility that existing IRS regulations may tax many organizations out of existence. Perhaps more importantly, this Committee should take positive steps to see that the Treasury Department does not, on its own initiative, tax these organizations out of existence.

V. THE AMERICAN ASSOCIATION OF PETROLEUM GEOLOGISTS URGES THE ENACTMENT OF SPECIFIC LEGISLATION EXEMPTING ADVERTISING INCOME FROM TAXATION

The American Association of Petroleum Geologists urges this Committee to take positive steps to see that such advertising income is not taxed, by recommending to the Congress that legislation be enacted specifically exempting advertising income derived from the publication of a journal which is related to the purpose or function constituting the basis for an organization's tax-exempt status. Such legislation has been proposed and introduced by Representatives Curtis, Watts and others in the past, and we urge that similar legislation be recommended to the House for passage.

Respectfully submitted.

THE AMERICAN ASSOCIATION OF PETROLEUM GEOLOGISTS,
By NORMAN C. SMITH, *Executive Director*

SCOTT & WHITE CLINIC,
Temple, Tex., September 10, 1969.

Senator RUSSELL LONG,
Chairman, Senate Finance Committee,
New House Office Building, Washington, D.C.

DEAR SENATOR LONG: Upon careful analysis of H.R. 13270, the tax reform bill reported out of the House Ways and Means Committee, and passed by the House, I notice that the Committee did not include an amendment which I had previously suggested regarding the difinition of "debt financed" income. The problem centers around the tax treatment of rentals from the Scott and White Clinic paid to Scott and White Memorial Hospital and Scott, Sherwood and Brindley Foundation. This bill would also effect other major medical centers in the United States wherein clinic rentals are paid to a medical research or education foundation.

In December, 1967, Congressman Poage arranged for me to have an oral conference with Mr. Leo Irwin, former Chief Counsel of the Ways and Means Committee, and with several other members of the legal staff regarding this problem which then came to my attention as H.R. 12663.

It was concluded from this conference that the wording of H.R. 12663 could create a problem for institutions such as our Clinic and Hospital-Foundation, and that it was not intended to treat the Clinic rentals paid to our Hospital-Foundation as unrelated business income through the new definition of "debt financed" income to a tax exempt non-profit organization. It was also concluded

that a proposed amendment should be adopted or that the matter would be cleared up in the legislative history of the bill. The newly printed H.R. 13270 contains the same wording as the old H.R. 12663 and nothing in the report or supplemental report of the Tax Reform Act of 1969 clarifies our situation.

In January, 1968, I brought this matter to the attention of Representative Bush of the House Ways and Means Committee, explaining to him in detail the organizational setup between Scott and White Clinic and the tax-exempt foundation, Scott and White Memorial Hospital and Scott, Sherwood and Brindley Foundation. In order to determine if the definition of "debt financed" income would have an effect on medical organizations such as ours, Representative Bush requested and received the enclosed analysis from Mr. George J. Leibowitz of the Legislative Reference Service. Mr. Leibowitz prepared an excellent summary of the problem and I attach it hereto as Exhibit A. On February 8, 1968, Representative Bush sent to me a letter wherein he had discussed the matter with Mr. John M. Martin, Jr., Chief Counsel of the Committee on Ways and Means and received a reply from Mr. Martin indicating that it was not the intention on the drafters of the introduced Bill to tax rental income paid by a clinic to a tax-exempt hospital-foundation, where the clinic is *substantially related* (aside from the need for income or funds) to the activities of the Hospital-Foundation. This letter is attached as Exhibit B.

I call to your attention these previous contacts to indicate that I believe that it was strictly through inadvertence that the matter was no clarified through either the Legislative Report or by Amendment in the House of Representatives. Since this matter has not been clarified in H.R. 13270, as sent to the Senate, nor in the Ways and Means Committee Reports on said legislation, I respectfully ask that the Senate Finance Committee give its utmost consideration to clarification of the wording of "debt financed" income in the present draft of H.R. 13270.

The exact wording which creates the problem is that which is located on Pages 96 and 97 of H.R. 13270 wherein the term "debt financed" property is defined. Under the first exception it lists "*(A) any property* ALL OF USE OF WHICH IS RELATED . . ." I would hope that the current test related to business leases might be adopted which exempts income received from a *substantially related organization* because there may be some doubt that the Clinic would be considered "all related". There is no doubt that it is "substantially related" to the activities of the Hospital-Foundation. A suggested amendment is enclosed which would clear up the matter or it could be clarified in your final report on the legislative history of the Bill. (Suggested amendment is enclosed as Exhibit C.)

This is a matter of utmost importance to us, Senator, and to the continuation of an organization which delivered health care this immediate past fiscal year to 75,870 patients from throughout the United States on a basis of the patients' ability to pay. The medical research and education programs of Scott and White Memorial Hospital and Scott, Sherwood and Brindley Foundation could be seriously retarded if the Clinic rentals paid to the Hospital-Foundation are deemed taxable through this definition of "debt financed" income. We are currently embarking on a $5 million expansion program which will include addition of two floors to the Clinic portion of our *combined Hospital and Clinic building* and there is no doubt that we will have to assume some indebtedness to help pay for this vitally needed expansion. It would appear from this new concept of "debt financed" income that, because the Hospital-Foundation would have to borrow money to help pay for additions to the Clinic portion of the combined Hospital and Clinic facility, the Hospital-Foundation will be penalized solely by the fact that money must be borrowed to expand our facilities and our services.

The Scott and White Clinic provides all of the out-patient medical and surgical services of the Hospital-Foundation, provides all of the research staff for the significant research activities of the Hospital-Foundation; and provides all of the training for residents and interns of the Hospital-Foundation. The medical care provided by the Clinic to Hospital patients is given regardless of the patients' financial ability. All patients determined to be total or part charity by the Hospital-Foundation are also treated in like manner by the Clinic for professional services rendered. Out-patients are treated by the Clinic doctors regardless of their financial ability. All doctors of the Clinic are salaried, and the budget of the Clinic is approved by the Hospital-Foundation Board of Trustees. There is no doubt that the Scott and White Clinic substantially furthers the exempt purposes of the Hospital-Foundation by assisting it to render a full range of hospital and medical services to patients from throughout the State of Texas, the Southwestern United States and from some forty other states in the country. I enclose

as Exhibit D a brief statement outlining the relationship between the Scott and White Clinic and the Hospital-Foundation.

The Association of physicians and surgeons (some one hundred and three senior staff) is organized as the Scott and White Clinic and is a separate organization from the Hospital (a non-profit Texas corporation), because the Texas law does not allow the corporate practice of medicine. The contractual relationship between the Clinic and the Hospital-Foundation is a fifty year contract (made in 1953).

The present Internal Revenue Service Code and Treasury regulations relating thereto, clearly establish that there is a "substantial relationship" between the two organizations. The new definition of "debt financed" income, however, should be clarified to allow the continuance of this concept which has allowed the two organizations such as ours to continue its outstanding programs of diagnosis and treatment, medical research and medical education, all of which has been so meaningful to the continuation and advancement of high quality health care for hundreds of thousands of patients who have received care at our institutions—regardless of their ability to pay—since 1953 when our organizations were structured and organized along the present lines outlined to you.

We respectfully urge the consideration of the Senate Finance Committee for clarification of the definition of "debt financed" income as it presently appears in H.R. 13270 insofar as it might effect our own Clinic and Hospital-Foundation, as well as others in the country which are established and operated along the lines described to you in this statement.

Sincerely,

JAMIE H. CLEMENTS, *Staff Attorney.*

Enclosures.

EXHIBIT A

THE LIBRARY OF CONGRESS,
Washington, D.C., January 22, 1968.

To: Hon. George Bush.
From: George J. Leibowitz, senior specialist in taxation and fiscal policy.
Subject: Effect of H.R. 12663 upon medical clinic associated with tax exempt hospital, your letter of December 12, 1967.

This is in reply to your letter enclosing correspondence from Mr. Jamie H. Clements, Staff Attorney for the Scott and White Clinic. The clinic is affiliated with the Scott and White Memorial Hospital and the Scott, Sherwood and Brindley Foundation of Temple, Texas.

Mr. Clements is concerned about whether H.R. 12663, which would impose a tax on unrelated debt-financed income of tax-exempt organizations, would unintentionally result in the *taxation of rentals* received by *Hospital-Foundation from the Clinic.* These rentals are *not subject to tax under present law* (Sections 511 to 514), which *taxes business lease rents* as *unrelated business income,* by reason of an *exception* in section 514(b) (3) (A) (i) which reads as follows:

3. Exceptions:

(A) No lease shall be considered a business lease if:

(i) such lease is entered into primarily for purposes which are substantially related (aside from the need of such organization for income or funds or the use it makes of the rents derived) to the exercise or performance by such organization of its charitable, educational, or other purpose or function constituting the basis for its exemption under section 501, or

Mr. Clements has questioned whether the *rentals paid by the clinic to* the hospital-*foundation* would be *excluded* from "*debt-financial income*" of the Foundation just as they are *now excluded from "business lease income."* The fact is that the *bill does contain an exclusion from "debt-financed property"* similar to but not identical to the present exclusion (quoted above) from a "business lease." The exclusion from "debt-financed property" read as follows:

. . . except that such term does not include:

(A) any property all the use of which is related (aside from the need of the organization for income or funds) to the exercise or performance by such organization of its charitable, educational, or other purpose or function constituting the basis for its exemption under section 501 (or, in the case of an organization described in Section 511(a)(2)(B), to the exercise or performance of any purpose or function designated in section 501(c)(3)):

Thus the question boils down to *whether these two formulations of exclusionary language* would have an *identical result* in this particular instance. On this, after conversation with Committee and Treasury personnel, Mr. Clements continues to have some doubt. Consequently, Mr. Clements has proposed additional language for the bill as follows:

Insert after line 9 on page 9 (the end of the General Definition of "debt-financed property") the following sentence, flush with the margin:

"All the use of a property or a portion of a property shall be considered related to the exercise or performance by an organization of its charitable, educational, or other purpose or function constituting the basis for its exemption, for purposes of subparagraph (A), if such property is real property subject to a lease and such lease is entered into primarily for purposes which are substantially related (aside from the need of such organization for income or funds or the use it makes of the rents derived) to the exercise or performance by such organization of its charitable, educational, or other purpose or function constituting the basis for its exemption under section 501."

In your letter, you asked for my views as to whether Mr. Clements' proposal would achieve the intended purposes.

My *first* reaction was that the *proposed change* might not be needed since the quoted exceptions seemed to be sufficiently similar. *Upon reflection*, and some discussion however, it would *appear to be less than a complete certainty that all functions of the clinic would be regarded as "related" to the purposes of the hospital.*

Accordingly, to be completely certain of the result, a change would be in order. Mr. Clements' change appears to accomplish the result satisfactorily. It might be desirable to go one step further and introduce an example into the committee report on the bill like the one used in 1950 when the predecessor to Section 514(b)(3)(A)(i) was enacted. The 1950 example which could be modified and used again, reads as follows:

> "Your committee has amended section 423(a) (of the 1939 IR Code, Section 514(b) of the IRC of 1954), as it appeared in the House bill to provide that no lease shall be considered a Supplement U lease if such lease is entered into primarily for purposes which are substantially related (aside from the need of such organization for income or funds, or the use it makes of the rents derived) to the exercise or performance by such organization of its charitable, educational, or other purpose or function constituting the basis for its exemption under section 101. For example, where a hospital leases a clinic to an association of doctors, the rents derived under such lease would be excluded from the tax imposed by this section if the lease was made for purposes substantially related to the carrying on of hospital functions."

The material you received from Mr. Clements is returned herewith.

EXHIBIT B

CONGRESS OF THE UNITED STATES,
HOUSE OF REPRESENTATIVES,
Washington, D.C., February 8, 1968.

JAMIE H. CLEMENTS,
Staff Attorney,
Scott & White Clinic,
Temple, Tex.

DEAR MR. CLEMENTS: Mr. John M. Martin, Jr., Chief Counsel of the Committee on Ways and Means, has advised me that it was not the intention of the drafters of the introduced bill to tax rental income as you described. He also said that your amendment and Mr. Leibowitz's memo will be made available to the Legislative Counsel's Office at the time the final bill is drafted.

It was a pleasure to co-operate with you on this subject and please let me know when I may be of further assistance.

Yours very truly,

GEORGE BUSH, *Member of Congress.*

EXHIBIT C

PROPOSED AMENDMENT TO H.R. 12663

Insert after line 9 on page 9 the following sentence, flush with the margin: "All the use of a property or a portion of a property shall be considered related to the exercise or performance by an organization of its charitable, educational, or other purpose or function constituting the basis for its exemption, for purposes of subparagraph (A), if such property is real property subject to a lease for a term of more than five years and such lease is entered into primarily for purposes which are substantially related (aside from the need of such organization for income or funds or the use it makes of the rents derived) to the exercise or performance by suc horganization of its charitable, educational, or other purpose or function constituting the basis for its exemption under section 501."

EXHIBIT D

RELATIONSHIP BETWEEN SCOTT & WHITE CLINIC, AN ASSOCIATION OF PHYSICIANS AND SURGEONS, AND THE TAX EXEMPT NONPROFIT ORGANIZATION, SCOTT & WHITE MEMORIAL HOSPITAL, AND SCOTT, SHERWOOD & BRINDLEY FOUNDATION

Scott and White Memorial Hospital and Scott, Sherwood and Brindley Foundation (one legal entity) is a non-profit Texas corporation, organized and operated exclusively for charitable and scientific purposes. Our designation as an exempt organization under IRC(c) (3) was approved by the Internal Revenue Service on October 6, 1953.

Scott and White Memorial Hospital and Scott, Sherwood and Brindley Foundation operates a 315 bed charitable hospital; a School of Professional Nursing which has graduated over 1200 licensed professional nurses; a resident and intern training program which now includes some 60 physicians; and a Department of Research which carries out an extensive program in medical research.

The institution occupies a 300 acre campus with several structures on it, the main one being a combined hospital and clinic building. All properties, including buildings and equipment therein, are owned by the Hospital-Foundation. Additionally, the name "Scott and White Clinic" is owned by the Hospital-Foundation.

The Hospital-Foundation, by contract dated August 7, 1950, leases its Clinic space, equipment, services of technicians and other personnel, and the name "Scott and White Clinic" to an unincorporated Association of physicians and surgeons. The Association (Scott and White Clinic) consists of one hundred and three senior staff physicians, all of whom are on salaries. They receive no individual fees for services. The Association is a legal entity under Texas law and is taxable as a Corporation for Federal tax purposes. In addition to operating an out-patient clinic which had some 75,870 patient registrations last fiscal year, the Association is responsible for carrying out many functions related to the activities of the Hospital-Foundation. All Association physicians are members of the Hospital medical staff (the Hospital medical staff also has other physicians in the area on its staff); Association physicians are responsible for training the Hospital's residents and interns; they serve as instructors in the Hospital School of Nursing; and all of the Hospital's professional research staff are members or employees of the Association. The contract provides that patients who are declared by the Hospital-Foundation as being total charity patients will not be charged by the Association for professional services, and persons declared part-charity patients will be charged by the Association only those charges approved by the Hospital-Foundation.

For the license and permission to use the name "Scott and White Clinic", and for the use of the buildings, hospital properties and equipment of the Hospital-Foundation, and for the services rendered by the employees and other personnel of the Hospital-Foundation to the Association and its patients, the contract provides that the Association shall pay as rental to the Hospital-Foundation all net profits of the Association over and above the salaries to members and employees of the Association and the operating expenses of the Association. The Association is required to submit its annual budget each year to the Board of Trustees of the Hospital-Foundation, which has the right to approve or disapprove the Association's annual budget. In event of disapproval, the Association must make such

gross alterations in its budget as may be required to meet the approval of the Board of Trustees of the Hospital-Foundation.

The aforementioned rentals paid by the Association to the Hospital-Foundation are not presently computed as unrelated business taxable income under the present law. (IRC 514(b)(3)(A)(i) and Reg. 1.514(b)-1 (c)(1).)

ALPHA GAMMA RHO FRATERNITY,
Des Plaines, Ill., September 12, 1969.

HON. RUSSELL B. LONG,
Chairman, Senate Finance Committee,
U.S. Senate, Washington, D.C.

DEAR SENATOR LONG: Alpha Gamma Rho Fraternity is very much interested in the portion of H.R. 13270, referred to your Committee on August 8, 1969, which would tax the investment income of college fraternities.

The effect of this proposal, if made law, would be to substantially hinder our ability to assist in construction or improvement of student housing on the campuses of land-grant and other public agricultural colleges in the United States.

Alpha Gamma Rho is the fraternity for agriculture, having 43 chapters and approximately 2,000 student members. The fraternity does not hold a substantial investment portfolio nor does it derive a substantial portion of its income from investments. Assessments have been made upon members for a building fund, the maintenance and operations of which have been entirely in keeping with clear public interest.

In our judgment, taxation of the income of fraternities—income which is directly or indirectly devoted to developing leadership and character in young Americans—places the development of human resources below the desire for federal revenue. Such would be a grave and serious error in national policy.

We appreciate this opportunity to comment on the proposed legislation before your Committee, and we respectfully request that this letter be included in the record of the hearings.

Sincerely yours,

MAYNARD H. COE,
Executive Secretary.

FLORISSANT, MO., *September 30, 1969.*

Hon. RUSSELL LONG, *Chairman,*
Senate Finance Committee,
New Senate Office Building, Washington, D.C.

DEAR SENATOR LONG: As a compulsory dues-paying union member who is in full accord with a fair and just "tax reform" bill, I have certain objectives to H.R. 13270 in its present form.

I work as a driver for the Yellow Cab Company in St. Louis. I've been a union member all my adult working life. We drivers were stuck for several years with the Teamsters as our collective bargaining agent, but we voted by secret ballot to replace them with the Seafarers International Union. Ever since that time we have been saying, "Out of the frying pan into the fire."

We belong to Transportation and Allied Workers of St. Louis Local #1. Our parent union, the Seafarers International, has been the subject of much unfavorable publicity—and rightly so—because our salaried officials have spent several fortunes on partisan political activities. Our international union has only 80,000 members, but last year it spent more than half a million dollars for political purposes.

On April 3, 1968, the international's Political Activity Donation Committee sent checks totalling $100,000 to the coffers of various Democratic Party campaign organizations. These checks were written just a few days after a member of President Johnson's cabinet refused to send a fugitive from justice back to Canada. Harold Banks, an official of the Seafarers International, had been convicted of assault and sentenced to five years in a Canadian prison, but he jumped bond and escaped to the United States. It may be a coincidence that these generous campaign contributions were made by the union after the Secretary of State saved Banks from a prison sentence. But maybe it wasn't a coincidence.

We union members are sick and tired of having our money used to support politicians who help union officials keep us in bondage. Union officials are licensed to compel us to pay dues in order to keep our jobs, and all union income is exempt

from taxation. The "tax reform" bill now before you would penalize foundations for engaging in political activities. I urge you to impose the same penalties on unions engaging in political action. All tax-exempt institutions should receive the same treatment under our laws.

Sincerely yours,

ELMER FOERST.

RESOLUTION OF THE EXECUTIVE COMMITTEE, NATIONAL CONFERENCE OF STATE LEGISLATIVE LEADERS, SUBMITTED BY CHARLES O. DAVIS, JR., EXECUTIVE SECRETARY

Whereas it is essential to the well-being of our American federal system that all levels of government—federal, state and local—be equipped to meet the challenges of our time, and

Whereas the Executive Committee of the National Conference of State Legislative Leaders recognizes the need for improving state legislatures and welcomes the cooperation and assistance of the general public in bringing about legislative modernization, and

Whereas the Citizens Conference on State Legislatures, a tax-exempt 501(c)(3) organization, has had the assistance of the National Conference of State Legislative Leaders in joint efforts to involve the private sector in strengthening the legislative branch of state government, and

Whereas section 4945 of HR 13270 places stringent limitations on the ability of tax exempt organizations to influence legislation at the state level by: (1) engaging in private communications with legislators and their staffs; (2) influencing any election, whether or not candidates are involved; and (3) making individual grants to certain people including state legislators, and

Whereas the state legislatures may be deprived of access to the free flow of information and technical assistance as a result of proposed restrictions on the valued aid of the private sector of our body politic as an unintentional consequence of HR 13270; now, therefore, be it

Resolved, That the Executive Committee of the National Conference of State Legislative Leaders strongly urges the House of Representatives and the Senate of the United States to insure the "Tax Reform Act of 1969" does not impose new and additional restrictions which would impair the ability of tax-exempt organizations, such as the Citizens Conference on State Legislatures, to respond to requests for aid from governmental bodies, to appear before legislative bodies, to have free and open communication with public officials and to provide objective technical assistance and comparative information to legislative bodies and public alike, so long as such organizations neither support or oppose candidates for public office nor publicly support or oppose specific matters of legislation; and be it further

Resolved, That the Executive Committee of the National Conference of State Legislative Leaders directs its Executive Secretary to inform members of the Congress of the United States of the content of this Resolution.

Adopted September 13, 1969, Washington, D.C.

BOY SCOUTS OF AMERICA,
New Brunswick, N.J., September 11, 1969.

Subject: Concerns re Tax Reform Act of 1969.

COMMITTEE ON FINANCE,
U.S. Senate, New Senate Office Building,
Washington, D.C.

GENTLEMEN: Boy Scouts of America has expressed itself in formal presentations to hearings conducted both by the Internal Revenue Service and the Ways and Means Committee of the House of Representatives concerning elements of the Tax Reform Act of 1969. Since both presentations contained material which we believe your Committee should consider in its deliberations, we have attached excerpts from both presentations to which reference is made in this written statement to you.

Our several concerns stem from the fact that the ability of the Scout movement in the United States to fulfill its Congressionally chartered purpose of serving this nation's youth must be enhanced, not hampered, by conscious acts of the federal government.

Proposals in the Tax Reform Act raise philosophical and financial considerations bearing on the subject of the privileges of exemption from taxation and the

degree to which it should be limited, on one hand, or the activities of tax-exempt organizations encouraged on the other hand. Since these philosophical and financial considerations bear importantly on the proper approach to several aspects in the Tax Reform Act which would apply to Boy Scouts of America, we would like to reiterate a portion of a statement made recently by BSA to a State study commission concerned with kindred issues:

"* * * A number of justifications has been advanced for the exemption from taxation of property used for charitable purposes. *First, and most important, is that government desires to encourage certain activities that promote the general welfare or foster humanitarian ideals or are inherently meritorious.* To this end, government aids and stimulates these activities by granting a tax exemption. We believe that Scouting is such an activity—an activity worthy of encouragement whose funds should not be sapped by a tax * * *. Indeed, when the Congress of the United States created the Boy Scouts of America in 1916, it said that Scouting was organized to promote * * * the ability of boys to do things for themselves and others, to train them in Scoutcraft, and to teach them patriotism, courage, self-reliance, and kindred virtues * * *. These words charted a course for Scouting that it has followed with ever increasing strength to the present. Some rough measurement of the success of the Scouting movement may be seen in its rapid growth. The National Headquarters * * * now charters and supervises more than 152,312 Cub Scout packs, Boy Scout troops and Explorer posts. During 1968, a total of 4,608,000 boys and 1,639,000 leaders belonged to the Boy Scouts of America, * * * the ranks of former members swelled to more than 45,800,000 * * *. Since the beginning, fifty-nine years ago, Boy Scouts of America has been one of the leaders in the effort to curb juvenile delinquency, to encourage good mental, physical and moral habits, and to kindle and develop a spirit of community service and patriotism among this country's youth. Our programs have been directed to molding good character by training boys in leadership and self-reliance. And the benefits to society have been innumerable. Communities, both rural and urban, have witnessed the worthy deeds of Scouts—ranging from conservation of our natural resources to aiding communities struck by disasters.

"But today our most important and most relevant contribution is our efforts to help disadvantaged boys. In these days of Black Power and White Power, I think you will find it refreshing and encouraging to hear about Boypower. Scouting's BOYPOWER '76 program is designed to serve boys in inner-city and rural poverty areas and to provide a camping experience for needy boys. These programs were begun in 1965 by cooperation between the National Council and 16 selected (local) councils * * *. Through these programs, we are just beginning to open doors.

"Nearly 50,000 disadvantaged boys spent at least a week in the outdoors last year as guests of the Scouts. Upon their return home, additional Scout units were formed in their neighborhoods.

"We believe that these activities must rate high in the scale of human values We believe that these activities are most worthy of aid from government by the continued granting of a tax exemption. * * *

"*Another justification for the exemption from taxation of property used for charitable purposes is that government may seek to encourage an activity that government itself may find difficult or inappropriate or too controversial to undertake.* Simply put, certain activities are better left in private hands. As a result private resources are utilized; many minds with many views are brought to bear on problem; there is diversity and pluralistic values are fostered. Scouting is an excellent example of this. Through a tax exemption, government can aid and stimulate the Scout movement while not controlling it.

"*Finally, government may grant a tax exemption to an organization because of the fiscal advantages that government receives from the organization.* This means that the organization is performing services necessary to the community that government otherwise would be called upon to fund directly. Since the charitable organization is supported in large measure by funds from the public voluntarily given, the burden upon government of partially supporting these necessary services through tax relief is but a small measure of what it would be if direct and total funding were required. * * *"[1]

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[1] Statement on February 18, 1969 of Judge Arthur S. Lane to New Jersey Tax-Exempt Property Study Committee.

The Tax Reform Act of 1969 is a complex proposal designed to accomplish many worthy objectives. Elements of this proposal most, however, be carefully weighted by those potentially affected. Boy Scouts of America cannot speak with authority to the total proposal but does feel concern over two major elements. This paper sets forth our general view of these elements. Attachments referred to in this general view speak to each of the subjects in more detail.

First, tax saving incentives and charitable contributions

Provisions of the Act regarding "Gifts of Appreciated Property", "Allocation of Deductions", and "Life Income Gifts" tend to reduce the taxpayer's incentive to make charitable contributions.[2] Many elements of the Act are sound. However, the principles should be achieved without destroying traditional incentives or making the guidelines to action so complex that prospective donors decline to become involved. Just as the withholding system made the income tax a dependable federal revenue source, so existing tax saving incentives for charitable contributions have sustained philanthropy as an endeavor of private citizens.

Second, application of unrelated business income tax

From the earliest hearing before the Internal Revenue Service, Boy Scouts of America has maintained that although it does not seek to enter "unrelated" business enterprises it does not agree the "unrelated business income tax" properly should be applied to activities which relate to the carrying out of its exempt purposes such as the publication of balanced magazines for boys and adult leaders containing both editorial matter and advertising concerning products, services and programs intimately involved with the execution of the Scouting program.

We offered suggestions to the Treasury Department to assist it in distinguishing between "related" advertising, which should not give rise to unrelated business income and "unrelated" advertising, which would.[3] The only response has been that because it is difficult to establish a simple definition of "unrelated" and "related" advertising, all advertising will be considered "unrelated." The logic of this conclusion leaves many questions unanswered.

These suggestions were repeated to the House Ways and Means Committee.[4] We also suggested to the House Ways and Means Committee that it may be inappropriate to treat all exempt organizations alike and that there were important policy considerations which distinguished BSA; we recommended ways in which legislation could be drafted which would exempt Boy Scouts of America from legislation obviously aimed at others or at least permit the taxing authorities to treat different cases differently. Although they are set forth in Attachment C, we would like in this general statement to quote these recommendations to you as they were stated to the House Ways and Means Committee:

"Boy Scouts of America suggests that consideration be given to one or more of the following proposed courses of action.

"1. It has been proposed to Congress that general legislation be adopted rescinding the new regulations as they apply to all tax-exempt organizations. The passage of such legislation of general applicability would, of course, cure the problem insofar as Boy Scouts of America is concerned. If the Congress does not wish to go so far, it might consider whether the facts warrant distinguishing between exempt organization publications which are distributed principally to members of the organization (membership being characterized by active participation in the programs of the organization, not just by subscription to the publication) and all other exempt organization publications.

"2. If the Government prefers to deal with the problem on a case by case basis, there are several approaches by which, given the fact that there are considerations which distinguish Boy Scouts of America's position from that of exempt organizations generally, the Government could assist Boy Scouts of America:

"(a) Legislation[5] could be adopted which would add to Section 501(c)(1) of the Internal Revenue Code a new category of organization defined (in general terms) as corporations organized by Act of Congress which satisfy the exempt organization tests of Section 501(c)(3) and Section 170(c)(2).

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[2] The impact on the Scouting movement and our views of these provisions is discussed in Attachment A—"Effect of Tax Reform Act on Public Support of Scouting.

[3] Excerpts from presentations to the Internal Revenue Service, Attachment B.

[4] Excerpt from presentation to Ways and Means Committee, Attachment C.

[5] Our suggested course of action speaks in terms of legislation. It might be more expeditious and preferable for other reasons if the results here sought to be achieved could be effected through administrative action. Boy Scouts of America requests that those to whom this position statement is addressed consider the possibility of such administrative action.

"Reclassification of BSA as such a new type of 501(c)(1) would afford a practical solution to the problems created for it by T.D. 6939.[6]

"(b) Legislation could be adopted which would leave BSA's present classification unchanged but would expressly exempt Boy Scouts of America from Internal Revenue Code Sections 511–514 (the unrelated business income (tax). Such legislation could be in the form of an amendment to Section 511(a)(2)(A) or a separate law granting Boy Scouts of America relief from the unrelated business income tax.

"(c) Legislation could be adopted exempting *Boys' Life* from the operation of T.D. 6939. There are a number of ways such legislation could be worded. One possibility would be to provide in the legislation that the publication of advertising by Boy Scouts of America in *Boys' Life* and *Scouting* is an activity substantially related to the charitable and educational purposes of Scouting for which Boy Scouts of America was granted tax-exempt status. One way of accomplishing this result without expressly characterizing advertising in *Boys' Life* and *Scouting* as "related" (and thus raising the issue of how to distinguish the BSA situation from that of other organizations) would be to provide that, in computing BSA's unrelated business income, if any, there shall be excluded *any* net income received by BSA from the publication of its magazines, if such net income is used in the furtherance of BSA's exempt purposes. (In this connection, compare IRC Section 114.)

"(d) Legislation could be adopted distinguishing between 'related' and 'unrelated' advertising in publications of Boy Scouts of America—i.e., treating as an activity substantially related to the exempt purposes of Boy Scouts of America the publication in its magazines of advertising of products, services or programs directly related to means of achieving the exempt purposes of Boy Scouts of America."

Although these recommendations appeared to receive a sympathetic welcome by the Ways and Means Committee, they were ignored when the act was drafted. We seriously urge these recommendations to you.

In our official statements we have pointed out that Scouting requires every legitimate resource if it is to pursue its purpose of serving youth in these demanding times. The erosion of these resources as contained in the Tax Reform Act jeopardizes this movement's ability to function within traditional fiscal policy.

We appreciate this opportunity to present our continuing concern to the Senate Finance Committee.

Very truly yours,

IRVING FEIST, *President.*

ATTACHMENT A

BOY SCOUTS OF AMERICA, LOCAL COUNCIL FINANCE SERVICE

EFFECT OF TAX REFORM ACT ON PUBLIC SUPPORT OF SCOUTING

We feel that the long-standing position of the Federal Government in encouraging the support of charitable organizations, such as Scouting, through the allowance of tax deductions for charitable contributions should be continued. The problems facing our Nation today call for an increase and not a decrease in the support of Scouting by the private sector through laws that encourage charitable contributions. Should the Tax Reform Act of 1969, as passed by the House, be passed by the Senate in its present form, it cannot help but greatly diminish charitable contributions and, in the long run, prove detrimental to the Nation as a whole.

At the root of the considerations involved in whether to allow deductions for charitable contributions is each citizen's personal conviction about the importance of voluntaryism in America. The intangible benefits of voluntaryism come from involving the individual citizen in the personal support of a specific voluntary cause. The more this responsibility is felt, the healthier democracy will be.

The Boy Scouts of America is strongly in favor of legislative changes that will correct the abuses that have arisen under the present tax law. However, we

[6] Although BSA can suggest technical wording by which any of the solutions suggested by it in this presentation could be implemented, we have felt it would be presumptuous and premature to go into such detail at this time.

believe that several of the proposed provisions are not limited to correcting these abuses but are so broad as to diminish the incentive toward charitable giving and destroy much of the vitality of charitable organizations. These provisions are discussed below:

1. Gifts of Appreciated Property: The present law allows a deduction equal to the fair market value of the property given to charity. Under the proposed provisions, if the donor transferred tangible personal property or certain other types of property or engaged in a bargain sale, he would have to limit his charitable deduction to his cost or other basis unless he included the appreciation in his income. Would a potential donor not be more likely to hold the property or profit from the appreciation by selling the property for his own account?

The impact of the proposed provisions is clear: BSA and other bona fide charitable organizations will be deprived of an important source of income. The importance of gifts of appreciated property to Scouting cannot be overemphasized. Much of the land now devoted to Scout camps was purchased with the income from gifts of appreciated property. In the past ten years, BSA has received gifts of appreciated property, which had a fair market value of approximately $55,000,000, nearly $6,500,000 in 1968. In addition, trust funds maintained by many local councils are the recipients of gifts of appreciated property. For the continued growth of these trust funds, which are essential for a strong Scouting program, the incentive for such gifts must be maintained. The loss or diminution of such an important source of income would greatly curtail Scouting programs and plans.

2. Limit on Tax Preferences (LTP) and Allocation of Deductions: Those types of property (such as securities) that are not included in the provisions taxing the appreciation of gifts of property to charitable organizations such as BSA are subject to tax under other provisions. Under the Tax Reform Act, a donor of appreciated securities to BSA would be faced with two new and unfavorable tax consequences. First, the amount of appreciation is a "tax preference" item. A portion of this amount together with other items of tax preference may be taxed under the LTP provisions, thereby requiring very complicated computations. (Indeed, the LTP provisions and the provisions dealing with allocation of deductions are so complex that they may discourage charitable degiving by their very complexity.) Second, the donor may be required to allocate his deductions between his taxable income and his untaxed appreciation so that his allowable deductions will be reduced. Would this donor not be more likely to hold the securities or sell them for his own account rather than incur a tax and reduce his deductions because he gave the securities to charity?

3. Deferred Gifts: Both the provisions concerning charitable gifts of appreciated property and those concerning charitable trusts will affect deferred gifts to charities.

A. *Charitable Remainder Trusts.*—The law presently affords a donor a deduction for the value of the charitable remainder where property is transferred to a trust which provides that the income is to be paid to a non-charitable beneficiary with the remainder to go to charity. We believe that this treatment should be maintained. The Tax Reform Act would disallow a deduction for a transfer of property to fund a charitable remainder trust and would allow a deduction only for a transfer to a charitable remainder annuity trust or a charitable remainder unitrust. We do not believe that the complicated provisions of the charitable remainder annuity trust and the charitable remainder unitrust should be substituted for the widely used and readily understood charitable remainder trust.

We would also stress that the general reasons given for the change in the law by the House do not apply to BSA's charitable remainder trusts. The House would deny a deduction in the case of the charitable remainder trust because it fears that the charitable remainder might be jeopardized by investment in high-risk, high income securities, by giving the charity only a contingent remainder interest or by allowing invasion of the charitable share. However, we would point out that the abuses sought to be corrected are not possible in the case of BSA since BSA administers these trusts under its Deferred Giving Program.

B. *Charitable Remainder Annuity Trusts and Charitable Remainder Unitrusts.*—Even the transfer of property to a charitable remainder annuity trust or a charitable remainder annuity unitrust would incur unfavorable tax treatment. The appreciation of the property transferred would be subject to tax, as described under headings 1. and 2. above.

C. *Charitable Gift Annuities.*—In order to reduce the tax benefits of bargain sales to charity, the Tax Reform Act provides that the cost or adjusted basis of appreciated property sold to charity for less than its fair market value is to be allocated between the portion of the property sold and the portion of the property donated on the basis of the fair market value of each portion, thereby increasing the taxable gain recognized on the sale. We are concerned that the transfer of property to a charity in return for an annuity may be treated as a bargain sale where the fair market value of the property exceeds the value of the annuity. Such treatment will increase the amount of gain recognized by the annuitant. Also, under the proposed bargain sale provisions, the annuitant will be taxed on a portion of the appreciation even where his cost or adjusted basis exceeds the actuarial value of the annuity. This treatment will deprive organizations such as BSA of a major source of support.

The Boy Scouts of America feels strongly that the long-established tax incentives should be maintained. Such incentives are well-known, easily regulated, not subject to flagrant abuse, and have provided vital support to Scouting programs. That reform, modernization, equalization and regulation are necessary will not be denied. Many elements of the Tax Reform Act are sound. However, the principles sought to be established can be achieved without destroying the traditional incentive or making it so difficult to give that the prospective donor is discouraged from giving.

ATTACHMENT B

EXCERPT FROM LETTER TO COMMISSIONER OF INTERNAL REVENUE, DATED JUNE 22, 1967, CONCERNING PROPOSED REGULATIONS UNDER SECTIONS 512 AND 513 OF THE CODE

"RELATED ADVERTISING INCOME SHOULD NOT BE TAXED

Based on the legislative mandate that income from only unrelated trades or businesses is taxable,[1] *only unrelated advertising income* of an exempt organization publication should be subject to tax if a decision is made to tax advertising income. Under the approach suggested herein, income from *related* advertising arising from the sale of space in a publication for the advertising of a product, service or program that directly relates to a means of achieving the purposes of the exempt organization which publishes the publication would not be taxable: income from unrelated advertising would be treated as income from unrelated trade or business and taxed accordingly.

The proposed regulations themselves recognize that in proper circumstances advertising income received by an exempt organization may properly be considered related income. It is submitted that the publication of advertising by an exempt organization, in a periodical which is distributed to further the organization's exempt purposes, of products, services and programs directly related to the carrying out of such exempt purposes is no less related to the exempt purposes of the organization than the publication of the editorial content of such a periodical. An examination of Boys' Life, a magazine published by Boy Scouts of America, readily demonstrates this fact.

Boy Scouts of America was incorporated by an Act of Congress of June 15, 1916 to promote

"* * * through organization, and cooperation with other agencies, the ability of boys to do things for themselves and others, to train them in Scoutcraft, and to teach them patriotism, courage, self-reliance and kindred virtues, * * *." 39 Stat. 228, 36 U.S.C. § 23 (1954).

Among the many activities conducted by Boy Scouts of America in the fulfillment of its exempt purposes are its extensive camping and outdoor, recreational, arts and craft, thrift, vocational development, safety and hobby development

[1] There is substantial doubt whether the proposed taxation of income from a component element of a trade or business as unrelated business income is in accord with law. The legislative history shows that Congress evidently intended to tax income from the operation of a business enterprise as a whole that was not substantially related to the purposes of the exempt organization; there was no suggestion that the unrelated business tax was to be imposed on component parts of a business enterprise. See *e.g.*, H.R. Rep. No. 2319, 81st Cong., 2d Sess. 37 (1950); S. Rep. No. 2375, 81st Cong., 2d Sess. 26, 29 (1950); 96 Cong. Rec. 9274 (1950) (remarks of Rep. Sabath); Hearings before the House Ways and Means Committee on the Revenue Revision of 1950, 81st Cong., 2d Sess. 19 (1950) (remarks of Secretary of the Treasury Snyder). However, this objection, while not conceded, will not be fully discussed here since it is understood that other organizations will comment on this matter at length.

programs. An important instrument for implementing these programs is the publication of—

"* * * a periodical [*Boys' Life*] for all boys of Scout age providing wholesome stories and other material of interest and educational value which will stimulate ambition and help character development of boys. *All stories and material shall be in harmony with the principles of Scouting as laid down in the Scout Oath and Law.*" National By-laws Article XXIII, § 2, at 96. (Emphasis added.)

As the proposed regulations recognize in the case of the editorial content of publications of other exempt organizations,[2] the editorial content of *Boys' Life*, with its variety of articles relating to Scouting, contributes importantly to the exempt purposes of Boy Scouts of America. Similarly, advertising in *Boys' Life* which relates to outdoor and camping equipment, clothing apparel and footwear appropriate to Scouting activities (much of which bears the official emblem of Boy Scouts of America), handicrafts, safety devices and hobby and vocational development directly serves to implement the activities that make up the Scouting program.

UNRELATED ADVERTISING INCOME SHOULD BE CONSIDERED UNRELATED BUSINESS INCOME ONLY IF IT CONSTITUTES A SUBSTANTIAL PROPORTION OF ALL ADVERTISING INCOME

Boy Scouts of America further recommends that no advertising income be taxable if 80 percent or more of such income in any one tax year is derived from the sale of related advertising. The suggested approach introduces a test of substantiality which accords with the statutory mandate that a trade or business need only be substantially, not wholly, related to the performance of an exempt organization's purposes for the income therefrom to be tax-exempt. Additional statutory support for such a test comes from other sections of the unrelated business income tax provisions of the Code, such as Sections 513(c) and 512(b)(14), as well as other sections of the Code and the regulations thereunder. The adoption of a fixed percentage test (80 percent) eases the administrative burden of the Internal Revenue Service in a manner consistent with applicable law. This approach is restrictive in that the advertising must relate directly to a means currently used by an organization to achieve its exempt purposes in order to qualify as related advertising, and thus makes any inquiry into projected or speculative activities of an organization unnecessary."

ATTACHMENT B

EXCERPT FROM LETTER TO COMMISSIONER OF INTERNAL REVENUE, DATED JULY 28, 1967, CONCERNING PROPOSED REGULATIONS UNDER SECTIONS 512 AND 513 OF THE CODE

Assumptions Underlying the BSA Proposals.—Before discussing the applicability of the proposed distinction between related and unrelated advertising to situations other than *Boys' Life* magazine, we wish to re-emphasize strongly two points made in our written and oral presentations on behalf of Boy Scouts of America.

First, in our view a proper interpretation of existing law requires that a determination whether the publication by an exempt organization of a periodical or other publication constitutes the carrying on of an unrelated trade or business must be made by looking at the trade or business as a whole and not by considering the publication of editorial matter and advertising as separate businesses. The legislative history which supports this reading of the unrelated business income tax provisions of the Internal Revenue Code is cited in the footnote on page 5 in our June 22nd presentation: presentations made to the Service on behalf of other exempt organizations have persuasively articulated this point. Although we will not pursue the point here we do wish to say once again that by making the proposals in our June 22nd presentation we did not indicate any agreement that a component element of a trade or business may properly be taxed as an unrelated trade or business.

Second, if the Service decides to view the publication by an exempt organization of advertising as a trade or business separate from its publication of editorial matter, the Service *must*, under the legislative mandate of Sections 511–514 of the Code, determine whether that business is related or unrelated to the exempt purposes of the organization. That such a determination may in some cases be difficult to make or in some cases may result in a judgment that all or a sub-

[2] Prop. Treas. Reg. §§ 1.513–1(d)(4)(iv) Ex (6) and 1.512(a)–1(d)(3) Ex (2).

stantial portion of advertising carried in a particular publication is related to the exempt purposes of the publishing organization does not detract from the fact that the Internal Revenue Code requires a determination be made whether the trade or business in question is related or unrelated. The conclusive presumption which the proposed regulations seem to establish that all advertising in an exempt organization publication necessarily is unrelated to the exempt purposes of that organization does not conform to the test established by Congress. Thus, if the Service concludes that it is proper to consider the publication of advertising as a separate trade or business, it must then take the *next* step and establish guidelines which will allow determination on a case by case basis whether that trade or business is related or unrelated to the exempt purposes of particular organizations. The revisions to the proposed regulations which we have suggested are not only a workable means of doing this but are the means required by the Code itself.

Attachment C

Presentation on February 25, 1969 to Committee on Ways and Means

Boy Scouts of America

Mr. Chairman and members of the Committee, my name is Marshall Monroe. I am Administrative Assistant Chief Scout Executive of Boy Scouts of America and would like, on behalf of Boy Scouts of America, to express appreciation for this opportunity to express our views concerning several of the issues relating to tax exempt organizations which are before this Committee for study. We are particularly interested in, and wish today to comment on, first, the application of the unrelated business income tax to the net advertising revenues of our two magazines, *Boys' Life* and *Scouting*, and, second, on the effect on Scouting of the adoption of any legislation that would permit deductions for charitable contributions only to the extent they exceed a certain percentage of the donor's income.

The Philosophical and Financial Nature of the Questions Before Us.—We are pleased that these issues are before this forum because the subject of the privilege of exemption from taxation and the degree to which it should be limited, on the one hand, or the activities of tax exempt organizations encouraged, on the other hand, raises philosophical and financial questions best considered by the legislative branch of government. Before giving our views on the two subjects discussed in our presentation, I would like to read to you a short excerpt from a presentation made last week by BSA to a state study commission defending the philosophical and financial bases of tax exemption since these words, in our view, also apply to the matters before us here today. Last week our spokesman pointed out that—

* * * A number of justifications has been advanced for the exemption from taxation of property used for charitable purposes. *First, and most important, is that government desires to encourage certain activities that promote the general welfare or foster humanitarian ideals or are inherently meritorious.* To this end, government aids and stimulates the activities by granting a tax exemption. We believe that Scouting is such an activity—an activity worthy of encouragement whose funds should not be sapped by a tax * * *. Indeed, when the Congress of the United States created the Boy Scouts of America in 1916, it said that Scouting was organized to promote * * * the ability of boys to do things for themselves and others, to train them in Scoutcraft, and to teach them patriotism, courage, self-reliance, and kindred virtues * * *. These words charted a course for Scouting that it has followed with ever-increasing strength to the present. Some rough measurement of the success of the Scouting movement may be seen in its rapid growth. The National Headquarters * * * now charters and supervises more than 152,312 Cub Scout packs, Boy Scout troops and Explorer posts. During 1968, a total of 4,608,000 boys and 1,639,000 leaders belonged to the Boy Scouts of America, * * * the ranks of former members swelled to more than 4[illegible],800,000, * * * . Since the beginning, fifty-nine years ago, Boy Scouts of America has been one of the leaders in the effort to curb juvenile delinquency, to encourage good mental, physical and moral habits, and to kindle and develop a spirit of community service and patriotism among this country's youth. Our programs have been directed to molding good character by training boys in leadership and self-reliance. And the benefits to society have been innumerable. Communities, both rural and urban, have witnessed the worthy deeds of Scouts—ranging from conservation of our natural resources to aiding communities struck by disasters.

But today our most important and most relevant contribution is our efforts to help disadvantaged boys. In these days of Black Power and White Power, I think you will find it refreshing and encouraging to hear about Boypower. Scouting's Boypower '76 program is designed to serve boys in inner-city and rural poverty areas and to provide a camping experience for needy boys. These programs were begun in 1965 by cooperation between the National Council and 16 selected [local] councils * * *. Through these programs, we are just beginning to open doors.

Nearly 50,000 disadvantaged boys spent at least a week in the outdoors last year as guests of the Scouts. Upon their return home, additional Scout units were formed in their neighborhoods.

We believe that these activities must rate high in the scale of human values. We believe that these activities are most worthy of aid from government by the continued granting of a tax exemption. * * *

Another justification for the exemption from taxation of property used for charitable purposes is that government may seek to encourage an activity that government itself may find difficult or inappropriate or too controversial to undertake. Simply put, certain activities are better left in private hands. As a result, private resources are utilized; many minds with many views are brought to bear on problems; there is diversity and pluralistic values are fostered. Scouting is an excellent example of this. Through a tax exemption, government can aid and stimulate the Scout movement while not controlling it.

Finally, government may grant a tax exemption to an organization because of the fiscal advantages that government receives from the organization. This means that the organization is performing services necessary to the community that government otherwise would be called upon to fund directly. Since the charitable organization is supported in large measure by funds from the public voluntarily given, the burden upon government of partially supporting these necessary services through tax relief is but a small measure of what it would be if direct and total funding were required. * * *" [1]

I. *The Unrelated Business Income Tax Should Not Diminish the Advertising Revenues of Boys' Life and Scouting.*—With these general principles in mind, let me turn first to our views concerning the impact of the recent administrative expansion of the unrelated business income tax. The publication on December 11, 1967 of T.D. 6939 by the Internal Revenue Service has created potentially serious and far reaching problems for Boy Scouts of America. This new regulation will subject to Federal income tax for the first time, at rates applicable to commercial businesses, the net advertising income of *Boys' Life* magazine and *Scouting* magazine which are published by Boy Scouts of America.[2]

The Boy Scouts of America urges that responsible government officials, both elected and appointed, give careful consideration to the propriety and consequences of this new regulation which will deprive the Scout movement of one of its traditional and principal financial resources and place in jeopardy the ability of Scouting to finance itself. Concerted and effective government action to remedy the situation and remove this new tax burden from Scouting is essential if the Scout movement is to continue to maintain itself through its own resources.

A. *The Arguments Advanced in Support of the Regulation Do Not Apply to Boys' Life Magazine.*—Proponents of the new regulation, including the IRS itself, defend the imposition of the tax on the ground that inclusion of advertising in a periodical published by a tax-exempt organization constitutes unfair competition with the commercial press. It is important to recognize that *Boys' Life* magazine is not interested in competing with the commercial press. *Boys' Life* speaks essentially only to those in the Scout movement; virtually 9 of every 10 (86%) of its approximately 2,400,000 subscribers are Scouts or Scouters. *Boys' Life* is not sold on the newstand to the general public and its readership is made up principally of male youths from ages 8 through 17. The magazine is published to provide a medium of expression of the principles and programs of Scouting to those within the Scout movement. Advertisers wishing to reach readers of the type included in the Scout movement find *Boys' Life* a helpful avenue to this specific reader group.[3]

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[1] Statement on February 18, 1969, of Judge Arthur S. Lane to New Jersey Tax-Exempt Property Study Committee.

[2] For convenience, in the balance of this statement we have referred only to *Boys' Life*. The statements made, however, also apply to *Scouting* magazine.

[3] All of the approximately 1,600,000 subscribers of the *Scouting* Magazine are persons in the Scout Movement.

B. *Boy Scouts of America Presented Cogent Reasons to the IRS Why the Regulation Should Not Be Adopted.*—Boy Scouts of America made careful and detailed written and oral presentations to the Internal Revenue Service supporting its position that the proposed regulations which became T.D. 6939 should not be adopted. These presentations demonstrated that

(1) the new regulations are inconsistent with the intention of Congress when it passed the unrelated business income tax in 1950;

(2) the new regulations are inconsistent with the 17 year history of the interpretation of that tax;

(3) there is no basis in the tax law for splitting one integrated actvity—the publication by an exempt organization of a periodical in furtherance of its exempt purposes—into two enterprises, *viz.* the publication of editorial matter which is conceded to be "related" to the exempt purposes of the organization and the publication of advertising which arbitrarily is deemed to be "unrelated" to those exempt purposes; and

(4) contrary to the IRS assumption that all advertising necessarily is unrelated to the exempt purposes of an organization, the advertising contained in *Boys' Life* magazine in the main *is substantially related to the exempt purposes of Boy Scouts of America* and, therefore, even if it were appropriate to adopt the IRS approach of splitting publication of a magazine into components comprised of publication of editorial matter and publication of advertising matter, advertising income of *Boys' Life* should not be subject to tax.

C. *What is the Issue?*—Boy Scouts of America is seriously concerned with the apparent erosion of Government support of Scouting. Scouting enjoys the individual and public endorsement of most elected and appointed officials of the Government. Accordingly, it is distressing to Boy Scouts of America when, in spite of declared interest by the Government in furthering the Congressionally ordained objectives of Scouting and the principles which Scouting seeks to promote, the Government adopts regulations that reduce the ability of Scouting to perform for the good of the country and its citizens programs that otherwise must be carried forward by the Government itself.

Boy Scouts of America does not believe that the current unhappy position in which it finds itself was the result of a deliberate policy decision by Government directly at Scouting—rather Scouting has become the unfortunate victim of a general policy which was not designed with BSA in mind but which hits BSA very hard nonetheless. If this is the case, Boy Scouts of America can only plead for relief before the problem is compounded beyond correction.

The question is simple.—Is it the desire of the Government of the United States to continue to allow Scouting to carry forward without the burden of taxation its declared program of character development, citizenship training, mental and physical fitness?

We believe the answer is also simple.—The Government of the United States *does* agree that the Scout movement serves a valued national interest. Recognizing Scouting's Congressionally chartered responsibilities, the Government wishes to assure the Scout movement of its continued support and specifically urges it to direct its resources even more aggressively towards serving our nation's youth, helping them to prepare to master the changing demands of the nation's future.

D. *What Can Be Done to Remedy This Serious Situation.*—Boy Scouts of America suggests that consideration be given to one or more of the following proposed courses of action.

(1) It has been proposed to Congress that general legislation be adopted rescinding the new regulations as they apply to all tax-exempt organizations. The passage of such legislation of general applicability would, of course, cure the problem insofar as Boy Scouts of America is concerned. If the Congress does not wish to go so far, it might consider whether the facts warrant distinguishing between exempt organization publications which are distributed principally to members of the organization (membership being characterized by active participation in the programs of the organization, not just by subscription to the publication) and all other exempt organization publications.

(2) If the Government prefers to deal with the problem on a case by case basis, there are several approaches by which, given the fact that there are considerations which distinguish Boy Scouts of America's position from that of exempt organizations generally, the Government could assist Boy Scouts of America:

(a) Legislation[4] could be adopted which would add to Section 501(c)(1) of the Internal Revenue Code a new category of organization defined (in general terms) as corporations organized by Act of Congress which satisfy the exempt organization tests of Section 501(c)(3) and Section 170(c)(2). Reclassification of BSA as such a new type of 501(c)(1) would afford a practical solution to the problems created for it by T.D. 6939.[5]

(b) Legislation could be adopted which would leave BSA's present classification unchanged but would expressly exempt Boy Scouts of America from Internal Revenue Code Sections 511–514 (the unrelated business income tax). Such legislation could be in the form of an amendment to Section 511(a)(2)(A) or a separate law granting Boy Scouts of America relief from the unrelated business income tax.

(c) Legislation could be adopted exempting *Boys' Life* from the operation of T.D. 6939. There are a number of ways such legislation could be worded. One possibility would be to provide in the legislation that the publication of advertising by Boy Scouts of America in *Boys' Life* and *Scouting* is an activity substantially related to the charitable and educational purposes of Scouting for which Boy Scouts of America was granted tax-exempt status. One way of accomplishing this result without expressly characterizing advertising in *Boys' Life* and *Scouting* as "related" (and thus raising the issue of how to distinguish the BSA situation from that of other organizations) would be to provide that, in computing BSA's unrelated business income, if any, there shall be excluded *any* net income received by BSA from the publication of its magazines, if such net income is used in the furtherance of BSA's exempted purposes. (In this connection, compare IRC Section 114.)

(d) Legislation could be adopted distinguishing between "related" and "unrelated" advertising in publications of Boy Scouts of America—i.e., treating as an activity substantially related to the exempt purposes of Boy Scouts of America the publication in its magazines of advertising of products, services, or programs directly related to means of achieving the exempt purposes of Boy Scouts of America.

II. *The Congress should not adopt legislation which will tend to discourage br ad-based public support of exempt organizations such as Boy Scouts of America.*

The point here is simple and can be stated very briefly. We do not see how Scouting as we now know it could survive legislation which inhibited private philanthropy by eliminating the charitable contribution deduction or limited its use to wealthy donors by imposing a floor of 2 or 3 percent of adjusted gross income on deductible contributions. Scouting depends on grass roots support—on individual contributions by millions of interested donors throughout the country. In 1967, the local councils of the Boy Scouts of America received 92.8 percent of their total revenues from gifts, both as a result of direct campaigns and through Chests and United Funds. We estimate that the average gift to Boy Scouting was under $8.00.

No one can predict how many potential donors would be eliminated if the charitable contribution deduction were curtailed,[6] but there can be no doubt that there would be a loss and Scouting would have to curtail its programs with the unhappy result that some segment of the public, presently supporting our activities, would be lost to us and their loss would cost us more than dollars.

I will not dwell further on this point because I know others will make more complete presentations to you concerning it. Do not let the brevity of my remarks on this point indicate to you that there is any limit to the concern which we feel regarding this issue.

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[4] Our suggested courses of action speak in terms of legislation. It might be more expeditious and preferable for other reasons if the results here sought to be achieved could be effected through administrative action. Boy Scouts of America requests that those to whom this position statement is addressed consider the possibility of such administrative action.

[5] Although BSA can suggest technical wording by which any of the solutions suggested by it in this presentation could be implemented, we have felt it would be presumptious and premature to go into such detail at this time.

[6] In 1966, of the 27 million persons who itemized their deductions and their income tax returns, 52.7 percent contributed 3 percent or less of their adjusted gross income.

ST. CHARLES, MO., *September 30, 1969.*

SENATE FINANCE COMMITTEE,
Washington, D.C.

DEAR SIRS: I am grateful for your willingness to give consideration to this written statement on the tax-reform bill. It is being sent in reply to a telegram I received from the Committee's chief counsel, Mr. Vail.

I work for the McDonnell-Douglas Corporation in St. Louis as an hourly-rated wage earner. A collective bargaining agreement between the tax-exempt International Association of Machinists and the corporation requires me and all other employees to pay dues to the union every month, regardless of our opinion of the IAM.

Being a registered Republican voter, I am galled by the fact that this union is practically an arm of the Democratic Party. Its paid officials are always active in campaigns to elect Democrats, and their activities are financed in part by money I have earned. They are taking unfair advantages of the union's tax exemption, and I protest.

I am 62 years of age and have three children at home to support. The loss of my job would work a hardship on us all, so I hesitate to withhold my dues from the union and risk being fired.

What can I do to remedy this injustice? As I see it, the only thing I can do under these circumstances is appeal to Members of Congress to stop giving favored tax treatment to unions that abridge the rights of working men and women.

What good does it do us to go to the polls and vote for the candidate of our choice if our union is using our money to defeat that candidate? Money talks, and our political freedom is being violated ruthlessly.

I also ask that government spending be reduced so that tax relief can be given to us overburdened taxpayers.

Thank you for giving me an opportunity to share my thoughts with you.

Respectfully yours,

STEWART A. GOFF.

STATEMENT OF GLASS CONTAINER INDUSTRY RESEARCH CORPORATION

Glass Container Industry Research Corporation ("GCIRC") submits this written statement in lieu of appearance respecting an apparently unintended, but potentially serious, defect in Section 121(b)(3)(A) of H.R. 13270, which would add a new Section 278 to the Internal Revenue Code. GCIRC is a membership corporation organized not-for-profit under the laws of Ohio, for the purpose of conducting a research program for the glass container industry. It undertakes projects of general interest to the gl[illegible]ntainer industry, results of which are given to its members. Although mer[illegible]ership in GCIRC is open to all glass container manufacturers, not all have joined. While many of the smaller glass container manufacturers are members, several of the largest are not.

During the twelve-year period from 1957 through 1968, GCIRC's entire gross receipts consisted of $3,042,980.65 dues from members and $804.72 interest, the latter primarily from Federal income tax refunds. During this same period the total costs of operation before Federal income taxes were $3,021,569.72, leaving a net excess of receipts over costs before taxes of $22,215.65. In nine of the twelve years, the sole source of receipts was membership dues. In seven of the twelve years membership dues exceeded costs before taxes by a total of $111,027.75, and in five of these years, costs exceeded membership dues by a total of $89,555.07. The Internal Revenue Service has specifically ruled that membership dues paid to GCIRC are deductible business expenses of its members.

GCIRC presently is engaged in litigation with the Internal Revenue Service over whether it is a tax-exempt organization. Should the Government prevail in this litigation, as may well happen, apparently GCIRC would be an organization described in proposed new Section 278, namely a non-exempt membership corporation operated primarily to furnish services to members. Proposed new Section 278 states that organizations to which its provisions apply will be allowed deductions in each taxable year for the costs of furnishing services, goods or other items of value to members only to the extent of the membership dues or other membership income received during that taxable year. There apparently is no provision for carryover or carryback of disallowed deductions to other taxable

years and no provision which would restrict the application of Section 278 to organizations where membership dues or receipts constitute personal, recreational or other non-deductible expenses of the members. If it is the intent either that Section 278 would not override and preclude application of the net operating loss carryover and carryback provisions of the Code or that Section 278 would apply only where membership dues and receipts are non-deductible expenses of members, then it is respectfully submitted that such intent should be clarified.

The remainder of this statement is made on the premise that proposed Section 278 as passed by the House of Representatives would preclude the application of the net operating loss carryover and carryback provision of the Code to costs disallowed by Section 278 and that Section 278 is intended to apply irrespective of the deductibility of membership dues and receipts by the members.

Proposed new Section 278 in effect treats non-exempt cooperative membership corporations in the same manner as the present Internal Revenue Code treats gamblers. On an annual basis, net gains from gambling are taxed and net losses from gambling are permanently non-deductible. It should be elementary that no cooperative operation can exactly balance membership receipts and costs on an *annual* basis even though overall operations are conducted for members at cost.

Section 278 makes no distinction between investment income and membership income. It would permanently disallow costs of membership operations where sole receipts were from members and no investment income existed. If proposed new Section 278 had been in effect during the twelve-year period from 1957 through 1968, GCIRC would have been permanently disallowed deductions for almost $90,000.00 in costs and taxed on approximately $111,000.00 in membership dues even though during this period its entire interest receipts totaled only $804.72. No policy reason is stated in the House or Staff reports for such a result and none is apparent. If the real intent is merely to tax investment income, Section 278 in the form passed by the House seems a clear case of overkill. Its result will be to impose an irrational and possibly prohibitive tax burden on non-exempt cooperative membership organizations where investment income is de minimus or even non-existent.

If the objectives of proposed new Section 278 really are as stated at page 49 of House Report No. 91-413 (Part 1), at page 25 of House Report No. 91-413 (Part 2) and at pages 29-30 of the Summary of H.R. 13270 prepared by the staffs of the Joint Committee on Internal Revenue Taxation and the Committee on Finance, it is respectfully suggested that one or more of the following three modifications should be made to Section 278 as presently proposed:

1. Limit the application of Section 278 to non-exempt membership organizations where the membership dues and other membership receipts are personal, recreational or other non-deductible expenditures of the members and do not apply Section 278 to non-exempt membership organizations where the membership dues or other membership receipts are deductible business expenses of the members.
2. Abandon presently proposed Section 278 and substitute a provision which would, irrespective of all other provisions of the Code, impose a minimum taxable income on the prescribed non-exempt membership organizations equal to investment income received each year.
3. If the approach of presently proposed Section 278 is retained, add a provision to the effect that any costs of membership operation disallowed for a given taxable year by Section 278 may be carried back or forward to other taxable years, under the provisions applicable to net operating loss carrybacks and carryovers, to the extent membership dues and other membership receipts exceed membership operating costs in such other taxable years.

ERNEST GRUENING,
September 26, 1969.

Hon. RUSSELL B. LONG,
U.S. Senate,
Washington, D.C.

DEAR RUSSELL: While I am wholly sympathetic with and applaud the Congress's efforts to put an end to tax evasion through the proposed tax reform, the language as passed by the House would have a disastrous effect on many worthy educational and charitable efforts.

As you may know, I have been deeply concerned with the need of family planning and the related population problem for many years, and am serving on a voluntary basis as a consultant to the Population Crisis Committee, a tax-exempt educational organization under Section 501(c)(3) of the Internal Revenue Code.

The bill itself now exempts colleges and certain other educational institutions as well as hospitals and medical facilities. I would strongly urge, in line with this thinking, that organizations dealing with the important population problem here and abroad, either from an educational or research point of view, or the medical aspects of family planning, be similarly exempted.

Specifically, I suggest that a new exemption section under 201(a)(1)B of the Tax Reform Bill as passed by the House be included, as follows:

"An organization whose major purpose is educational and research activities relating to population and family planning problems or operation of family planning clinics wherever located."

I would think that this exemption would not be controversial. It is directly in line with nearly fifty public statements on population by former President Johnson. It would help to implement President Nixon's recent population Message to the Congress in which he stressed the need for private agencies in this field to supplement the Government's efforts.

Sincerely yours,

ERNEST GRUENING.

CENTURY TOWNHOUSES,
September 9, 1969.

Hon. WENDELL WYATT,
House of Representatives,
Washington, D.C.

DEAR SIR: We are engaged in the business of building townhouses in the area of Portland, Oregon. The type of homes we are promoting make it possible for an individual, particularly in the lower or middle income bracket, to own his own home and also to insure that all of the neighboring houses in the tract will be properly maintained. In most instances, the tract will provide certain common areas for recreation and the beautification of the area which tend to make residential living more enjoyable for the home owners.

With the skyrocketing costs of housing, the difficulty for the average wage earner to own a home of his own and make the payments thereon has become increasingly more difficult and it is for this reason, as I am sure you are aware, that townhouses, condominiums and similar developments have become so popular, since these methods do give this class of people the opportunity to enjoy a better home than if the person acquired a custom built home for a similar purchase price.

In the development of a townhouse tract it is desirable to have the owners in a given area become shareholders or members of a non-profit corporation which will—

(*a*) Own and maintain the common areas, and
(*b*) Collect from each owner a sum each year for the common maintenance of all townhouses for the following items:
(1) Exterior painting,
(2) New roofs,
(3) Such other exterior care as is common to all of the properties, and
(4) Maintenance of lawns, yards and other common areas.

The need for a new roof occurs between once every 8 to 15 years. The need for painting occurs every 3 to 10 years, dependng on the quality and type of paint used, and the other items at various times of frequency. The shareholders and property owners, when they contribute to the corporation, are making an expenditure which to them is generally a nondeductible expense for tax purposes.

The Internal Revenue Service has taken the position that the payments by the shareholders to such a corporation are taxable income to it, without any offsetting deductions, until the money is used, at which time we assume the Internal Revenue Service would allow the expenditures as deductions to the corporation. This, in effect, penalizes this type of a housing development in that a corporate tax would be paid for the number of years the reserves were being built up for painting, repairs, and capital improvements. In effect, the money expended for home improvements would be taxed twice—once upon the receipt of the income and secondly, when received by the corporation.

As has been set forth, the homeowner in creating these reserves has initially a non-deductible item and it is therefore inequitable, upon the part of these people that in order to provide reserves for maintaining their homes and to beautify the surrounding area, that they should indirectly have to pay an additonal tax simply because they choose to use the corporate entity to provide these services.

Since Congress is now considering tax reform, we as citizens assume that such reform goes both ways, that is, inequities which allow taxpayers to avoid tax where they should be taxed should be eliminated and inequities which cause those to be taxed when Congress really did not intend for them to be taxed should likewise be corrected.

It is, therefore, hoped that you will consider our suggestion while H.R. 13270 is being considered by the Senate, to discuss with the Honorable Mark O. Hatfield and Honorable Robert W. Packwood, Senators from Oregon, the proposed amendment to be added to Title 1, Subtitle B, Section 121 to provide the aforesaid exemption from income tax for corporations formed for the sole purpose of providing services to owners of condominiums, townhouses and similar housing developments. It is, of course, expected that such corporations would be taxed on their true income from interest, dividends or other gains earned on these reserves. This could be accomplished by making the proposed amendment subject to the provisions of Subtitle 8, Section 121 (b) (1) (a) (3) of H.R. 13270 (Relating to definition of Unrelated Business Taxable Income). A suggested amendment and explanation thereof to be introduced on the floor of the Senate and/or the House Ways and Means Committee is submitted herewith.

This letter and proposed amendment have been prepared for me by Mr. Garthe Brown of Jones & Brown. Mr. Brown advises me that he is well acquainted with you and would be more than glad, if you choose to discuss the matter with him by phone or otherwise, or to do anything else which might assist your understanding of the matter and assistance in causing the matter to be given appropriate attention by the Congress of the United States.

Very truly yours,

WILLIAM GRAEPER.

EXPLANATION OF THE AMENDMENT TO SECTION 501(c) OF THE CODE

Exemption from taxation of certain housing corporations (Section 121 of the bill and 501(c) of the Code) Present Law—

Under present law, a non-profit corporation organized to provide services, such as maintenance and improvements, to townhouses, condominiums, and similar dwellings or the common areas contiguous to such buildings is subject to the tax imposed by Section 11 of the Code.

General Reasons for the Change—The tax exemption for corporations organized to provide services and improvements to its members' dwellings and the common area surrounding such dwellings is designed to place the member in substantially the same position as if he had spent his income on his home and its surrounding area without the intervening separate organization. It is felt that it is equally important to exempt such corporations from tax as it is to exempt such social clubs described in Section 501(c)(7) of the Code from tax.

The amendment provides that 95 percent of corporation's gross receipts must be derived from assessments or contributions from the members in order to insure that the cost of the services provided to the members has not been defrayed by income derived from providing similar services to non-members at a profit. Similarly, such corporation's investment income is subject to tax to prevent tax-free dollars to be used to provide services to the members.

Section 501(c) of the Internal Revenue Code of 1954 is amended to read as follows by the addition of the following subsection (18):

(18) Corporations not organized for profit, but operated exclusively for the preservation, maintenance and repair of houses, apartments or dwellings of the members of such corporations; and the preservation, maintenance, landscaping and operation of the common area owned by such corporations situated contiguous to such houses, apartments or dwellings, if:

(A) No part of the net earnings of such corporations inures (other than through the rendition of services) to the benefit of any member of the corporation or other person, and

(B) 95 percent or more of the gross receipts of such corporation consists of amounts collected from members and amounts contributed to the corporation by such members for the sole purpose of providing such services.

Section 121(b) (1) (a) (3) (A) of Subtitle B of H.R. 13270 is amended by deleting the "or" after "(9)" and inserting "(10)" or "(18)".

STATEMENT TO THE COMMITTEE ON FINANCE OF THE U.S. SENATE BY THE BENEVOLENT AND PROTECTIVE ORDER OF ELKS

The Benevolent and Protective Order of Elks is a fraternal beneficiary order operating under the Lodge system and exempt from income tax under Section 501(c)(8) of the Internal Revenue Code of 1954. The Grand Lodge of the Order is located in Chicago, Illinois, and there are local lodges located throughout the United States. In determining that the Order is exempt from tax, the Commissioner of Internal Revenue has issued a group exemption to the Grand Lodge which also applies to local lodges which meet the qualifications established by the Grand Lodge.

We of the Order have reviewed provisions of H.R. 13270, the Tax Reform Bill of 1969, as they apply to organizations exempt from income tax under the provisions of Section 501(c)(8) of the Code. We would respectfully like to call to the attention of the Committee two aspects of the Bill which we believe merit further consideration.

1. Section 121(b) of the Bill amends Section 512(a) of the Code by providing that unrelated business taxable income of organizations exempt from tax under Sections 501(c)(7),(8),(9) and (10) includes all gross income of such organizations except only their "exempt function income" which is a term defined in the amendment generally as dues, fees, charges or similar amounts paid by members of the organization, less only deductions directly connected with the production of gross income other than exempt function income. This amendment has the effect of not only taxing the gross income from an active business unrelated to the exempt function of the organization, but also of subjecting to income tax the passive or investment income of the exempt organizations set forth above.

We believe that the total effect of this amendment produces a result which is unsound as applied to the activities carried on by the Grand Lodge of the Benevolent and Protective Order of Elks. We are particularly concerned about taxing the investment income earned by the Grand Lodge and local lodges. We have no objection to taxing the income from the active conduct of an unrelated business. We however respectfully suggest that consideration be given to exempting all investment income at both the Grand Lodge and local lodge levels. The investment income of our local lodges is relatively small in most instances but nevertheless an important consideration in the furtherance of their charitable and community service activities and we respectfully suggest that at the very least, consideration be given to exempting the investment income of each individual Lodge not in excess of $10,000 annually.

Investment income is used by the Grand Lodge to support activities which it regularly carries on and which we believe are of significant social and national importance. These activities include:

(1) Comprehensive programs for U.S. Military Veterans confined to U.S. Veterans Hospitals such as multi-type entertainments, vocational training with therapeutic value and recreational programs.

(2) Welcoming programs for U.S. Servicemen returning from Viet Nam.

(3) Americanism Programs designed to preserve our Country and its heritage. These programs include (a) Get-out-the Vote (b) Know Your America Week (c) Bill of Rights Day (d) Freedom Week (e) Flag Day Observance (f) Independence Day (g) Citizens' awareness of the Canons of American Citizenship and reemphasis on the Respect to our Flag.

(4) Youth programs designed to build our youth into law abiding, useful and upright adults. These programs include (a) sponsorship of 1100 Boy Scout Troops (b) participating with and sponsoring Girl Scouts and Campfire Girls (c) providing manpower and financial resources for Boys' and Girls' Clubs (d) fostering character building and encouraging youth leadership by annually making awards of $33,000 to outstanding youth leaders (e) providing annually educational scholarships for youth totaling $500,250.

(5) Working with each State Elk Association in effecting its multi-major projects which are (a) 3 Vocational Rehabilitation Centers (b) 9 Cerebral Palsy Treatment Hospitals and Centers (c) Operating approximately 75 mobile cerebral palsied treatment units each staffed with a therapist (d) 6 crippled children's hospitals (e) 1 children's colony (f) 4 crippled children's programs (g) 1 cancer research assistance program (h) 1 eye clinic (i) 1 eye bank (j) 9 youth camps (k) 3 handicapped children's programs (l) 3 mobile dental clinics for disabled children (m) 3 speech and hearing clinics. Total operating cost of these projects approximately 5 million dollars.

OUR SERVICES ARE EXTENDED TO ALL IN NEED—REGARDLESS OF RACE, COLOR, CREED OR NATIONAL ORIGIN

Also, our 2130 Subordinate Lodges have many charitable and community service programs. Last year 8½ million dollars were spent by these Lodges.

The Order operates a Home for Elks incapable of earning a livelihood; and under certain conditions provides assistance to worthy and needy members who are disabled.

We believe that the Grand Lodge is to be distinguished from social clubs exempt under Section 501(c)(7) of the Internal Revenue Code and discussed in the Report on H.R. 13270 of the Committee on Ways and Means of the House of Representatives, where investment income could be used to increase the recreation and pleasure benefits available to social club members at no increased cost to them. The activities carried on by the Grand Lodge and described above are not of any direct benefit to members of the Order but rather are of direct benefit to the communities in which they are carried on and are of a quasi-charitable nature. If the investment income of the Grand Lodge is subjected to tax and if only those deductions can be taken which are directly connected with the production of that income, important programs of the Grand Lodge will have to be significantly cut back in order to provide the money necessary to pay the tax due.

We submit that the result which will flow from subjecting the investment income of the Grand Lodge to tax is a wholly unwarranted and seriously ill-advised use of the taxing power. We would have no quarrel with the amendment if this investment income were used to directly benefit members of the Order by making available increased recreation and pleasure services at no increased cost to them. However, this is simply not the case as the amendment is applied to the Grand Lodge.

The amendment exempts from tax as unrelated business taxable income that investment income of an organization exempt under Section 501(c)(8) which is permanently committed to charitable purposes as that term is defined in Section 170(c)(4) of the Internal Revenue Code or which is used to provide for the payment of life, sick, accident or other similar benefits to members. We suggest that our objection to the amendment could be overcome by broadening this exemption which the amendment itself contains to include investment income which is not used by either the parent Lodge or any of the local Lodges of any organization exempt from tax under Section 501(c)(8) either directly or indirectly for the recreation and pleasure benefit of members. This approach would meet the purposes of the amendment as set forth in the Report of the Committee on Way and Means, and at the same time would not result in the taxation of income which is used to support important programs which benefit the entire community.

2. As already pointed out, Section 121(a) of the Bill would subject to tax all income from the operation of a business carried on by an organization exempt under Section 501(c)(8) of the Code which is unrelated to its exempt purpose. We are in full agreement with this provision. However, we believe that it may well be in conflict with Regulations promulgated by the Secretary of the Treasury under Section 501(c)(8). Treasury Regulation 1.501(c)(8)-1(b) states in effect that an organization exempt under Section 501(c)(8) may not engage in any business not directly connected with its exempt purpose without jeopardizing its exempt purpose. We have long believed that there was no statutory basis for this Regulation, since it would preclude such an organization from operating an unrelated business no matter how insignificant. Apparently in recognition of this problem, we understand that the Internal Revenue Service has not attempted to revoke the exemption of organizations exempt under Section 501(c)(8) if the amount of income which they derive from an unrelated business actively conducted is very small in comparison to their total receipts. Nevertheless the Regulation referred to above is still in full force and effect. We might mention that a similar Regulation is also applicable to social clubs exempt under Section 501(c)(7).

By taxing the income from an unrelated business actively conducted by an organization exempt under Section 501(c)(8), the House of Representatives must have intended that such an organization could operate such a business without jeopardizing its exemption, which is in direct conflict with Treasury Regulation 1.501(c)(8)-1(b). Therefore, we recommend that Section 121 of the Bill be amended to make it clear that the operation of an active business, even though unrelated to its exempt purpose, will not itself jeopardize the exemption of an organization exempt under Section 501(c)(8) of the Code. If the unre-

lated business becomes so significant a portion of the organization's activities that the organization no longer can be said to be operated for its exempt purpose, there is ample judicial precedent for revoking the organization's exemption in a body of law which has developed with respect to organizations exempt under other subsections of Section 501(c) and which have been authorized by statute since 1950 to operate an unrelated business.

Respectfully submitted,

FRANK HISE,
Grand Exalted Ruler.
FRANKLIN J. FITZPATRICK,
Grand Secretary.

AMERICAN MEDICAL ASSOCIATION
Chicago, Ill., October 6, 1969.

Senator RUSSELL B. LONG,
Chairman, Committee on Finance,
U.S. Senate, Washington, D.C.

DEAR SENATOR LONG: The American Medical Association wishes to submit its views on H.R. 13270, now pending before your Committee.

This organization and many other tax exempt, non-profit groups, including the National Education Association, the American Bar Association, the American Dental Association, the Boy Scouts, the Girl Scouts, church groups, and all the civic groups and the state and county component groups of all these organizations appeal to the Senate Finance Committee for assistance. All of these groups which publish journals, pamphlets, etc., are in need of relief by way of a short amendment to the House-passed tax bill.

We are willing that net journal advertising and other pamphlet and publication sales income be subpect to federal corporate income tax—but, IRS has stated that it will, if the House-passed language prevails, not permit consolidation of all types of publishing income in arriving at a net taxable income. IRS will, unless the present language is clarified, tax the advertising income separately without permitting a consolidation of the other publishing business income, such as sale of pamphlets, etc. As an example, the American Medical Association publishes nearly 2,000 pamphlets to educate the public about health subjects. All of these are sold at anywhere from ten cents to twenty-five cents per copy. Many are aimed at school-aged children and are on subjects such as marijuana, smoking, exercise, care of the body, etc. We cannot always be assured of making a profit on pamphlets of this type, and we have a better opportunity to realize a net profit on publications which carry advertising, like the Association's journals.

We seek tax equality with commercial businesses which have more than one publication. A for-profit publication company may, for instance, market ten publications—if eight of these make a profit and two suffer a loss in any given year, consolidation of the financial experience of all is permitted to determine a net taxable income. We are simply seeking an amendment of one sentence to be added to the House language which will accomplish equality in taxation as shown by the attachment.

Sincerely,

ERNEST B. HOWARD, M.D.
Executive Vice President,
American Medical Association.

Section 121(c) of H.R. 13270, amending Section 513 of the Internal Revenue code by substituting the following new subsection. *Proposed addition underlined.*

(c) Advertising, Etc., Activities.—For purposes of this section, the term "trade or business" includes any activity which is carried on for the production of income from the sale of goods or the performance of services. For purposes of the preceding sentence, an activity does not lose identity as a trade or business merely because it is carried on within a larger aggregate of similar activities or within a larger complex of other endeavors which may, or may not, be related to the exempt purposes of the organization. *Provided, that the activities carried on by an organization in the sale of publications, and advertising in any of such publications may, at its option, be treated as a single unrelated trade or business.*

STATEMENT BY THE AMERICAN PSYCHIATRIC ASSOCIATION,[1] PRESENTED BY BARTHOLOMEW W. HOGAN, DEPUTY MEDICAL DIRECTOR, IN OPPOSITION TO PROPOSALS TO TAX INCOME FROM ADVERTISING IN PROFESSIONAL JOURNALS

Mr. Chairman and Members of the Committee: I am Dr. Bartholomew W. Hogan, Deputy Medical Director of the American Psychiatric Association, the oldest national medical society in the United States. On behalf of the Association I will testify in opposition to the U.S. Treasury Department's 1967 ruling which would tax what it calls the "unrelated" business income of tax exempted organizations such as ours.

The Treasury Department's ruling relates to the revenue our Association, and others like it, derive from advertising in its journals. We object to the ruling on the grounds that it is at variance with the intent of the Congress and therefore lacks legal validity; that the ruling is not in the national interest because it threatens to withdraw a measure of financial support essential for "exclusively educational and scientific organizations" to carry on their good works; that the advertising published in our journals is very much related to our purposes; that the ruling promises no significant gain in financial returns to the Treasury Department; and that the ruling, if allowed to stand, may subject the future functioning of associations such as ours to the value judgments of a federal agency which, in our view, is unqualified to make them. I will elaborate briefly on these points.

DOUBTS AND LEGALITY

Consultation with legal and financial experts leads us to the belief that the Department of the Treasury had no authority to issue the regulation in the first place. We fully share the sentiment already expressed by the American Medical Association, to wit: "In the Revenue Act of 1950, Congress intended to tax the income derived by certain types of exempt organizations from operating an ordinary business which is not substantially related to the purpose constituting the basis for their exemption. What Congress had in mind, as shown in the history behind Sections 511–514 of the Code, was to tax the income of such businesses as a macaroni or tire factory owned by an exempt organization. It is abundantly clear that the term 'unrelated trade or business' was intended to apply to a substantially unrelated business entity or commercial enterprise. The tax is imposed on income derived from 'any unrelated trade or business' and *NOT* on unrelated income from a trade or business as contemplated by the proposed regulation."

Thus, we believe that the regulation is, in effect, unlawful, since it presumes that any advertising in trade and professional journals is "unrelated" to the purposes of the organization and as if it were income from a purely independent business enterprise.

Formerly, the Department of the Treasury defined a "related trade or business" as "substantially related if the *principal purpose* of such trade or business is to further the purpose for which the organization is granted exemption." Fair enough. But the new regulation apparently does away with the "principal purpose" test and simply presumes that advertising income from professional journals equates with an unrelated independent business operation.

NOT IN THE NATIONAL INTEREST

We cannot speak for other nonprofit, educational, charitable, and such organizations beyond asking the questions: Wherein does the national interest lie in a federal intervention which would have the potential of jeopardizing their future income? Where are they to derive the resources to fund their good works? Is there a suggestion in the Treasury Department's regulation that the work of these private sectors in our economy is really not so important after all, and had perhaps better be done by public financing?

So far as our own Association is concerned, however, there is not a single enterprise in which it engages which does not have to do directly with one of the four stated objectives of our Constitution which are:

To further the study of the nature, treatment, and prevention of mental disorders and to promote mental health;

To promote the care of the mentally ill;

[1] Exempt from income tax under Section 501(c)(3), formerly Section 101(6), of the Internal Revenue Code as an organization "organized and operated exclusively for educational and scientific purposes."

To further the interests, the maintenance, and the advancement of standards of all hospitals for mental disorders, of outpatient services, and of all other agencies concerned with the medical, social, and legal aspects of these disorders:

To make available psychiatric knowledge to other branches of medicine, to other sciences, and to the public.

These objectives are reflected above all in our publications program, notably the *American Journal of Psychiatry*, the *Journal of Hospital and Community Psychiatry*, and *Psychiatric News*, which are the only three that derive income from advertising. These journals are the media through which we advance scientific knowledge and exert leadership in the field. Most of our staff and office facilities are assigned to their production. Without them the Association is a weak reed. They are the very backbone of our being. Advertising revenue makes them possible. And it may be pointed out in passing that we have many more specialized publications, without advertising, that in no wise pay for themselves and may properly be viewed as subsidized by those that do.

It must be manifest to any objective observer, that are no "profits" as such in an Association such as ours. There are no fortunes being made. No stock is issued. No dividends are paid. Most of the manpower energy that goes into our programs on the part of hundreds of leading scientists who serve on its boards, committees, and task forces, is altogether uncompensated. Only the staff is paid, and modestly at that.

In sum it makes no policy sense to question the relatively meager income of such an organization when one considers not only how and why the income is produced but also the purposes for which it is expended.

THE "RELATEDNESS" OF ADVERTISING

The American Psychiatric Association publishes three journals which derive substantial income from advertising. This advertising takes four forms: (1) advertisements of drugs used in everyday practice by psychiatrists and other physicians; (2) advertisements of professional and scientific meetings and of professional literature of interest to physicians; (3) advertisements of institutions such as private hospitals and specialized services to physicians; and (4) classified notices or notices of job vacancies in the field of psychiatry.

We submit that all of these forms of advertising are intimately related to our purposes. It is a matter of no small concern to us that psychiatrists and many other physicians depend so much on drug advertisements to learn about new developments and products in the field (and we are doing something about it). But the fact is that they do learn in this way about new drugs, indications, and contraindications for their use, and other information of practical value. We may, indeed, be thankful that we have such informative drug advertisements, regulated as they are by the Food and Drug Administration and so carefully articulated by the advertisers. What could be more related to our purposes than to disseminate such information to our members?

Surely, there can be no question about the relatedness of advertisements of the upcoming professional meetings of our own and many other professional societies in the field of which there are scores, all of whom wish to curry the interest of psychiatrists in attending their meetings. The scientific meeting is another one of the chief mechanisms by which professional and research information is disseminated in the field.

Nor could one interpret advertising by private mental hospitals, psychological testing services, hospital equipment firms, etc., as unrelated. This kind of advertising is manifestly in the nature of an "information service" to our members and the dissemination of information which will advance standards of treatment and care in the field is the quintessence or the *raison d'etre* of our very being.

By the same token, the publishing of notices of job vacancies is perhaps one of the most crucial services that we render to the myriad of psychiatric treatment facilities which stand in constant and desperate need of more personnel. All of this must be viewed in the context of the general manpower shortage that exists across the board.

In short, there is nothing in the income derived from these paid advertisements and announcements that is in any sense unrelated to the information disseminating function of the American Psychiatric Association. The same may be said of the income that derives from the exhibits at our annual meetings. We are not in the business of promoting the sale of detergents, or spaghetti, or fried chicken for profit. We are in the business of advancing the treatment and care of the mentally

ill and the promotion of mental health in America and of furnishing our people with all the information we can that will sharpen their tools to further this singular endeavor.

WHAT GAIN FOR THE U.S. TREASURY?

It is simple enough to fill out the Treasury Department's new Form (990-T) for reporting "unrelated business taxable income." But we venture that the early returns from associations such as ours are scarcely going to show any excess of "gross receipts" from "unrelated business" over "costs of operations." So far as our Association is concerned, I can assure this Committee that a trial run in filling out the form shows a slight excess of "costs of operations" over "gross receipts." The depletion of our resources in the coming fiscal year is not serious.

What concerns us is what the future holds if this precedent is allowed to stand. What value judgments in years to come will the Treasury Department bring to bear on our accounts? In what respects will they find our assessment of "costs of operation" improper? Who knows? All we know is what it takes to support our programs and publications, which we consider very much in the public interest. There is no reason, however, to think that Treasury Department personnel will always agree. They will make the rules, not us, and we don't think they are qualified to do so in this social context. We think, rather, that this is a decision for the Congress to make in the context of evaluating the social usefulness of "exclusively educational and scientific" organizations such as the American Psychiatric Association.

IN CONCLUSION

It is impossible and improper, in our view, to separate out any of our relatively modest income—from members' dues, from sale of publications, from advertising in our journals, and from public and private grants—as "unrelated." It all goes into the same pot to support the educational purposes we have espoused for 125 years.

With the Chairman's permission I would like to conclude this testimony with a short pamphlet on the history, purposes, and programs of the American Psychiatric Association which was written for the edification of new members.[2] I should be surprised if one could read this pamphlet and honestly conclude that it would be in the national interest to jeopardize our Association's effectiveness in any way by threatening taxation of any part of its modest income.

We very much hope that this distinguished Committee will see eye to eye with us and reverse the regulation of the Treasury Department by legislative action.

KITCHEN EQUIPMENT FABRICATING CO.,
Houston, Tex., October 3, 1969.

Hon. RUSSELL B. LONG,
Chairman, Senate Finance Committee,
Washington, D.C.

DEAR SENATOR LONG: The most glaring loophole in the federal income tax law is the exemption given to the income of labor unions. Nothing was done to close this hole in H.R. 13270, the House passed tax reform bill which is now being considered by the Senate Finance Committee.

Labor unions have been the most vociferous of all organizations in demanding tax reform and the closing of tax loopholes. The reforms unions demand are aimed at further increasing the heavy tax burden borne by American business, and the so-called loopholes on which unions have concentrated their attacks are those applying to business, such as the investment tax credit, real estate depreciation write-offs, and the oil depletion allowance. Such tax provisions were placed in the law to stimulate investment by private enterprise so as to strengthen the national economy and provide more jobs and more goods and services for the American people.

Unions, through dues extracted from working men and women—frequently against their will, have amassed billions of dollars which they have invested in all types of income producing property and enterprises—income that is tax exempt under present law.

There is no justification for tax exemption of union investment income. H.R. 13270 would make the investment income of churches and foundations and

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[2] The pamphlet referred to was made a part of the official files of the committee.

other exempt groups subject to taxation for the first time. *WHY CHURCHES, BUT NOT UNIONS?*

The use by unions of their tax exempt income from both dues and investments for direct contributions to favored political candidates and to maintain elaborate and expensive lobbying apparatus in Washington is *highly improper.*

Union officials and lobbyists have been completely silent on the inequitable tax advantages enjoyed by their organizations, while leveling their criticism at the tax advantages for non-union businesses. The House Ways and Means Committee, unfortunately, let them get by with it.

I strongly urge the Senate Finance Committee to *amend H.R. 13270 to eliminate the tax exemption presently given to the investment income of labor unions and remove the tax exemption from unions* which make political contribution, attempt to influence legislation, or engage in forms of political activity.

Respectfully yours,

J. A. HOLSTIEN.

STATEMENT OF THE STATE COMMUNITIES AID ASSOCIATION, SUBMITTED BY A. VAN W. HANCOCK, PRESIDENT

My name is A. Van W. Hancock and I am President of the State Communities Aid Association of New York. The Association is a statewide voluntary organization founded in 1872, and aids communities in the development of health and welfare resources. Our service programs include community counseling, research, experimental projects and inter-agency coordination. We work closely and productively with voluntary and governmental agencies.

We have a governing Board of 30 community-minded lay citizens from all parts of New York State, all of them recognized as leaders in the fields of finance, law, business, and in the case of the women, social welfare activities. We have a membership of some 300 persons and a highly qualified full-time staff.

Our Association is vitally concerned with those provisions of H.R. 13270 which categorize it as a private operating foundation. We are not a foundation, nor are we private. On the contrary, we are a public service organization with a long history of service to the people of New York State. We believe many other public service agencies, both local and national, also find themselves mistakenly labelled foundations under the tax reform bill.

We are confident the House of Representatives intended no such result. In distinguishing among 501(c)(3) agencies, the House bill draws a line based upon the nature of financing, without due regard for an organization's purpose and program. In seeking to curb questionable activities by some grant-making foundations, the House bill cast a wide net—and snared many organizations, including our Association, that were not intended to be affected.

On behalf of State Communities Aid Association I would like to suggest a simple way that we and similar organizations could continue to enjoy the rights and benefits of 501(c)(3) agencies dedicated to community betterment in such fields as health and welfare, without detracting in any way from the objectives of the bill.

First, however, I believe I should sketch briefly the justification for describing State Communities Aid Association as a public service organization. We were founded 97 years ago by a number of distinguished and public-spirited citizens who were dismayed at the squalid conditions in hospitals and almshouses.

In our early days, a time when nurses were recruited from outcasts and derelicts, our Association set up the nation's first training school for nurses, at Bellevue Hospital in 1873.

When the mentally ill were banished to attics and almshouses, the Association in 1890 worked closely with state officials to create the state mental hospital system.

At a time when homeless children roamed the streets, our Association in 1898 formed a committee to place them in private homes through foster care or adoption. Eventually, adoptions for more than 8,000 children were arranged.

In 1906 another committee was formed on after-care of the mentally ill, and this eventually became the New York State Association for Mental Health.

In 1907 our Association created a committee to combat TB, then the leading cause of death. This evolved into the New York State Tuberculosis and Respiratory Disease Association.

More recently, in 1949, the TB Association and the SCAA joined in organizing the New York State Heart Assembly.

In recent years our Association has had great interest in home care and homemaker services, and in 1966 helped organize the New York State Council for Homemaker-Home Health Aide Services. We provide staffing and office space for the Council.

For 75 years we have maintained county committees in rural areas to foster services for indigent children. We are linked with planning councils in urban areas by giving secretariat services to the New York State Association of Councils and Chests.

Currently we are offering consultation to communities that are interested in developing coordinated health services, especially in home care. Recently we sponsored social research on community organization and the consultative process. We are developing procedures to evaluate community programs for the aging. We give graduate social work students field training. We conducted a 31-month social research program on casework with multi-problem families. We are supporting public agency efforts on Comprehensive Health Planning. And we have many other program interests in various stages of development.

In addition, Board members and staff serve on at least nine advisory commissions to state agencies or the state legislature, thus serving as a resource to government. Also, Board members and staff are actively involved in a score or more voluntary groups—including the American Public Welfare Association, American Public Health Association, National Conference on Social Welfare, Family Service Association of America and the United Community Funds and Councils of America.

This, I submit, is not the kind of activity that characterizes foundations.

It is true we derive a large proportion of our operating income from dividends and interest. But this is the yield of principal funds built up over many years by numerous contributors, most of whom had been active as volunteers within the Association. It is *not* an investment fund provided by a single individual, a family, or a commercial corporation.

In fact, our Association has always considered it a valuable asset that by prudent management we could finance most of our service programs in this fashion, rather than divert the time and talents of staff from program to annual fund-raising campaigns, or frequent appeals for governmental grants.

In addition to our investment income, we receive annual contributions from a number of donors, and we frequently receive project grants from foundations and government agencies.

As I mentioned earlier, we have a suggestion that would correct the inadvertent designation of our Association and other organizations as private operating foundations—and do so quite simply.

We urge you to consider adding a fifth subsection to Section 509(a) of the bill approved by the House of Representatives. This would add a new category, public service organizations, to the several types of organizations already excluded in the bill—churches, schools, hospitals and public charities, among others.

We suggest it be recognized that public service organizations are formed by concerned individuals to meet specific public needs—and these individuals then seek the funds required to do the job—whereas a foundation comes into being with the establishment of a fund, usually made available by a single individual, family or corporation. I do not suggest that foundations are not in fact valuable instruments for the common good—quite the contrary. I do suggest they have a different genesis and different method of operation.

Contributors to public service organizations like mine do not exercise control of operations or influence the election of officers, directors or members. In the case of unrestricted contributions, the governing board of the organization has the choice of using contributions to finance current activities, or investing the money to provide continued income.

The investment of contributions can yield a steady, generally reliable income in dividends and/or interest, enabling the organization to maintain a capable staff, an uninterrupted program, consistency of service and stability of operation. By continuing to invest contributions and bequests over the years, an organization may accumulate a relatively large principal fund, producing as much as 50 to 60 percent of its total support in dividend and interest income—but it is an important distinction that the funds were given by a variety of contributors, and not by donor-creators.

We do not presume to propose statutory language, but we suggest several criteria to define a public service organization.

First, it must have been formed to engage in public service, as distinguished from making gifts to other organizations.

Second, it raises funds from a variety of contributors, who do not exercise control over the organization's program, use of funds, election of members, or election of the governing board. In some instances, of course, the contributor may restrict his gift to some specific phase of the organization's work.

Third, it is governed by a Board whose members serve without compensation, and has a general membership significantly larger than the governing Board.

In short, we believe that such public service organizations should not suffer inappropriate restrictions based solely on a financing formula, and that consideration should be given their origin, purpose, organization, manner of operation, and contribution to the public good.

Should the Committee so desire, we at State Communities Aid Association would of course be happy to cooperate with Committee staff to facilitate the addition of an appropriate exclusion clause to Section 509(a) of H.R. 13270.

We thank you for this opportunity to testify, and would be glad to answer any questions.

UPPER DARBY, PA., *September 29, 1969.*

Hon. RUSSELL LONG,
Chairman, Senate Finance Committee,
New Senate Office Building, Washington, D.C.

DEAR SENATOR LONG: I am writing to you and other members of the Senate Financial Committee about the "tax reform" bill approved in August by the U.S. House of Representatives, H.R. 13270.

Can House members face the American people with clear consciences after voting to (1) tax churches and foundations and (2) exempt from taxation the income earned by millions of dollars invested by labor union officials in various businesses?

I am a dues-paying member of Local No. 307, Moving Picture Operators Union, affiliated with the International Alliance of Theatrical Stage Employees and Moving Picture Machine Operators (IATSE). I won reinstatement in my union after being expelled by vindictive officials who tried to prevent me from speaking out against the evils of compulsory unionism. I also blocked an attempt by those officials to increase wage assessments without Constitutional authority and requirement under Federal Law.

Much of my dues money is used for purposes other than what would be classified as proper collective bargaining. I vehemently deplore my union's practice of digging into the dues money for political purposes and spending the money to support and finance political campaigns for candidates I am opposed to.

Last week you were urged by AFL-CIO President George Meany to "improve and strengthen" the "tax reform" bill. Did he say anything about the tax loopholes enjoyed by labor unions? He's probably in favor of closing all loopholes except his own.

Organized labor claims to be a watchdog against social ills. If it is, union officials will want to make sure they are not in the privileged class—especially when previously exempt institutions stand to be taxed under the legislation your Committee is now considering.

Certainly Congress has an obligation to see that unions neither misuse their members' funds nor enjoy "special benefits" from the use of those funds at the expense of all taxpayers. I urge you to tax the unrelated business income of unions and revoke the tax exemptions of unions that spend compulsory dues for partisan political activities.

Respectfully yours,

VELIO IACOBUCCI.

STATEMENT OF THOMAS M. JENKINS, ATTORNEY, SAN FRANCISCO, CALIF.

I am Thomas M. Jenkins, attorney, No. One Kearney Street, San Francisco, California. My appearance today is as a legal representative of the California Association of Homes for the Aging, Sacramento, California, and as immediate past president of the American Association of Homes for the Aging, 315 Park Avenue South, New York, N.Y.

The members of these two organizations and their counter-parts give care t over one-half million elderly persons in the United States. They are particularly concerned with those portions of H.R. 13270 which can have a major effect on the care of the aged. Much has been said to you about specific provisions of the

Tax Reform Act. I will limit my testimony to one area—the effect on housing and care for the aging in the United States.

I start with the fundamental premise that taxation is not an *end* unto itself but is only a *means* by which income is realized to meet needed services. One very badly needed service, ever increasing, is additional facilities and care for our older population.

This committee is acutely aware of the growth in number of those over 65, as well as the extraordinary increase in costs of their care, particularly in the medical field. Over 80% of the long term care facilities built in the United States in the past 20 years are under the auspices of non-profit organizations, mostly church oriented. In the San Francisco Bay Area alone, over 70 million dollars has been put into the field of the aging by such non-profit groups in the past ten years. This amount is multiplied many times over when the entire country is considered. And this major contribution of hundreds of millions of dollars is by the private sector—that is, *not* tax monies.

By the proposed act, this source of funds, this participation by the voluntary segment of our society, is, as many previous speakers have stated, greatly endangered. It is an extraordinarily serious threat to voluntarism as a part of the American way of life. Specifically, it is my opiinon that it will drastically alter and curtail existing facilities and is a death knell to any new ones.

Without detail or reiteration our concerns lie with:

(*a*) The definition of private foundations;

(*b*) Taxation of income of non-profit organizations;

(*c*) Placing charitable contributions in the "allocation of contributions" category;

(*d*) Limitation on gifts of appreciated property; and

(*e*) Restrictions on "political" activity—other than party or candidate action.

Let me be specific on the matter of definition of private foundations. I am personally aware of a number of homes for the aging, who, through contributions over a period of many years, have acquired endowments which produce income. As a result they are able with that income to give service to many residents without financial means, who are not qualified for major aid programs and have no place else to go. The new definition would put these homes in the "private foundation" classification, impose a tax on income, and require distribution of both current income and a proportion of invested assets. The net result and only course of action for such Home would be to reduce the number of economically deprived persons they serve and take in others with some financial resources. This, we submit, is contrary both to the objectives of our Homes, to the voluntary system, and indeed to the entire rationale of tax reform.

There is another major problem in this area of "private foundation" definition. Certain local jurisdictions, including the State of California, have by statute required a 501(c)(3) exemption as a prerequisite to exemption from local property taxes. Under the proposed definitions, many homes for the aging would lose their exemption and thus also lose their local property tax exemption. This would again have only one result—an increase in the per capita cost of care (conservatively estimated at $30 per person per month) and a drastic reduction in the economically deprived residents who could be served.

We are firmly convinced that this is not the result that Congress intends. There are many studies, and this Senate has conducted many hearings, which clearly establish that homes for the aging are a much needed community service. They should be encouraged, not emasculated. We, therefore, strongly urge that, as has been done for hospitals, the definition of "private foundation" be changed and that Homes specifically be classified as exempt organizations.

I shall not repeat the cogent arguments already made many times over on the problem of allocation of charitable deductions and limitations on appreciated gifts. In the form proposed by this bill, the net cost to the American taxpayer of service to the aging will be many times the potential saved by this "reform". For it is quite clear that homes for the aging will lose a major proportion of the gifts which they now received. Those sums can only be made up by additional aid programs which must of necessity come from tax funds. Again, we are sure that this is not the intent of the Congress and urge reconsideration.

We feel strongly that the American Association of Homes for the Aging has been of invaluable assistance to Federal agencies in the preparation of standards

and guidelines in the housing and medicare fields. The knowledge of thousands of well qualified workers in the field of the aging, worth many millions of dollars, has been given willingly and freely to agencies, personnel and legislative committees. In California, representatives of the California Association of Homes for the Aging are called on with increasing frequency by members of the legislature, their staff assistants, by the Director of Social Welfare, and many others. Reliance is placed in the background and experience of highly motivated members of the non-profit associations. This would be lost, or very seriously restricted, by the present bill, and we urge deletion of the language or major re-writing to accomplish the valid purpose of prohibition of partisan activity.

To summarize:

(1) Homes for the Aging should be classed as needed community service organizations and, like hospitals, be specifically *not* included in the term "private foundations".

(2) Restrictions on gifts of appreciated property to qualified non-profit tax exempt organizations should be eliminated.

(3) Any "income tax" on qualified non-profit organizations should be rigorously opposed.

(4) The language on "political activity" should be amended in a major manner, to save the invaluable knowledge and assistance which is given to government by representatives of non-profit agencies and associations.

We commend your serious consideration and again offer our assistance.

SPRINGFIELD, VA., *September 29, 1969.*

Hon. RUSSELL B. LONG,
Chairman, U.S. Senate Finance Committee,
New Senate Office Building, Washington, D.C.

DEAR SENATOR LONG: The tax reform bill now being considered by your Committee was written to discourage managers of private foundations from spending foundation money for political purposes. Unfortunately, there is nothing in the bill to discourage union officials from spending union money for political purposes. I sincerely hope the Senate will correct this oversight.

I am employed as a locomotive engineer by the Richmond, Fredericksburg and Potomac Railroad Company. In 1941 I voluntarily joined the union representing my craft on the R. F. & P. After twenty-eight years I am still a dues-paying member of the Brotherhood of Locomotive Engineers, which is a tax-exempt organization.

I think everyone has a constitutional right to support a labor union, a church, a veterans organization, or any other private association. I also think the laws of our country should uphold everyone's right to withhold his support from private organizations, including labor unions.

Although Virginia has a Right-To-Work Law forbidding compulsory unionism, it does not apply to railroad employees. We are covered by the National Railway Labor Act. It originally prohibited the compulsory "union shop," but Congress amended the Act in 1951 to permit the compulsory unionization of employees governed by this law.

Consequently, I will be penalized by the loss of my job if I stop paying dues to the Brotherhood of Locomotive Engineers. Otherwise, I would not hesitate to withdraw from the brotherhood because I am not in sympathy with its political aims. Some of the money I am paying in the form of dues is being used by officials of my union to support political candidates I will not vote for.

My political freedom is being violated by a private organization which enjoys special tax privileges. It is not required to pay taxes on either its dues income or the income it receives from business investments. And the officials of this union are brazenly spending some of this income for partisan political purposes. I urge the Senate Finance Committee to amend H.R. 13270 for the purpose of revoking the tax exemptions of labor unions engaging in partisan political activities. Thank you for your consideration of this request.

Respectfully,

GRAYSON JOHNSON.

ARENT, FOX, KINTNER, PLOTKIN & KAHN,
Washington, D.C., September 25, 1969.

Re Ambiguities in Section 121(b)(1) of H.R. 13270, relating to fraternal beneficiary societies.

Hon. RUSSELL B. LONG,
Chairman, Committee on Finance,
United States Senate, Washington, D.C.

DEAR SENATOR LONG: I represent the B'nai B'rith, a fraternal beneficiary society. There are several ambiguities in the provisions of H.R. 13270 which extend the unrelated business income tax to fraternal beneficiary societies (section 121(b)(1) of the Bill, adding section 512(a)(3(B) to the Code). I have previously brought this matter to the attention of the staff of the Joint Committee on Internal Revenue Taxation and to the attention of Mr. Ingolia of the staff of your Committee. I believe it highly desirable that this matter be clarified by the Committee on Finance.

The proposed section 512(a)(3)(B) of the Code, defining "exempt function income", could be interpreted as excluding from the tax only amounts paid *directly* by members to the society. Furthermore, the exemption could be interpreted as being inapplicable to payments for insurance policies insuring the life and health of the *dependents* of members of the society.

It is my understanding that the tax is not to apply to a fraternal beneficiary society where (a) gross income is derived *directly* or *indirectly* from members in connection with activities related to its exempt function, or (b) gross income is derived from members (directly or indirectly) as consideration for providing insurance for the *dependents* of members.

INDIRECT PAYMENTS

Instead of carrying insurance themselves and thereby causing the risks to be shared among all members, in recent years fraternal beneficiary societies have arranged for insurance companies to issue group policies for the protection of the life and health of the members and their dependents. This not only provides a more efficient administration of the insurance for the benefit of the members, but also permits the insurance to be carried on an optional basis; in this way the risks and benefits accrue only to the members who participate, and there is no risk to the members who do not participate in the particular insurance program.

In such a case, the members may pay the premiums directly to the insurance company, and the insurance company then may pay part of the money to the fraternal beneficiary society for its services in establishing the program, for its administrative costs, and for retrospective adjustments in rate reflecting good experience under the program. In substance, these are *indirect* payments to the fraternal beneficiary society from its members for an activity related to its exempt (beneficial) function.

Similarly, the society may arrange for a travel tour for its members through an independent travel agency, where the fellowship and education provided will promote the fraternal purposes of the society. In such case, the members may pay the travel agency which in turn may make some payments for its services to the society; these payments to the society by the travel agency are *indirect* payments by the members for an activity related to its exempt (fraternal) function.

It is my understanding that the Bill intends to continue to exempt from tax these indirect payments by members.

My understanding of the intent with respect to the foregoing example is supported by the following parts in the House Committee Report which states (at p. 47) that—

> "the bill continues to exclude from 'unrelated business income' earnings from businesses *related* to an organization's exempt function—such as an insurance business run by a fraternal beneficial association for its members",

and that the Bill would tax—

> "these other membership organizations on all income *other than that derived* from rendering services to the members." (Emphasis added.)

However, in order to avoid unnecessary controversy on this, it is requested that the Committee make the clarification described below.

MEMBERS' DEPENDENTS

One other matter needs clarification.

Historically, fraternal beneficiary societies have provided insurance for the protection of their members and the dependents of members. Indeed, this is one of the basic reasons for the formation of such societies, and section 501(c)(8) of the Code specifically provides that a condition of the tax exemption of a society is the providing for the payment of life, sick, accident, or other benefits to the members *or their dependents*. Accordingly, it seems obvious that income from insurance (as well as other activities which are related to the exemption) provided for dependents of members would be included in the definition of exempt function income.

However, section 512(a)(3)(B) would exempt from the tax income paid to the society as consideration for providing "members of their guests" goods, facilities or services in furtherance of the exemption of the organization. An overly technical interpretation of this provision could result in a holding that a dependent of a member is neither a "member" not a "guest" of a member in the context of the exemption of income from insurance programs provided by the society, even though income from insurance provided for members is clearly exempt from the tax. This obviously is not the intention of the Bill.

In view of the foregoing ambiguities on this matter, I would very much appreciate any clarification which can be given by the Committee on Finance. I respectfully suggest that this could be done if the report of the Committee on Finance explaining the foregoing provisions contained a statement of the type attached to this letter.

Since I have previously discussed this matter with the staff of your Committee and of the Joint Committee on Internal Revenue Taxation, I am taking the liberty of sending them copies of this letter.

Respectfully submitted,

EDWIN L. KAHN.

ATTACHMENT

PROPOSED EXPLANATION FOR INCLUSION IN REPORT OF COMMITTEE ON FINANCE

(Note: The following explanation is a revision of a sentence which begins on line 24 of page 47 of the Report of the Ways and Means Committee (Part 1).)

> "*Explanation of provision.*—In extending the unrelated business income tax to virtually all exempt organizations (only governmental instrumentalities, except colleges and universities, would remain outside its scope) the bill continues to exclude from 'unrelated business income' earnings from businesses related to an organization's exempt function—such as the earnings received directly or indirectly from its members by a fraternal beneficiary society in providing fraternal activities or insurance benefits for its members on their dependents. For example, if the fraternal beneficiary society directly provides insurance for its members and their dependents, or arranges with an insurance company to make group insurance available to them, the amounts received by the society from its members for providing, or from the insurance company for arranging, for this exempt function will continue to be excluded from the unrelated business income tax."

STATEMENT OF GEORGE W. KEITEL, JR., DIRECTOR OF BUDGET, UNITED CHURCH BOARD FOR WORLD MINISTRIES

Gentlemen, I am George W. Keitel, Jr., Director of Budget for the United Church Board for World Ministries on the 16th Floor at 475 Riverside Drive, New York, N.Y.

The United Church Board for World Ministries is the oldest Missionary Board in the United States, with a charter in 1810 as a non-profit charitable corporation, domiciled in Massachusetts with offices at 14 Beacon Street, New York at 475 Riverside Drive, and St. Louis at 1720 Choteau Avenue. The United Church Board for World Ministries has 404 missionary personnel serving in 32 countries, with financial support to educational, medical, national leadership training, refugee and rehabilitation and communications programs in a total of 70 countries.

The United Church Board for World Ministries is the overseas instrumentality of the United Church of Christ, which has 2 million members representing 2000 churches in the United States. The 158th Annual Report,* the Treasurer's report for the year 1968,* and the Calendar of Prayer and Directory for 1968–1969* of the United Church Board for World Ministries are enclosed for your reading. These documents outline the programs of the Board, the overseas personnel and their work, and the audited financial statements reflecting the assets, the liabilities, the equities, and investments of the United Church Board for World Ministries.

The United Church Board for World Ministries very life depends on the continuation at present levels of the charitable contributions. The unrestricted investment balances are equal to only one year's operation. For the year 1970, after stringent budget cuts, we are still faced with a deficit of $1,507,000, which must be paid from unrestricted investment fund balances, *assuming that the charitable contributions continue at present levels.*

We realize that many who contribute to the United Church Board for World Ministries may take advantage of a tax exemption for that contribution. However, the United Church Board for World Ministries attests that the inherent and constitutional right of every American citizen to give without restriction to the charity of his choice is fundamental to freedom.

The first missionaries to Asia were sent by the United Church Board for World Ministries. The first missionaries to the Sandwich Islands 150 years ago created the vital educational, medical, and religious freedoms which helped bring the 50th state into our nation. The educating of national leaders in Africa today continues to create the freedoms envisioned by our founding fathers. These outstanding examples of "return on investment" of a few dollars donated to extend religious liberty and freedom must be preserved. The efforts of the United Church Board for World Ministries are in the highest tradition of ministering to the needs of mankind.

In light of our background and the obligation to continue present programs and to be involved in new ventures of mission on six continents, the United Church Board for World Ministries calls upon the Committee on Finance to adopt the following proposed reforms.

PROPOSED REFORMS

We recognize that a revision of the federal tax structure involves many technical questions. We recognize the need for a more equitable levying of taxes and for simplification of recording and collection procedures. But we are certain that some of the proposals currently before Congress would inhibit private giving and seriously affect the organizations which rely upon many small contributions and in turn affect the millions of people who now benefit from them. We see certain guidelines as basic in any meaningful reform.

1. All personal income, whatever its source, should be subject to a graduated rate of taxation which is progressively heavier as the total amount increases. The actual payment of tax dollars due must flow for deposit into the government treasuries on a current basis. Any exceptions must be fully *justified by a vital social or economic purpose*, and must be scrutinized particularly as to their effect upon the less affluent members of society.

2. In the interest of greater equity and sufficiency, the following steps should be taken to correct existing preferences and inconsistencies:

(*a*) There is a constitutional question whether the federal government can tax income from state bonds. State bonds are not a part of the federal base (unless new state laws say that the income from state bonds can be taxed by the federal government.) *However, assuming no constitutional question*, bonds presently tax-exempt, hereafter issued by state and local governments, should be taxed like income from other investments. Existing and proposed federal grants to state and local governments would more than make up for any difficulty they may encounter in borrowing, and would capture important revenue for public purposes from individuals in the upper income brackets. The recent proposal by the Treasury to issue taxable U.S. securities, and then make federal low-interest loans to state and local governments, would provide an alternate solution. The present tax exemption costs the Treasury more than $2-billion in tax loopholes, yet saves states and local governments little more than $1-billion in lower interest payments.

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*The items listed were made a part of the official files of the committee.

(*b*) Provision should be made for averaging capital gains to prevent unduly high rates being applied to unusually large gains realized in a single year. Capital gains shoud be taxed at present rates.

Internal financing and decentralization of diversified corporations fosters the development of vast corporate conglomerates and the submerging of the smaller firms deprived them of access to capital funds and separate existence in the business community.

(*c*) Provisions for averaging income for tax purposes should be extended to taxpayers not presently enjoying this advantage. Persons who receive the bulk of their income in a relatively short period of their working life tend to pay higher income taxes over their lifetimes than those who receive their income more evenly throughout their productive years. In 1964, Congress took a step forward to eliminate this inequity by providing for some averaging of income over a five year span. The averaging provisions are very complex and of limited application. They do not now apply to capital gains.

The law should be changed to provide for averaging over a more substantial period of an adult's life. Most of the restrictions and limitations on the avalability of the averaging provisions should be eliminated. The adoption of a fair, generally applicable averaging provision including capital gains income should be subject to averaging along with a taxpayer's other income. If this occurs, a taxpayer will not be penalized because he realizes in one year income which accrued through risk-taking over many years. Moreover, by greatly reducing tax differentials resulting when income is made reportable in one year rather than another, many complications of the present law that relate chiefly to such distinctions could be eliminated.

(*d*) The preferential treatment extended to taxpayers who invest in oil, gas, and mineral properties should be ended. Investors are allowed to deduct immediately much of this outlay as a "development expense," and then in addition they are permitted to deduct a substantial percentage (20.0 percent in the case of oil and gas) of the gross income in computing their tax base, notwithstanding the fact that their total deduction may, and usually does, far exceed their actual investment. Depletion deductions, like depreciation deductions available to taxpayers in other fields, should be limited to the amount of the taxpayer's own actual investment in the oil or mineral property that has not already been recovered tax-free.

(*e*) Foundations, church and educational institutions, which legally and legitimately fulfill the purpose for which they were established are exceedingly important in meeting social needs of people. Such organizattons should continue to be recognized as tax exempt charitable organizatitons and required to file annual business statements with the local, state, and federal governments and pay tax on unrelated business income. If a charity owns a manufacturing plant, that operation should be fully taxable.

(*f*) We support the proposal to increase the standard deduction and remove the charitable deduction from that area. Charitable giving can very well stand on its own merits.

(*g*) We support the proposal to increase the limit on deductibility of individual contributors to 50%. If it is fair to assume that a great number of those who give 30% or more do so for the tax deduction benefit, it is also fair to assume that their giving will increase under more liberal provisions.

(*h*) We are distressed over the proposal to eliminate the provisions for unlimited contributions. The small number of taxpayers eligible for such deductions are generally the "pacesetting" givers, often essential for financing needed programs.

(*i*) The provision that permits the profits on appreciated property to be realized tax free at the owner's death should be continued.[2] Such property is taxable at the high rates under federal estate and state inheritance tax laws at actual value as of the date of death.

(*j*) Individuals who give a charitable institution property (including stocks) which has appreciated in value since its purchase should be able to secure tax deduction for a charitable contribution of the full appreciated value.

(*k*) Federal estate and gift taxes should be revised to permit a husband or wife to receive property from the spouse tax free; but the law should not

[2] A study of individual donors who made gifts of a million dollars or more in 1965 reveals that without the tax benefit they would have reduced their total giving by approximately 46%.

permit wealthy families to avoid estate taxes for generations by the use of long-term trust arrangements. Estate and gift taxes should be integrated so that individuals, who make sizeable lifetime grants and receive a tax advantage under present law, and those who do not transfer their property until death, will have equitable and reasonable treatment.

(*l*) We oppose any proposal to establish a 3% threshold or any threshold below which charitable gifts would not be deductible. According to the Internal Revenue Service report,[3] more than half of 27 million who itemized deductions gave 3% or less. By imposing a 3% threshold, the giving incentive for more than half of the taxpayers itemizing deductions could be drastically affected. This in turn would have serious impact on the ability of such organizations to continue their educational, medical, community services to meet human needs. It is in the interest of the United States that these efforts continue to nurture the lives of citizens. Through the efforts of many and varied agencies, the support of philanthropic works with private giving has increased. If that giving is decreased because of proposals advanced by the Treasury Department, the Government will undoubtedly be faced with the necessity for providing greater aid.

3. The income tax should be completely eliminated for those below the poverty line, and should not fall so heavily upon those immediately above the poverty line that they are thereby brought below it. Millions of citizens living below the subsistence level already pay unduly large portions of their income in income, sales, Social Security, and other taxes.

It would seem reasonable to eliminate the 7% investment credit for corporations.

4. Tax dollars should be made available to furnish food and basic clothing and shelter for those living below the poverty line.

5. Any future increases needed to augment our Social Security trust funds for higher benefits to persons below or near the poverty level, *should come from general revenues*, principally the graduated income tax, rather than from increased taxes on the low-income worker's take-home pay.

The poor of our nation must not have real income minimized through taxation. They and the poor of the world will never gain wealth on the distribution of tax dollars as will others. Likewise, sharing wealth becomes a greater burden as wealth is increased. The principle of the graduated income tax as the source of funds for all federal programs and tax sharing plans must be preserved.

If national priorities ranging from military defense to health and welfare for all mankind are determined first within long range goals and purposes, then the extent and sources of taxation can be determined. To continue a short range pattern to meet the crises of government first, then to seek taxation to fund programs will destroy the role of taxation in the lives of all American citizens and alienate the various special interest groups, all seeking relief.

We wish to express our appreciation for the opportunity to present this written statement on proposed tax reform.

LAW OFFICES OF ROBERT E. KLINE, JR.,
Washington, D.C., October 3, 1969.

Re H.R. 13270—Section 121(c).

Hon. RUSSELL B. LONG,
Chairman, Senate Finance Committee,
U.S. Senate, Washington, D.C.

DEAR MR. CHAIRMAN: The Bowling Proprietors Association of America, of which I am Washington Counsel, whose membership consists of some 3,125 bowling establishments operating 61,150 lanes, supports and joins in the testimony of Mr. Walker Winter, Vice President of the Chamber of Commerce of the United States, and of Mr. S. Rayburn Watkins, President of the American Society of Association Executives, before your committee on Friday, October 3, 1969 in opposition to the proposed taxation of income derived from advertising in the trade publication of an exempt organization such as ours, on the ground that it should not properly be considered income derived from an unrelated business.

Respectfully,

BOWLING PROPRIETORS ASSOCIATION OF AMERICA,
ROBERT E. KLINE, Jr., *Washington Counsel.*

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[3] "Statistics of Income, 1966, Individual Income Tax Returns."

AMERICAN DENTAL ASSOCIATION,
Washington, D.C., October 2, 1969.

Hon. RUSSELL B. LONG,
Chairman, Committee on Finance,
U.S. Senate, Washington, D.C.

DEAR SENATOR LONG: On behalf of the 111,183 members of the American Dental Association, I wish to submit the following brief comments on certain provisions of H.R. 13270 as passed by the House of Representatives.

Advertising Income of Professional and Scientific Organizations: The Association is a federation of 54 constituent (state) and 467 component (local) societies. About one-half of these societies sponsor professional and scientific publications and most of these include advertisements. The Association itself sponsors three journals that accept advertisements, the *Journal of the American Dental Association*, the *Journal of Oral Surgery* and *Dental Abstracts.*

Section 121 of H.R. 13270 includes a provision under the title "Advertising, Etc., Activities" which, according to the explanation in the House Report (Part I, page 50), apparently is intended to provide statutory authority for part of a regulation promulgated by the Treasury Department on December 12, 1967.

By that regulation the Department sought for the first time to apply the unrelated business income tax law, which was enacted 17 years previously, to income from advertising in any journal published by a tax-exempt organization regardless of (1) whether such journal is in competition with private publications or (2) whether the advertising contained in such journal is, in fact, related directly to the organization's tax-exempt purposes.

The Association is concerned that this departure from long-standing policy will impose an unnecessary hardship on many professional journals and will discourage the dissemination of information of great importance to the health-science community and in turn to the public.

The underlying purpose of the unrelated business income tax law was to assure that tax-exempt organizations do not have an unfair competitive advantage over tax-paying businesses. The Association agrees with this premise, but does not believe it can be shown that there is in fact any effective competition between its publications and the publications of non-exempt organizations. The advertisements in the Association's journals are limited to products and services that are essential to the proper and efficient practice of dentistry. They are of interest exclusively to members of the dental profession, and would not under any conceivable circumstances be placed in magazines or other media for general circulation to the public. The Association's journals themselves are circulated only to its members and to libraries and other educational and scientific institutions. The advertisements in them are carefully screened both with respect to their relevance to dental health and to the quality of the products they represent. No therapeutic agent or device may be advertised unless its safety and effectiveness meets standards set by the two responsible councils of the Association and its approval is listed in *Accepted Dental Therapeutics* or certified in *Guide to Dental Materials and Devices*. Moreover, the advertising copy must conform to the description of its usefulness as set forth in those two books, which are recognized by government, by manufacturers and by the health-science community as the most authoritative publications in their field of specialization.

There are only three or four commercial dental publications in existence. These are magazines that for the most part are not sold by subscription but are mailed to all dentists on an unsolicited basis. Their advertising includes some products advertised in professional association journals. But a large portion of it concerns investment opportunities and business management services, advertising of a type that seldom is featured in professionally sponsored publications.

In 1968, three of these commercial magazines accepted 2,804 pages of advertising as compared to 1,329 in the *Journal of the American Dental Association*. Five hundred eighty-six pages of the advertising contained in the former magazines would not meet the standards for publication in the *Journal of the American Dental Association*. This statistic demonstrates not only that there is no real competition between publications of the Association and those of commercial publications but that the advertising program of the Association is an important service to a practicing dentist. He is assured that each product advertised in the Association's publications is not only safe and effective but that its usefulness in his dental practice is represented with scientific accuracy.

It seems obvious that this educational service to the dentist, and in turn, to his patients, is directly related to the purposes for which the Association was granted its tax-exemption.

Accordingly, the Association strongly recommends and urges the Finance Committee to reject or amend the House-passed provision on advertising income to preserve the tax-exemption for activities of tax-exempt organizations when it is demonstrated that such activities are (1) not in real competition with activities of tax-paying organizations and (2) are directly related to the purposes of the tax-exempt organization.

In the event that the Committee determines to include in its bill a provision dealing with advertising income, it should be made clear, in the interest of fairness, that tax-exempt organizations are entitled to offset against advertising income all expenses allocable to the production and distribution of their publications. As it now stands, the "explanatory" language in the House Report (Part I, page 50) is ambiguous and might be construed in a way that would require a tax-exempt organization to exclude some legitimate expenses in calculating its income from advertising. Since commercial concerns are entitled to deduct their entire publishing costs, it would seem only fair to apply the same rule to tax-exempt organizations. A different course of action may well curtail the production and distribution of dental education and other materials that now are made available by the Association and its affiliated societies to schools and other public institutions at cost or on a no-charge basis.

The provision in H.R. 13270 also is ambiguous in another respect. While the apparent intent is to tax advertising income only, the inclusion of the abbreviation "etc." leaves this in doubt. If the Congressional intention is to tax advertising income, the statute should say so.

SMALL BUSINESS CORPORATIONS—SUBCHAPTER S

In recent years many states have enacted laws permitting professional persons to incorporate. A major purpose of these laws was to permit such persons to attain the same tax treatment as incorporated businesses. The Internal Revenue Service has engaged in extensive litigation in the federal courts seeking to deny to professional corporations the tax benefits available to other types of corporations. The IRS position has not been sustained by the courts and recently the Service announced its acquiescence in these decisions. The provision in H.R. 13270 (Section 541) dealing with Subchapter S corporations is therefore of concern to the Association since many of its members are in group practice arrangements that have been or may be incorporated under appropriate state laws.

The provision in H.R. 13270 would impose upon Subchapter S corporations a special limitation on the annual tax deductible amount that may be contributed toward retirement programs. A similar limitation does not exist nor is it proposed with respect to other types of corporations.

The House-passed provision would widen further the disparity that now exists in the tax treatment of retirement plans as between corporate employees and other taxpayers. The Association agrees with the recommendation of Secretary Kennedy to the Committee on September 15, that "the provision be deleted from the bill and be dealt with when other aspects of Subchapter S and compensation plans are dealt with in legislation."

It is respectfully requested that this letter be included in the printed record of the tax reform hearings.

Sincerely yours,

I. LAWRENCE KERR, D.D.S.,
Chairman, Council on Legislation.

LAWRENCE, KANS., *September 29, 1969.*

HON. RUSSELL B. LONG,
Chairman, Senate Finance Committee,
U.S. Senate, Washington, D.C.

DEAR SENATOR LONG AND MEMBERS OF THE COMMITTEE: Thank you gentlemen for giving me the opportunity to submit a statement on one facet of H.R. 13270. I have not digested the entire bill because of its complexity, but I have read Section 101(b), which pertains to taxation of private foundations. I want to make clear that I have no startling facts or figures, no scandal to tell. But I do have a story. And my story is one that is repeated all over our country and for this reason it is valid and it should be told.

My name is Mrs. Ursula (Sue) Lightfoot. I am employed by Hercules, Inc., at the Sunflower Army Ammunition Plant, DeSoto, Kansas, and I have been a

member of Production Workers Local 605, The Laborer's International Union of North America, for a year. I am married and have two children. I am the bread-winner in our family, as my husband is a full-time student at the University of Kansas.

In preparing this statement, I hope to show that labor unions have grown so large that their stockholders—the dues payers—have lost control. Often the member merely signs over his compulsory dues, in my case $6.00 a month. I know that $1.95 goes to the International and $4.05 goes to the local. That's all I know. I have tried to find out how this money is spent and in the process I have made myself appear a real pest. Over the year that I have belonged to Local 605 I've written letters, I've attended meetings, and I've tried to find out the workings of my union. It has been an uphill battle. I've never received a reply that fulfilled what I requested. But this testimony is in no way a vendetta against unions. I do want to show that I don't have access to the union without making for myself a lot of trouble and then appearing slightly foolish, when there is no justification for being foolish.

To me, compulsory unionism carries with it a responsibility to know that my money is being spent wisely. When I voluntarily donate money to an organization, I give it with my faith that it will be spent wisely. But when money is taken from me, I darned well want to know where every penny of it is spent. And that has been my position in this local, besides one of embarrassment for myself and for them.

We are temporary residents of Lawrence; our emotional and financial ties are in Richmond, Kansas, a small town some 50 miles away. We own property there and my husband has a small business there. September 16 I telephoned the Reverend Jerrald Harnden, pastor of the United Methodist Community Church at Richmond and asked him to supply me with the church's financial statement and a statement of all investment properties owned by the church. He courteously told me that this local church had few investments except shares in the local bank, but that he would send me what he had. I received the information September 19, even though Reverend Harnden was on vacation that week. I felt no embarrassment in seeking the church's financial statement and the church was more than willing to meet my request.

Where donations are voluntary, if the money giver disagrees with the bookkeeping, he simply doesn't contribute. In this way, the voluntary contributor has ultimate control over his organization. In contrast, as a compulsory union member, I control nothing. It is frustrating, to say the least.

There are numerous examples of labor unions, like the churches, enjoying tax exemptions on funds used for investment. But I have also read of unions using their funds for political purposes. What haunts me, as a union member and private citizen, is: How do I know where my dues money is going? How do I even find out? I can write letters, and the union has the choice of either ignoring me, telling me the truth, or lying to me. It takes a very wise person to tell which has been done.

This last year the plant (Sunflower Army Ammunition Plant), where I've worked three years, switched from an open shop to a union shop, under a loophole in Kansas law. When I first found out that the Kansas right-to-work law did not apply on a federal enclave, I was stunned. A bill was proposed in our House of Representatives in Topeka which would have helped the situation at my plant. I worked hard for the passage of that bill. I wrote my legislators, visited my state capitol, helped write and edit a news sheet—in short, did everything I could, including sell vanilla, to help do away with compulsory dues-taking in Kansas. The bill passed the House and Senate, but was vetoed by the governor; the House failed to override the veto by eight votes.

And this is where I begin to be haunted again. I am wondering if some of my dues money or that of my bretheren in the great brotherhood was used for political purposes. I have no way of knowing. And I can multiply my own for frustration and my own sense of unfairness over the situation over and over, for I am only one caught union member, and there are thousands.

In summary, I want to make the following two things clear. They are: 1) I want every thin dime that is investment income for unions to be taxed. It's unfair to speak of taxing church investments where the money is obtained voluntarily and not, in the same breath, speak of taxing labor unions, where the money is squeezed out. 2) I want to see some concrete benefit from my dues money. The protection money I so grudgingly write away each month is gone,

but I want some of that money to come back to me in the form of federal highways, school benefits, etc. It shouldn't all be a dead loss.

I sincerely thank you, Senator Long, and all the Committee Members for the consideration given me on this statement.

Respectfully,

MRS. URSULA A. LIGHTFOOT.

NATIONAL INTERFRATERNITY CONFERENCE, INC.,
New York, N.Y., October 8, 1969.

Whatever might be said about the objectives for which national college fraternities were originally founded, today their activities are overwhelmingly directed toward educational, charitable and public welfare objectives. Although admittedly they do have a social function, they are not at all comparable with such social organizations as golf clubs, luncheon clubs or other social organizations organized and operated primarily for social or recreational purposes. College fraternities at the local level provide, at no cost to the educational institutions, housing and meal facilities for students and thereby relieve, to that extent, the educational institutions from a major capital commitment and on-going operating expense and burden. In this respect the fraternities clearly subsidize the educational institutions themselves. Additionally at the local level and strongly saported by the national organizations, they provide a focus of disciplinary and supervisory control over students which, it is submitted, is far more effective in the overall than can be provided by the universities for students living in university faciliteis or off campus, as is increasingly prevalent in the larger universities. Furthermore, they exercise strong pressure to raise scholastic achievements and assist by furnishing guidance and assistance and, as has been shown, are highly effective in raising the scholastic performance of their member students. College fraternities are increasingly engaged in organized efforts in student loans, scholarship awards, and other welfare and charitable undertakings. These are important and should be fostered for their own sake. Additionally, they are important for their role in inculcating our youth with the sense of responsibility which the more fortunate members of our society should have toward those less fortunate.

There is attached hereto a more extensive statement of facts with respect to the activities primarily and customarily performed by college fraternities which, it is submitted, shows that they are in fact an integral part of the system of higher education in this country, and should not be forced, by taxation of their investment income, to curtail or discontinue such activities. As pointed out in that statement, some of the educational, charitable and public welfare activities of national college fraternities are performed by the fraternities themselves, using their investment income for this purpose, and, in other cases, such investment income is contributed to an affiliated Section 501(c)(3) organization which then devotes such income, as well as income from its other investments, to the performance of such educational, charitable and public welfare activities. In this connection, it should be emphasized that the only substantial source of the funds invested by college fraternities and their affiliated Section 501(c)(3) organizations consists of the dues, gifts and contributions made by members of such fraternities. None of such invested funds is derived from any outside business activities conducted either by the fraternities themselves or by such Section 501(c)(3) affiliated organizations. It thus seems clear that there is no legitimate or logical reason for subjecting the investment income of fraternities to federal income tax at the same rates as are applicable to the net income of business corporations. To do so would seriously impair, if not cripple the capability of college fraternities to continue their educational, charitable and welfare activities.

NATIONAL INTERFRATERNITY CONFERENCE, INC.,
New York, N.Y., October 8, 1969.

Hon. RUSSELL B. LONG,
Chariman, Committee on Finance,
Senate Office Building, Washington, D.C.

DEAR SENATOR LONG: The National Interfraternity Conference, Inc. hereby requests that appropriate amendments be made in the Tax Reform Bill of 1969 (H.R. 13270), as passed by the House of Representatives, in order to correct the unfair and inequitable consequences of the Bill, as enacted, insofar as it relates to the tax treatment of national collegiate fraternities.

As hereinafter explained in more detail, the Bill as enacted by the House would impose a tax, at ordinary corporate tax rates, on all investment income of organizations which are presently exempted from taxation under Section 501(c)(7) of the Internal Revenue Code of 1954. Although the term does not appear in the statute, these organizations are usually called "social clubs." However, it is important to note that this statutory exemption covers not only "clubs organized and operated exclusively" for "pleasure and recreation" but also for "other nonprofitable purposes." National college fraternities are "clubs", and, while they are not organized and operated exclusively for "pleasure" or "recreation", they are organized and operated for "other nonprofitable purposes." Accordingly, they fall within the general classification of Section 501(c)(7), which is commonly referred to as "social clubs."

It seems obvious that the House of Representatives, in enacting the Bill in its present form, did not intend to inhibit the important and valuable educational activities presently carried on by the national college fraternities. On the contrary, it appears that this unfortunate result is due only to the historical accident that such fraternities are exempted from taxation under Section 501(c)(7) of the Code, which also provides the existing exemption for country clubs, hunting clubs, fishing clubs, tennis clubs, dancing clubs and other organizations operated exclusively for the pleasure and recreation of their members. A careful examination of all of the printed publications of the Ways and Means Committee with respect to H.R. 13270 fails to reveal any instance where there is even a mention of national college fraternities, or any consideration of the educational and charitable activities of such organizations. In this connection, it should be noted that the purpose of the proposed changes with respect to the taxation of investment income of "social clubs" was succinctly stated by the Secretary of the Treasury in his recent appearance before the Finance Committee as follows:

"Investment income used to finance the social activities of members of social clubs and similar groups would be taxed, since in this situation it relieves the members of personal expense which otherwise would be paid by them out of after tax income."

While this suggested tax treatment of purely "social clubs" and other similar types of member organizations may well be considered to be appropriate for the reason stated, it obviously is not a desirable result in the case of national college fraternities whose investment income customarily is used for educational purposes, and to carry out legally binding obligations (incurred over a period of many years) to provide lifetime subscriptions to fraternity publications in which commercial advertising is not accepted.

Turning now to a brief description of the technical provisions of the Tax Reform Bill which are applicable to Section 501(c)(7) organizations, Section 121(a) of the Bill, in effect, extends the application of the tax on "unrelated business taxable income" (Section 511) to organizations not now subject to such tax, including organizations described in Section 501(c)(7) of the Code. Section 121(b) of the Bill amends the definition of "unrelated business taxable income" (Section 512), and also provides, in effect, that all of the gross income of Section 501(c)(7) organizations shall be deemed to be "unrelated business taxable income" with the exclusions and exceptions specified therein. Section 121(b)(3)(B) of the Bill then provides as follows:

"(B) Exempt function income.—For purposes of subparagraph (A), the term 'exempt function income' means the gross income from dues, fees, charges, or similar amounts paid by members of the organization as consideration for providing such members or their guests goods, facilities, or services in furtherance of the purposes constituting the basis for the exemption of the organization to which such income is paid. In the case of an organization described in section 501(c)(8), (9), or (10), the term 'exempt function income' also includes all income (other than an amount equal to the gross income derived from any unrelated trade or business regularly carried on by such organization computed as if the organization were subject to paragraph (1)), which is permanently committed—

"(i) for a purpose specified in section 170(c)(4), or

"(ii) to providing for the payment of life, sick, accident, or other benefits under section 501(c) (8)(B), (9), or (10).

If during the taxable year, an amount which is attributable to income so permanently committed is used for a purpose other than that described in clause (i) or (ii), such amount shall be included, under subparagraph (A), in unrelated business taxable income for the taxable year."

The net effect of the above described provisions of the Bill is to treat all gross income (including investment income) of Section 501(c)(7) organizations as "unrelated business taxable income" subject to tax at the regular corporate tax rates, except such amounts of gross income as may be received from members of the organization as payment for dues, fees, charges or similar amounts paid for services rendered to such members. As above indicated, the legislative history of the Bill clearly shows that the sole purpose of the proposed changes in taxation of the income of "social clubs" is to prohibit such clubs from using tax free income to provide social and recreational services to their members. A further provision in Section 121(b) of the Bill proposes to add a new Section 278 to the Internal Revenue Code to prevent a "social club" from giving up its tax exemption under Section 501(c)(7) and operating at a loss by claiming deductions for the expenses of furnishing goods and services to its members. The proposed new Section 278 would limit such deductions to the income which is derived during the taxable year from members or transactions with members. Obviously, the purpose of such proposed new provision is to make sure that any income (including investment income) received by social clubs from sources other than its own membership is to be subjected to taxation at ordinary rates. It is earnestly submitted that there can be no justification for subjecting the investment income of national college fraternities (which is used for educational, charitable and public welfare purposes) to such punitive tax provisions. Even if it shoulld finally be determined that some income tax should be imposed on the investment income of national college fraternities, it seems obvious that there is no conceivable reason why the rate of the tax so imposed should be greater than the 7½% rate which the Bill, as enacted by the House of Representatives, imposes on investment income of the so-called "private foundations."

If it is decided that the general plan of taxation of Section 501(c)(7) organizations, now incorporated in the Bill as above described, is to be continued, it seems clear that the definition of "exempt function income", as set forth in Section 121(b)(3)(B), should be appropriately amended to provide, among other things, that interest income received from loans made by college fraternities to students and to local fraternity chapters for chapter house construction and improvement should be treated as such "exempt function income". In addition, income received by college fraternities from the investment of funds received and held for the purpose of providing lifetime subscriptions to the national fraternity publication should also be treated as "exempt function income." If this is not done, in all probability, many college fraternities will be compelled to default on their legally binding obligations incurred over a period of many years, or else to discontinue such fraternity publications which, as already pointed out, are not otherwise supported by income from advertising or any other source. For like reasons, it appears that income received from the investment (as trust funds) of single sum life membership dues payments should also be treated as "exempt function income." Finally, there should be included in the "exempt function income" definition appropriate language to make sure that all income actually paid or permanently committed by a college fraternity during a taxable year for educational, charitable or public welfare purposes is to be treated as "exempt function income."

Summarizing the foregoing, national college fraternities are not, and should not be treated as, "social clubs" organized and operated only to promote the social activities of, and provide pleasure and recreation for, their members. On the contrary, they are serious organizations deeply concerned in and committeed to the objectives of the educational institutions of the United States. They do not engage in outside business activities, and are supported and maintained only by dues and other payments, and gifts and contributions from their own active or alumni members. Income derived from the investment of payments so received from their own members is not used for pleasure or recreation of fraternity members but instead is devoted to the many and varied educational, charitable and public welfare activities customarily and continuously carried on by such fraternities. In the public interest, these activities should be preserved and encouraged, and the investment income used by the fraternities for such purposes should not be subjected to the tax measures which the pending Bill imposes on the investment income of purely "social clubs" in order to prevent abuse of the existing tax exemption of such clubs by diversion of tax exempt income for the personal pleasure an recreation of members of such clubs.

We shall, of course, be glad to submit any additional information which you may request with respect to this matter, and request an opportunity to consult

with members of the Committee and the Committee Staff with respect to specific statutory language which would be appropriate to accomplish the modifications of the Bill herein requested.

Respectfully submitted.

Z. L. LOFLIN, *President.*

STATEMENT ATTACHED TO LETTER DATED OCTOBER 8, 1969, FROM NATIONAL INTERFRATERNITY CONFERENCE, INC.

A. INTERESTED PARTIES

The proposed tax on fraternity income affects, and is a matter of deep concern to, a very large number of persons. The National Interfraternity Conference, Inc., which is filing this request, is a corporation not for profit whose membership is made up of 61 of the larger national fraternities. However, there are many other national fraternities that are not members of the National Interfraternity Conference, Inc., and there are many national sororities and professional and honor fraternities and societies, and a very large number of local fraternities and sororities that are equally subject to the proposed tax.

The Fraternity-Sorority Directory, published annually by The Fraternity Month, is recognized as the most authoritative and complete summary of fraternity and sorority data. The 1969 issue of this Directory lists every national fraternity and sorority then in existence, and shows their membership and number of chapters to be as follows:

	Number	Members	Active chapters	Alumni chapters
Women:				
National Panhellenic Conference	26	1,265,066	2,244	4,385
Other academic sororities	3	34,995	17	15
Professional Panhellenic Association	24	337,824	1,121	432
National Panhellenic Council	8	242,695	967	1,201
Honor societies	9	174,111	512	59
Men:				
National Interfraternity Conference	61	2,333,620	4,229	2,979
Professional Interfraternity Conference	50	1,121,911	2,288	1,087
Honor societies	76	2,710,692	7,505	366
Total	257	8,220,913	18,883	10,524

In some cases the membership figures given above are expressly stated to refer to only living members. In other cases there is no such explanation, and the figures probably refer to the total membership. There is also some duplication of membership in fraternities and socorities and the honor societies. But even after making a liberal allowance for these possibilities, there are 5,000,000 to 6,000,000 men and women now living who are very much interested in the proposed tax. And, regardless of exact figures as to living membership, it is certain that there are at least 257 national organizations, with over 29,400 active and alumni chapters, as well as many hundreds of local fraternities and sororities, that are subject to the provisions of this bill and are very much opposed to its enactment.

B. EDUCATIONAL ACTIVITIES OF FRATERNITIES

1. Student loans

A very important educational activity of many fraternities and sororities consists of cash loans to needy and deserving students who are not able otherwise to finance their college expenses. Student loans are made by more than half of the members of The National Interfraternity Conference and the National Panhellenic Conference. These loans are made by either the fraternity itself or by a subsidiary organization created for that purpose. The requirements for and the conditions of such loans differ in details among the various fraternities, but in major respects they are the same.

As an illustration, fraternity "A", whose precise figures are available to us, had outstanding on June 30, 1969, 1,023 such loans totaling over $350,000 principal amount. This fraternity makes loans only to juniors and seniors. Each loan requires the filing of an application by the borrower, giving a detailed statement of his financial status, current indebtedness, and budget of expenses; also whether he has applied first to The National Defense Loan Program and The Guaranteed

Loan Program and been rejected by them, and if so why. The note must be signed by the applicant and two adult co-makers, only one of whom can be a member of the applicant's family. The loan bearers interest at the rate of 3% per annum, payable semi-annually. None of the principal will be due until the borrower has been out of school one year. 10% will then be due, 20% at the end of the second year, 30% at the end of third year, and the remaining 40% at the end of the fourth year after graduating or leaving school.

No loan will be granted unless the application has been formally considered and approved by the fraternity chapter of which the applicant is a member, and has also been approved in writing by the Dean of Men, or the corresponding officer, of the institution.

In these days of interest rates of 9% to 10%, and even higher, and with very little such loan funds available from banks or other lending agencies, these fraternity loans at only 3% interest are a real lifesaver to many indigent students, and may well mean the difference between their becoming college graduates or drop-outs.

2. Chapter house loans

Fraternities and sororities serve a very important function on many campuses, not only in the improvement of scholarship, but in the very practical matter of providing living and dining facilities for several thousand students, which the institutions frequently are not able to provide. This service is recognized by many colleges and universities to the extent that the institutions frequently provides sites for fraternity houses, and in some cases either finance entirely the cost of constructing the house, or guarantee payment of the mortgage loan.

When the institution is either unable or unwilling to assist in such financing, the chapter may find itself in a very difficult position. The cost of building has increased so greatly that the minimum for which a house can be erected for even a small chapter is approximately $200,000, and in the case of a fairly large chapter the cost, including the land, runs up well over $400,000. And there are houses, particularly in large state institutions, the over-all cost of which is in excess of $500,000. Ideally fraternity chapter houses are financed by a first mortgage for not to exceed 60% of the fair market value, and by contributions from alumni for the remaining 40%. Occasionally this goal can be reached, but in the great majority of cases there is a substantial gap that must be covered by a second mortgage. Yet in today's market second mortgage money is almost impossible to find, and, if it can be found, the cost is prohibitive.

This is where the fraternity steps in to bridge the gap by taking a second mortgage at a cost the chapter can afford to pay. As an illustration, fraternity "A" above mentioned held 25 such mortgages on June 30, 1968, with a principal unpaid balance of $374,276. These mortgages vary from $10,000 to $25,000, and are payable in ten to twenty years in quarterly installments. The interest rate is 8% per annum, also payable quarterly, which is reduced to 7% for each year that all payments are made promptly when due. Other fraternities whose figures are available are as follows:

Frat. B has 40 chapter house loans approximating $500,000.
Frat. C has 30 chapter house loans approximating $2,000,000.
Frat. D has 80 chapter house loans approximating $800,000.
Frat. E has 60 chapter house loans approximating $1,600,000.
Frat. F has 51 chapter house loans approximating $500,000.

These illustrations are typical of the larger fraternities. Without these loans from the fraternities, many of the 286 houses represented in the above tabulation could not have been built, and the institutions where they are located would have been obliged to provide living and dining accommodations for many hundreds of students now living in these houses.

3. Scholarship awards

A great many cash awards, as well as trophies, are given by fraternities to encourage excellence in scholarship and leadership. No tabulation is available as to the total number and amount of these awards by the various fraternities. However, we do have the figures on fraternity "H" which began giving awards in 1947. Up to and including 1968 it had given $433,300 in cash. In 1969 it is giving an additional $40,825, making a grand total of $474,125 to date. These awards are all given to individuals, after a very careful survey of their achievements. For 1969 the amount includes one award of $1,000, nine awards of $500 each, and one hundred fifty-seven awards of $225 each. The fraternity continues this practice

because it feels that the value of the awards has been fully demonstrated, both in improving individual and group scholarship, and in helping many boys to stay in college when they might not otherwise be able to do so.

4. Libraries

In order to make encyclopedias, dictionaries and reference books of all sorts more readily available to students living in a fraternity house, without the necessity of going to a school library when questions arise, and also to encourage and foster good reading habits, some fraternities have installed libraries in their chapter houses. These are provided on various bases. Fraternity "A", for example, will give any chapter a library of the retail value of $750 upon payment by the chapter of $150, the balance being paid by the fraternity. The books are selected by the chapter from a list of several hundred titles prepared by university librarians. So far 125 chapters have taken advantage of this offer, and the fraternity has paid $49,468.26 as its share of the cost.

As a further contribution to the educational facilities of the chapter houses, the latest edition of the Encyclopedia Britannica, selling for $598, has been offered by fraternity "A" to all chapters upon the payment of $140, the balance being paid by the fraternity. To date 74 chapters have availed themselves of this offer, and the fraternity has expended $20,162.99 as its share of the cost.

5. Tutors in residence

The most recent program that is now being developed is aimed at improving scholarship in chapters where improvement is needed by providing so-called "Tutors In Residence" for such chapters. These tutors are graduate students selected for their teaching ability and leadership qualities. They live in the fraternity house, supervise the study habits of all of the members of the chapter, and assist particularly those students who most need help. In the case of fraternity "A", the room and board of the tutors will be furnished by the chapter, while the national fraternity will pay the tutor a cash fellowship of $1,500 per year. This plan brought such good results in 1968, with two such tutors employed on an experimental basis, that it is being enlarged to four tutors during the coming year at a cost of $6,000, and will be further extended if the results continue to be so satisfactory.

6. Leadership School

The Leadership Schools that are conducted by most of the larger fraternities are perhaps the most important single tool employed by fraternities toward improving not only scholarship, but likewise those qualities of character, initiative and conscience that develop into leadership and good citizenship generally.

These schools are held each year, usually just prior to the opening of school. They consist of either one or two sessions, depending on the number attending. Each session lasts a full week. The schools are conducted by a carefully selected faculty of 10 to 12 instructors. Improvement in scholarship is a major goal, but the qualities that make for a good man and a good citizen are given equal attention. As an illustration, in fraternity "A" alone over 11,000 men have graduated from these schools since they were begun in 1935, and the results are so noticeable and so satisfactory that the scope of the school is increasing each year. During the current year the net cost to fraternity "A" was approximately $18,000. The cost of similar schools conducted by other fraternities ranges from $10,000 to $30,000.

7. Philanthropies

Sororities are particularly noted for their gifts to charities and philanthropies that in many cases are totally unrelated to colleges or universities. They make large gifts to such organizations. It probably is to be expected that the feminine sympathy of sorority members would lead them toward aiding the ill and helpless, and especially children. The 1969 report of the National Panhellenic Conference entitled "Philanthropies And Projects" reviews most of these activities in some detail. Space will not permit us to do more than barely mention a few of these philanthropies. They include organizations dealing with the care of blind, deaf, crippled, sufferers from brain damage, cardiac ailments, polio, muscular dystrophy, arthritis, cystic fibrosis, spastics, speech defects, mental defects and cancer, as well as the underprivileged from physical, mental or racial causes or otherwise. They include summer camps for girls, the revival and encouragement of native handicrafts, rehabilitation in many forms and many others. All of these are of the most direct and practical benefit to society.

8. Result of these programs

The effectiveness of these educational programs, and the value of the training received by a fraternity member, are apparent in many ways. One result that is particularly important, and that can be demonstrated with complete accuracy, is the much greater percentage of fraternity members, as compared with non-fraternity members, who continue their college courses to graduation. The United States Office of Education gives these percentages as 59% for members of national fraternities, and from 33% to 52% for non-members, depending on the school. (HEW Bulletin No. 1958-1)

Other illustrations are the respective percentages in important business positions and public life, including the legislative, executive and judicial branches of our Federal government; and loyalty to their respective alma maters as evidenced by their contributions after graduation. These and others are referred to in an article by William T. Gillis in the November 1968 issue of Fraternity Month, entitled "What Is There To Say".

C. MAGAZINE PUBLICATION FUNDS

Most fraternities follow the practice of requiring each active member to pay a flat one-time fee that goes into a trust fund the income from which is used to pay the cost of furnishing the fraternity magazine to the member for life, without any further payment by him. These trust funds are invested in securities or otherwise, and the income only is expended for the cost of the magazine.

If this income were subjected to income tax, it would simply mean, in probably every case, that the fraternity would be obliged to default in its legal obligations to those members who made their payments to the trust fund in good faith. We believe that this would be a thoroughly inequitable and unfair result, and we, therefore, urge that income received by such trust funds not be subjected to any income tax.

D. CONCLUSION

Fraternities and sororities receive income from two major sources, (a) dues, fees, gifts and contributions from members, and (b) income from investments. In most cases the dues and fees are sufficient to meet the ordinary current running expenses of the fraternities, including the social and recreational activities of the members, while the income from investments provides the funds for the educational and charitable activities above referred to.

Any tax imposed on the income of a fraternity from investments will ordinarily have no effect on the extent or cost of the social and recreational activities of the members, but will simply mean that the money otherwise available for educational and charitable activities will be reduced to that extent, or perhaps eliminated altogether. We submit that this would be a most unfortunate and unwise result, and we strongly urge that no such tax be imposed.

SIGMA NU FRATERNITY,
Lexington, Va., September 30, 1969.

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

GENTLEMEN: These comments are directed to provisions in H.R. 13270 which would seriously impair the ability of national college fraternities to continue to complement and supplement the educational programs and facilities of more than five hundred colleges and universities.

They speak in behalf of almost a quarter million fraternity men now in college, and more than two million alumni members as well. They appeal primarily to economic reason.

Education is big business, and higher education is very expensive big business. In its struggle to provide the best education possible to growing numbers in an inflationary economy, higher education has had to look increasingly to the private sector of the economy for support.

Fraternities play a significant role in that private sector support. They are making substantial contributions in two areas, educational and fiscal.

A broad spectrum of fraternity educational activities contribute both directly and indirectly to the better education which the nation seeks for its young men and women. (See Appendix, NIC Fiftieth Anniversary Declaration of Principles.)

The primary educational thrust of the colleges and universities is in the classroom and laboratory. What have fraternities to contribute there? Chiefly their contributions are in the areas of *motivation* and *guidance*.

The members motivate each other. If they are so disposed (and they often are) the young man's peers in his fraternity chapter can bring to him a sense of urgency to give his studies his very best efforts, which sense of urgency cannot be communicated to the same degree by faculty, staff, or parents. Fraternities motivate academic performance in a variety of ways. Some of them are providing individual and group awards and recognitions, setting high standards for pledging and initiation, offering instruction in effective study techniques, providing tutorial assistance when needed, and carrying out a systematic program planned to help each man improve his academic performance.

In the area of guidance, fraternities rely upon both professionals and alumni volunteers to provide educational as well as personal counseling and advisory services. In recent years there has been a sharp increase in the number of tutors or counselors-in-residence who are engaged to supplement and strengthen chapter scholarship programs.

The evidence is that fraternities are succeeding in both motivating and guiding. The U.S. Office of Education (HEW Bulletin No. 1958–1) identified a trend which attests success in motivation. It is a tendency of fraternity members to "persist to graduation," that is, to finish what they started. That "tendency" has since been researched and measured with gratifying results from the fraternity point of view. The HEW study reported that only 47% of non-member students persisted to graduation, whereas 59% of fraternity students went on to degrees. Subsequent research revealed that the graduation rate for fraternity initiates today has reached 64% and is rising. Fraternities may properly be regarded as the enemy of drop-outs. Obviously this has important economic implications.

Fraternity educational guidance has been successful too. A majority of the more than four thousand chapters of national fraternities are consistently above the all-men's average for their college or university, and many are campus leaders.

Success begets success. Because over the years fraternities have helped their members in college achieve their general and specific educational goals, these members as alumni have not forgotten their debt to either fraternity or alma mater.

It is not accidental that fraternity alumni are disproportionately generous contributors to the support of their colleges and universities. Their undergraduate experience helped develop their capacities for larger loyalties, and their institutions are the beneficiaries. At the University of Colorado, for example, a survey revealed that the twenty per cent of alumni who were members of fraternities had contributed eighty per cent of the funds raised. At Northwestern University the comparable percentage for fraternity alumni was even higher.

Even though fraternities, presently categorized by the Internal Revenue Service as "social clubs" under the provisions of the IRS Code (Section 501(c)(7)), cannot offer the benefit of a tax deduction to an alumnus who wishes to give financial support to his fraternity's general program, educational though it be, many contribute regularly and generously each year. Each gift is in reality an indirect contribution to higher education, since it helps support an organization whose primary objective is to enrich the education of its members.

Furthermore, more than thirty tax-exempt educational foundations have been organized to receive contributions from those wishing to give direct support to fraternity educational efforts. Their collective assets of about $12,299,000 produce annual revenues of about $460,000 which are allocated to such direct educational support as individual scholarships, fellowships, and loans and grants to chapters for tutorial services, libraries, and the like.

In addition, by its very nature the college fraternity experience can and does provide for the *general* educational development of its individual members in areas left largely untouched by the classroom. College fraternities have in fact been so successful in providing these outcomes for their undergraduates that increasingly the colleges and universities themselves are seeking to bring comparable values within the reach of more students, through living-learning centers and new approaches to dormitory programming.

But the most significant support which fraternities provide to higher education is *indirect*. It is the provisions of student accommodations and facilities which would have to be provided by the institution otherwise. This lightens the taxpayer's burden substantially.

Fraternity chapter homes provide living accommodations for 160,000 college students. It would cost an estimated $800 million to replace these with dormitories. Most fraternity chapter homes provide food services as well. Recognizing the importance of the educational contributions which fraternities are making, many institutions have helped with land or financing. However, in the main chapter houses are the end product of fraternity enterprise and fraternity dollars.

In sum, fraternities are making substantial contributions to the general educational development of students on the campuses of a fourth of the colleges and universities in the nation, and are providing living accommodations and food services and social facilities with a replacement value approaching a billion dollars.

The importance which higher education attaches to these contributions is attested by the growth of the fraternity system, a growth of sixty per cent since World War II. Further growth appears to be assured too. A recent survey by the National Interfraternity Conference revealed that the officials of eighty per cent of 150 institutions without fraternities would encourage the establishment of a fraternity system. Yet many colleges and universities which want fraternities are forced to do without them simply because national fraternity organizations have limited means to devote to growth.

In the form approved by the House of Representatives, H.R. 13270 will seriously curtail the operations of national fraternity organizations by subjecting to income tax passive investment income used by the national fraternities to help finance their operations.

The passive investment income of the national fraternities comes in part from the investment of life subscriptions to their magazine. They collect from members life subscription fees which are usually deposited in a separate fund administered by a board. Earnings are transferred to the fraternity's operating fund to cover costs of producing and distributing the magazine.

From these magazine funds have come many of the loans which have made chapter houses possible, since the loans are usually on second mortgage security at a preferential rate of interest. It is not usual for fraternity trustees to invest up to seventy or eighty percent of their magazine funds in loans to chapters for housing purposes.

The provision in H.R. 13270, which subjects to income tax at full corporate rates all of the income (except dues and payments for services) of organizations described in Code Section 501(c) (7), is applicable to national college fraternities, since they are erroneously included in the general category of social clubs. This means income from investments, such as those made by the trustees of magazine funds, would be taxed.

Investment income comprises up to thirty-five percent of the operating revenues of national fraternities. Taxation at the regular corporate rates would be a crippling blow. For example, it would mean the loss of about $50,000 a year in operating income for one large national fraternity with an annual operating budget of three hundred thousand dollars.

For the reasons stated, the harsh effect of the unrelated business income tax provisions on national college fraternities should be mitigated by the Senate Committee on Finance.

Respectfully,

RICHARD R. FLETCHER, *Executive Secretary*.

NATIONAL INTERFRATERNITY CONFERENCE'S FIFTIETH ANNIVERSARY DECLARATION OF PRINCIPLES

On this golden anniversary of the founding of the National Interfraternity Conference, we, the member fraternities of the Conference, reaffirm our acceptance of the responsibility for a positive contribution to the educational functions of the sheltering institutions, recognizing that the fraternity is under an obligation to promote the most complete personal development of its members—intellectual, moral, physical and social. We, therefore, declare that:

1. The college social fraternity, conceived in 1776 and perpetuated as a system of service to higher education in 1825, believes in the cardinal traditions of the United States of America and the Dominion of Canada—reverence to God, allegiance to country, fidelity to representative government, and devotion to personal liberty.

2. The fraternity considers superior intellectual achievement and impeccable behavior as being incumbent upon all fraternity men.

3. The fraternity accepts the obligation that the association of any group of students as one of its chapters involves the responsibility of the group for the conduct of its members.

4. The fraternity is committed to the purpose of training its members in the arts and practices of living together, culturally and socially, and of giving them as much responsibility as they can carry with dignity and success, as a supplement to the curricular aims of the college and university.

5. The fraternity, created and developed by self-governing means, and being dependent upon voluntary methods for its continuing successful operation, deems self-determination in the selection of its membership to be implicit in its organization.

6. The fraternity, recognizing the need for organized, positive and responsible rapprochement between students and administrators of colleges and universities, promotes constructive leadership by its members in such matters as scholarships, housing standards, extra-curricular values, training for successful citizenship, and sound business practice both in chapter finances and in the business relations of its members.

In the pursuit of the effective and complete fulfillment of these Principles, the fraternities of this Conference and their members renew their pledges of loyalty to the colleges and universities which have long extended to them the privileges and responsibilities of a home.

STRONGHOLD INC.,
Stronghold, Dickerson, Md., October 17, 1969.

SENATE FINANCE COMMITTEE,
New Senate Office Building,
Washington, D.C.
(Attention of Mr. Tom Vail, Chief Counsel.)

GENTLEMEN: Thank you for your telegram of October 13 telling us we may present our views on the Reform Tax Act of 1969 also known as H.R. 13270. We are very concerned lest such a law have a disastrous effect on our endeavors and appreciate your courtesy in allowing us to present our suggestions.

Probably what caused the confusion was that I am Treasurer of both the National Parks Association and Stronghold, Inc. and I wrote on behalf of each on August 22 asking for time before the Committee. An assignment of time was made for National Parks, but none for Stronghold. N.P.A. accepted and designated its President, Anthony Wayne Smith, to represent it. Mr. Smith chickened out after tax counsel advised him that his appearance might be construed as "political activity." I don't go along with that view but it is immaterial except that I know of others who would have liked to appear in protest of the bill but who are afraid for the same reason. *Fear, therefore has deprived the Committee of the opinions of many people.*

Now to show why we think *this bill should not be passed* in its present form. Gordon Strong, a Chicagoan, died in 1954 leaving his property (Sugar Loaf Mountain—some 2400 acres in Frederick County, Maryland) to this corporation, a non-profit one that he and his wife set up in 1946. He left a modest Trust Fund with The Riggs National Bank in Washington with the income to be paid quarterly to the corporation for upkeep of the mountain. In doing this he was prompted by the belief that "people who have an appreciation of beauty are better people, who will treat each other better." A partial copy of the charter of the corporation is attached. It has been granted complete exemption from taxation both as to its own income and as to gifts to it. The IRS has just reviewed the exemption in connection with tax returns for the years 1966, 67 and 68 and has written a confirmation of the tax exemption and acceptance of the returns.

Strong wasn't making any money on this deal, he was "giving." The same may be said for the present Trustees and officers who now administer the affairs of the corporation. Now we are concerned lest the Tax Reform law would tax income to the trust and then again tax the same income when received by the corporation. More about us is on the attached papers.

As we understand the law and as we are told by your office, the bill would subject Stronghold to a 7½% tax on its income. We object to that or to even 2% as we feel this is not the right approach. Practically all of our income is from stock dividends and bond interest and the former *have already been taxed 52%*. We feel that should be enough for a silent partner with no money invested

and whose contribution through over-all running of the country has not been too smart for many years.

There is a sensible way to achieve the desired end. If some non-profit and tax-exempt groups have been abusing their positions then the cure is not by penalty tax on everyone. It is by regulation as is done with many facets of business. Policing can be done as the Federal Reserve and the FDIC do with banks—they examine them for proper practices and charge for the examination according to the amount of work involved.

No, sir! We object to even a 2% tax on other grounds too. A 2% tax is only the entering wedge—it will grow just as the Social Security Tax has grown. Remember, it was very small, but year by year it creeps up. The same would happend to either a 7½% or a 2% tax when pressure groups convince future Congresses that money should come to them.

We object to the classifications set up in the Bill—there seems to be none that fits our kind of organization and too bad as there are many like us. We aren't a foundation and we aren't deriving ⅔ of our income from membership. We aren't a "school", but we are educational in nature and we do some scientific work. We are set up to have a membership but we have not yet had the need for it, nor the funds to get it started. We do have about 90,000 people who come to our place each year and we would dislike to place a charge on them because a greedy U.S. Treasury Department thinks this an easy way to get more money to squander. *Is there any justification for charging us a tax and not charging a corporation with 20,000 or 30,000 members when that corporation exacts an annual fee from its members?*

We object to the Bill, H.R. 13270 on constitutional grounds.

In the case of Elsner vs. Macomber it was ruled that the 16th Amendment did not give Congress power to levy income taxes on dividends from stock. This ruling in 1920 considered such a tax a "direct tax" and in violation of Article I, Section 9, Paragraph 4.

The Child Labor Act was voided in 1922 because it was a "penalty" rather than a tax and hence in violation of the 10th Amendment. Case of Bailey vs. Drexel Furniture Co.

In the same year a case of Lipke vs. Lederer brought out the ruling that the imposition of a tax as a "penalty" was a violation of the 5th Amendment. (due process clause).

In the case of the U.S. vs. Constantine (1935) the Supreme Court ruled "Where in addition to the normal tax fixed by law an additional sum is collected by reason of conduct of the taxpayer violative of the law, and this additional sum is disproportionate to the amount of the normal tax, the conclusion must be that the purpose is to impose a penalty as a deterrent and punishment of the unlawful conduct." The only support for such penalty was the 18th Amendment, repealed in 1933.

As to prohibiting "political activity" the bill is in violation of Article I of the Constitution as it is a clear "abridgment of free speech." If this is so important as respects foundations, why is it any less important with *such activities on the part of churches and labor unions?*

And, while the Treasury is looking for more money, *why does it overlook the three billion annual income of unions?* They have vast income from sources other than from members; income from ventures competing with other business that often pays 52% in taxes.

The change in the depletion allowances is too drastic. Why not *try 25% and see what that does?* Everyone knows that *a tax is passed on*, so whom does this provision benefit? Not the little man who is going to pay more for gasoline and more for other products where the depletion allowance is cut. And why not a depletion allowance where the product comes from outside our country. *Is the objective to force us to deplete our resources* while the rest of the world sits on theirs?

The change in capital gains is too drastic and can have damaging effects. One will be higher rents—again a tax will be passed on. The building business is hard hit enough at the moment by high interest rates. If you think a change must be made then why not *gear the rate of tax to the period during which the property was held?* Wouldn't that be equitable?

The present 7% incentive for investment, *if eliminated, will become another force for inflation.* Our productive capacity will be lessened, costs will be higher, supply will not measure up to demand.

Removal of tax exemption on securities issued by states and municipalities will merely *make them pay higher rates* which in turn *will mean higher taxes* for their citizens. It doesn't make sense. The people who buy tax exempts forego a possibly higher income from other sources—isn't that enough?

A curious provision of the Bill *denies the right* of a foundation or nonprofit group *to make a direct grant to an individual unless* the individual is selected by a school or college. In our case we want to have an ecological study made of our mountain. Why should we be compelled to take some student that some educator says we should have when what we want is one we feel can do the job we want so as to turn out a usable product? This is a provision intended to correct an abuse, but it is an infringement of a freedom. The correction would be to make it illegal to make grants to persons where the purpose is not in line with what the corporation was set up to do.

We dislike the tactics of some of the proponents of the Bill. They are *misleading and downright deceitful.* We have in mind the appearance on TV of an Under-Secretary of the Treasury who told of a wealthy man whose income last year was $1,200,000.00, but who paid only $400.00 tax, whereas under the Bill he would pay $400,000.00. We were not told the whole story—what exemptions made this low tax possible. It must have been legal, else there would have been prosecution. The inference was that the whole thing was wrong. Honesty and candor when addressing the public are good qualities. The FTC would have the hide of a manufacturer who didn't tell the whole story about his product and in fact SEC and other government agencies are zealous in being sure that the public gets complete information. Should a government man be immue?

We fear the economic impact that HR 13270 might have on the economy. It makes changes that can be damaging, changes that require more time and thought than have gone into this bill. We think the restrictions of the bill will impede the growth of our country. *The Bill is a hodge-podge*—such a set of changes should be made slowly and deliberately with study beforehand. Maybe someone did study the possible effects, but he must have just got out of kindergarten.

And, while we are still thinking of deceit, *why is it that vast numbers of taxpayers are given a reduction of taxes at a time when the need is for more governmental income?* We hope the Congress will *continue the surtax*. We have the feeling this was to *make a drastic bill acceptable to the majority* of people. We can be sure that this reduction will not long endure and that once the Bill is on the books the rates for individuals will go back up.

We feel sure the Senate will do better by the country than did the House in its consideration of Tax Reform. *We agree that there are possibly some inequities* and that these should be corrected, but slowly—don't do it all at once and pass a bill that will create confusion, lawsuits and unnecessary expenses for government and taxpayers. *This Bill has all those undesirable features,* including discrimination and unfairness.

1. It seeks to "penalize" all non-profit corporations because of the misdeeds of a few. *Misdeeds should be controlled by regulatory means, not by punitive taxes.* Regulation should be by law, not by men, then we would all understand.
2. Income from securities held by non-profit groups has already been taxed too heavily before it reaches them as dividends.
3. The classifications of non-profit groups do not make adequate provision for the kinds in existence.
4. The capital gains provisions can be oppressive—the change should take into consideration the time a property is held.
5. More inflation and higher prices will result through the depletion allowance changes. More also through the passing on of taxes in other cases.
6. The effect on giving may be disastrous to charities. Will we not have arrived at a police state when charity has been killed and government has to do what is now done by private means? Many non-profit groups, even those with membership income derive a substantial part of their funds from private giving and when this dries up many will be forced out of existence.
7. The "Constitutionality" of the Bill is open to question.
8. As it stands, a hastily drawn bill, a Bill conceived by some without too much economic experience or knowledge, it is a lousy piece of legislation and *our hope is that the Senate can turn it into real Tax Reform.*

Again, our thanks for allowing us to present our views. Other matters and the lack of time prevent us making as good a presentation as we would have wished,

but I believe you will understand our basic objections to the Bill. We trust that the final Bill will not spell "curtains for the work we want to do for our fellow man.

Sincerely,

DONALD R. MCCORMACK,
Executive Secretary-Treasurer.

ARTICLE OF RESTATEMENT

INCORPORATORS

This is to certify:

First.—That we, the subscribers, Gordon Strong, whose post-office address is Stronghold, Dickerson Station, Maryland; Louise Strong, whose post-office address is Stronghold, Dickerson Station, Maryland; and Donald A. McCormack, whose post-office address is 4931 Upton Street N.W., Washington, D.C.: all being of full legal age, do, under and by virtue of the General Laws of the State of Maryland authorizing the formation of corporations, hereby associate ourselves with the intentention of forming a Corporation.

NAME

Second.—That the name of the Corporation is "Stronghold, Incorporated."

PURPOSE

Third.—That the purpose for which the Corporation is formed and the business and objects to be carried on and promoted by it, are as follows:

To acquire land by lease, purchase, gift and/or devise; to develop such land with roads and other appropriate forms of landscape and/or architectural treatment; and to offer to the public for its enjoyment and education, access to such land whether developed or undeveloped; to take such other steps as shall appear desirable and compatible toward public enjoyment of and education in out-of-door beauty as one of the great sources of human happiness; to promote by example, by precept and by such further encouragement as the Corporation may find practicable, the development and enjoyment of out-of-door beauty elsewhere, and to engage in such incidental activities as promote and are compatible with the foregoing purposes all with the aim of promoting the physical and mental development of the greatest natural resources of this nation—its people.

To receive the real estate and other property devised and bequeathed to it by the will and codicils of Gordon Strong, such will and codicils having been admitted to probate and record.

STRONGHOLD: STORY OF A MAN AND A MOUNTAIN

(By Judy H. Caldwell)

Approximately forty miles northwest of Washington, D.C., near the town of Frederick, Maryland, a small mountain known as Sugarloaf rises 1281 feet above the surrounding countryside. It is a small detched segment of the Appalachian Mountain system which seemingly guards the farmlands in the Potomac-Monocacy watershed of Maryland. Sugarloaf Mountain is now a part of a 2350-acre preservation, called Stronghold, that is unusual both in its history and as the story of a man and his mountain.

* * * * * * *

While canoeing up the Potomac River toward the mountains, a group of Maryland's earliest explorers saw a detached, solitary mountain to the north. They saw only its south end, where slopes rose symmetrically to the highest peak. The shape of this isolated peak reminded them of a loaf of sugar, a common item in a colonial household. Thus the mountain was named "Sugarloaf"; a name hardly unique in the annals of American mountain-naming

In 1775 General Braddock's ill-started expedition passed the northern end of Sugarloaf on its way to Pennsylvania; and during the opening months of the Civil War, Union forces maintained a watch-tower and signal station on the summit. It was from this pinnacle that General Lee's advance guard was seen crossing the Potomac at White's Ferry in the first serious invasion of the North

in 1862. The capture of Sugarloaf was the opening action of a campaign that ended in the bloody struggle at Antietam.

Recent archeological excavations within the preservation have disclosed the remains of the eighteenth-century Amelung glass factory—the first large glass factory in this country—at the base of the mountain. The factory, called the New Bremen Glass Manufactory, is known to have been operated from 1795 to 1875 by John Frederick Amelung, and rivaled many European glass works in its size. Amelung's production is best known from a small group of copper wheel-engraved covered globets and flips—large flaring glasses—now in museums and private collections.

In the year 1902, Gordon Strong, a Chicago patent attorney and realtor, saw the mountain while vacationing in Washington. This first glimpse of Sugarloaf led to the gradual purchase of more than 2,000 acres of the land for a summer retreat after his retirement. He then poured years of patient labor and hundreds of thousands of dollars into making it into a scenic attraction that today draws over 75,000 visitors a year.

Around 1925, Strong considered erecting a planetarium at the top of Sugarloaf. He invited the eminent architect, Frank Lloyd Wright, to pay him a two-week visit and then design the planetarium. But Strong subsequently rejected the drawing which Wright submitted, and dropped the idea for the planetarium. Wright's 1925 drawing did, however, form the basis for the present Guggenheim art museum in New York City.

At one time the late President Franklin D. Roosevelt attempted to secure Sugarloaf as a summer retreat for his cabinet members, but without success. President Truman also attempted to acquire the mountain; but Strong remained adamant in his refusal to part with it.

In 1946, Strong established Stronghold, Incorporated, a non-profit corporation which is comprised of four officers and a board of ten trustees who administer the preservation. At Strong's death in 1954 the land was deeded to the corporation.

The preserve has never felt the impact of mechanized forces. It is covered in large part of a thick growth of trees, some of the boles of which are blackened by forest fires which once raged over the peaks and slopes. At the base of the east slope lies a shimmering small lake that appears to have been shaped by the hand of nature. In reality, it was a marsh bisected by a watery ditch. The twisting roads that plunge through the woods show no raw earth where the mountainside has been cut; needed cuts have been solidly planted in honeysuckle and myrtle. As the road slowly winds its way to the summit, visitors may pause at several lookout points that have been carved out of the stands of pine and oak. The Monocacy and Potomac Rivers gleam in the distance, and on a clear day the historic town of Frederick may be seen to the north.

Stronghold is singularly lacking in the gaudy tourist trappings that abound in many public parks. A gift shop sells local crafts, small antiques, and paintings by local artists—a far cry from the shoddy hawked in the souvenir shops of many a large preservation. The only other concession is a single soft-drink stand. In keeping with instructions left in Strong's will, the corporation's policy is to keep the preservation in as close to a natural state as possible.

Stronghold is used frequently by Boy Scout groups for campouts and other activities, and plans are currently underway to establish a nature center in the preservation. Church groups often hold sunset services on the western cliffs at the summit. The choral music rising into the air, the view to the west, and the slowly-sinking sun combine to create an inspiring setting.

This, then, is the brief story of a man and his mountain. Gordon Strong worked with the mountain to disclose its qualities of mass, power, and enduring beauty. He did not try to change nature; his was an attempt to make more apparent the qualities which lay largely hidden in this isolated ridge of the Appalachians.

STRONGHOLD—IS

April 1, 1969.

First, a small mountain, geologically unique; second, a man Gordon Strong, who "discovered" it and recognized its possibilities and then, in 1946, organized Stronghold, Inc., a non-profit corporation to develop the potential of the little mountain. He had some idea that people who have an appreciation of natural beauty are better people, people who treat each other better and that the mountain offered a means of bringing about that appreciation. Lastly, it is a dedicated staff, headed by a Board of Trustees of eleven men who serve without pay.

After "discovering" the mountain in 1902 (it was previously discovered in 1707 by Swiss, Louis Michael) Gordon Strong, a Chicagoan of Scotch ancestry spent over 50 years acquiring the mountain, until, at his death in 1954 he held 2350 acres. In 1926 he made arrangements that permitted the public to share with him and his wife the more spectacular parts of the mountain.

Gradually, the property was improved with roadways, landscaping and buildings, including his own residence. The natural-looking lake at the foot of the mountain is not natural at all; it was once a flat field where killdeers nested among the stones. The Georgian-Colonial residence was built in 1912 and enlarged in 1928. It is only one wing of an intended imposing structure that will be used to further the aims of Stronghold, Inc. that now owns the mountain property. The principal aim of the corporation is to do the thing that Gordon Strong conceived, "the teaching of an appreciation of natural beauty."

Since all his relatives were well-provided for in the will of his father, Henry Strong, and by the trust fund set up by it, Mr. Strong, in writing his own will could devote most of his assets to the mountain. Accordingly, a trust fund was arranged with The Riggs National Bank of Washington and the modest income thereby arising was directed to be paid to Stronghold, Inc. This income is now used by that corporation to maintain and develop the mountain.

In its administration of the now nearly 3000 acres in its care, the Board of Trustees proceeds on the principle of maintaining the area in as near a natural state as possible. Sugar Loaf Mountain as well as being possessed of considerable scenic attraction is geologically important. Geologists have that the determination of its formation and subsequent history may well provide the key to the structure of the western Piedmont area.

A motor road permits driving to near the foot of the sugarloaf-shaped top of the mountain and at its terminus is ample parking hidden among the trees. From this point a trail leads to the top, 1283 feet above sea-level, and at its beginning Mr. Strong had erected a sign which reads:

"One quarter mile horizontally (but it's not horizontal)
325 feet vertically (but it's not vertical either)
Tetanda est via (a trail well-worth trying)"

We feel sure that those who visit and walk about this little mountain will enjoy it and will benefit both physically mentally.

When he "found" it, Sugar Loaf Mountain was far off the beaten track, a wilderness surrounded by lovely farming country and accessible only by rough dirt roads, always dusty when not impassable with mud. Now it is an easy 50 minutes from the Nation's Capital, northwest on Interstate 70-S toward Frederick. Its wooded and rocky peak overlooks farm country, still lovely, but daily becoming more crowded with dwellings, government offices, laboratories and the many service facilities that population requires. We shall preserve this "gem."

STATEMENT OF THE NEW ENGLAND JOURNAL OF MEDICINE, SUBMITTED BY ROBERT J. MCGEE

The New England Journal of Medicine, which is published by the Massachusetts Medical Society, is one of the world's leading medical journals. For many years the Society subsidized the Journal, spending hundreds of thousands of dollars as a contribution to the dissemination of scientific knowledge. Over 90% of the circulation of the Journal is to subscribers who are not members of the Society.

In recent years the Journal has been profitable, mainly because of the need of the drug industry for advertising media. The Tax Reform Bill of 1969, as passed by the House of Representatives, is designed to tax those profits.

The Journal carries advertising (although it carefully selects ads and imposes extremely high standards of acceptability) in order to make money. Because of the large advertising revenue the Journal as a whole makes a profit, which is eventually used for the charitable and educational purposes of the Society. This is not merely passive income from investments; it is active income derived from the entry of the Journal into the marketplace of commercial advertising.

In light of this, it is the position of the Journal that broad considerations of social policy indicate that the profits of the Journal from advertising should be subject to federal income tax. The need for equitable sharing of the tax burden requires that all who enter into an active enterprise for the purpose of making money should contribute to the support of the essential programs which the federal government has begun to implément. While it can rightly be argued that private charitable and educational uses contribute equally to the welfare of our

society, and indeed may provide flexibility and imagination necessary to development of our social resources, thus justifying the exemption from tax of the Society's income, on balance we believe that the exemption should be limited to passive income.

We disagree emphatically with one of the arguments of the proponents of this section, that of "unfair competition." Our tax exemption gives no competitive advantage over nonexempt publishers. For one thing, we are not in competition in any real sense, because an enterprise which as a whole exists for the purpose of making profits cannot be and is not trusted to maintain the disinterested objectivity necessary to the selection and publication of learned scientific work. Sooner or later the judgment will be clouded and concessions will be made to the expedient and the profitable. For another, the tax exemption has no effect on our pretax profits as compared to those of any other publisher; it is merely that our after-tax dollars, devoted to charitable purposes, are greater than the after-tax dollars, devoted to selfish purposes, of profit-oriented businesses. There is nothing "unfair" about this.

Nevertheless, by receiving a share of the available advertising dollars we may be diverting money which would otherwise be subject to tax, and thereby depleting the available federal revenues. Although we believe that we can and do make good use of these funds for valuable purposes, we also believe that to the extent we derive revenue from active participation in the marketplace, we should share these revenues with the federal government and that the tax exemption should be eliminated.

We offer to the committee a substitute draft of section 121(c), which we believe is preferable as a matter of form since the present version is ambiguous and lacks precision. Our substitute also contains the following substantive changes:

1. The words "be deemed to include" are inserted to make it clear that ordinarily the term "trade or business" does not include an activity or element not capable of independent existence. The Society has engaged in extensive litigation with the Internal Revenue Service on this matter, and continues to resist the application of the regulations promulgated December 12, 1967. There are now two taxable years involved. If the Congress is to legislate on this subject, it seems to us unfair to leave those two years in dispute when the dispute will have no continuing importance.

Our opposition to the Internal Revenue Service has not been on grounds of tax policy. As stated above, we favor taxation of this income. We have done battle with the Internal Revenue Service and the Treasury, resisting their attempts to distort the meaning of the present statute by revoking their own long-standing construction of its meaning, because in this matter the executive branch has attempted to engage in legislation, rather than its proper function of interpretation. Only the Congress has power to change the law. The Senate, which in other areas is effectively resisting executive usurpation, should be equally vigilant here.

2. The requirement that a profit-motivated element be substantial, alone or in combination with other such elements, and the definition of substantial as being more than 10% of gross receipts, are intended to establish a *de minimus* rule. This will be helpful to some of our small brothers who may carry classified ads of the "doctor wanted" and "doctor available" sort, the revenue from which is insignificant in terms of dollar amount, while the necessity of calculating the tax would impose heavy administrative burdens.

3. The exclusion of "a necessary subsidiary procedure" from the "trade or business" definition is essential to cure an ambiguity in the present version. Under the present version the sending of bills for subscriptions to an educational magazine which carries no advertising would, literally, constitute an "activity which is carried on for the production of income." Since it is not intended that the subscription revenue be subject to tax (and there are similar examples in other areas) the bill requires the clarification supplied in our proposed substitute.

4. The proposed substitute provides that the tax is not to exceed what the tax would be if the whole publication were a taxable entity. For example, the advertising revenues may exceed costs allocable to the advertising element by $200,000; while the costs allocable to the educational element (the scientific articles themselves) may exceed subscription revenue by $100,000. Thus the overall profit would be only $100,000, and that is what a fully taxable publication with similar figures would pay. Since there could be no advertising without the educational matter, the net costs of the educational element are an ordinary and necessary expense of producing advertising revenue.

The Report of the House Ways and Means Committee (General Explanation of section 121(c)) indicates that this "net" result was intended, but the bill as drafted completely fails to provide for it.

5. The bill in its present form leaves a significant loophole. It would be possible for an exempt organization which now publishes a related magazine to sell the physical equipment outright to a commercial entity, and to grant the right to use the exempt organization's name, membership lists, etc., in return for a royalty. The royalty might be a large proportion of the net profits of the enterprise, but would constitute a business deduction to the commercial entity and yet would be nontaxable income to the exempt organization under section 512(b) (2) of the Code.

The second paragraph of section 121(c) contained in the substitute is designed to prevent tax avoidance by this method.

Annexed to this statement is a copy of the proposed substitute for section 121(c). Also annexed are two sentences which we suggest might be included in the committee report to explain the purposes of certain of the substantive provisions of the proposed substitute.

In summary, we believe that section 121(c) as passed by the House of Representatives is defective in form and to some extent in substance, and should not be enacted as it stands. However, we agree with the general purpose of the bill, and support enactment of our proposed substitute for section 121(c).

PORTION OF COMMITTEE REPORT ON SEC. 121(c) OF H.R. 13270 PROPOSED BY MASSACHUSETTS MEDICAL SOCIETY

The requirement that the element be substantial will usually eliminate from the category of an unrelated trade or business such activities as the carrying of a few classified ads in trade or professional journals or the infrequent filing for prescriptions for outsiders by a hospital pharmacy. The requirement that the element not be merely a necessary subsidiary procedure in carrying on the trade or business as a whole will make it clear that an activity such as the sending of bills for services which are directly related to the exempt function, for example bills for normal hospital charges or for the subscription price of professional journals, does not constitute a separate trade or business.

SUBSTITUTE DRAFT OF SEC. 121(c) OF H.R. 13270 PROPOSED BY MASSACHUSETTS MEDICAL SOCIETY

BILL SEC. 121 (C)

(c) Activities Included as Unrelated Trade or Business.—Section 513 (relating to unrelated trade or business) is amended by striking out subsection (c) and inserting in lieu thereof the following new subsection:

"(c) Advertising, etc., Activities.—For purposes of this section, the term 'trade or business' shall, with respect to any taxable year beginning after December 31, 1969, be deemed to include any element of an integral trade or business if such element exists for the principal purpose of producing income from the sale of goods or the performance of services, provided such element is substantial in relation to the integral trade or business, and is not merely a necessary subsidiary procedure in the carrying on of the integral trade or business as a whole. For purposes of the preceding sentence an element shall be considered substantial if it (or in the case of an integral trade or business containing more than one element described in the preceding sentence, the combination of all such elements) produces more than 10% of the gross receipts of the integral trade or business. The combined unrelated business taxable income of all elements of an integral trade or business, which elements are trades or businesses solely by reason of this subsection, shall be deemed not to exceed what would be the unrelated business taxable income of such integral trade or business if such integral trade or business were an unrelated trade or business, giving effect to any net operating loss deductions.

"If an organisation described in section 511(a) (2) receives royalties or other payments for the use of its name, membership lists, mailing lists or similar property, in a trade or business which if owned by it would be or would contain elements which would be, an unrelated trade or business, such royalties or other payments shall for purposes of section 512(b) (2) be treated as payments which are not royalties."

STATEMENT OF THE SOCIETY FOR THE PROPAGATION OF THE FAITH, PRESENTED BY THE RIGHT REVEREND EDWARD T. O'MEARA, NATIONAL DIRECTOR

APPRECIATION

The Society for the Propagation of the Faith expresses appreciation on behalf of the National Director, its one hundred and fifty Diocesan Directors, and over 300,000 priests, brothers, sisters and lay people working in the mission effort of the Catholic Church, for the privilege and opportunity to make this presentation to the Senate Finance Committee.

The Society for the Propagation of the Faith is well aware of the problems and perplexity that must surely confront members of the Senate Finance Committee as they seek to arrive at a Bill that is both fair and just. We sincerely hope that the presentation which follows will be helpful to you in making your final decision.

THE SOCIETY FOR THE PROPAGATION OF THE FAITH

What it is.
What it does.
Who it represents.

(a) The Society for the Propagation of the Faith is a religious charitable organization organized as a membership corporation under the laws of the State of New York.

(b) The scope and function of the Society for the Propagation of the Faith is accurately described by the following statement: "The Society for the Propagation of the Faith is the principal official agency of the Roman Catholic Church in the United States for the world support of the Church's missionary activities. The Society's funds are used to support its missionaries, to train its future personnel, and to subsidize its projects of assistance in the developing areas of the world."

(c) The Society for the Propagation of the Faith thus represents over 47 million Catholics in the United States in gathering assistance for the world-wide mission effort of the Catholic Church.

TAX INCENTIVES TO RELIGIOUS, EDUCATIONAL AND OTHER PHILANTHROPIC INSTITUTIONS

At the outset, we wish to recognize the munificent way in which our government has rendered indirect assistance to worthy causes by the provisions of its tax legislation. Gifts to educational, religious, social welfare and other philanthropic institutions are encouraged by the Federal Income, Estate and Gift Tax Laws.

However, except in most unusual circumstances, a donor sacrifices substantial economic worth when he makes a philanthropic gift. Thus, his prime giving motive is his belief in the philanthropy's work and goals. Tax savings became important only after he decides to make a gift. They reduce the cost of giving and enable a donor to contribute more than he initially thought possible. The Society for the Propagation of the Faith is grateful for the benefits reaped in the past from the operation of these concepts and makes its presentation in the hope that such benefits may continue.

TAX REFORM ACT OF 1969 (H.R. 13270)

This Act is probably the most far-reaching modification of the Internal Revenue Code since the inception of the Internal Revenue Act. We feel that the Act as passed by the House of Representatives includes many changes of substance which had not been announced as even tentative decisions, and this has been done without acknowledging that there has been a substantial change and direction. We admit that there have been abuses, but in small numbers. We are confident that these abuses could be stopped by the enforcement of present legislation and rulings. It is our opinion that this proposed legislation goes too far in expressing punitive regulations which may or may not meet the approval of the voting taxpayer. Be assured, however, that we are not in disagreement with the entire Bill. There are sections that we wholeheartedly approve and others that we are willing to accept. These will be listed later in our presentation.

DEFERRED GIVING

The Society for the Propogation of the Faith is particularly concerned about the passages in the House Bill which threaten the future of its Deferred Giving Programs. In the past few years Gift Annuities and Charitable Remainder Trusts

have become a large part of The Society for the Propagation of the Faith's plans and hopes for the raising of the necessary funds to support its work. Current giving sources are no longer sufficient to take care adequately of our needs and we have been forced to turn to Deferred Giving as a means of keeping abreast of steadily rising needs for the services provided by the Church's mission effort.

RECOMMENDATIONS

CHARITABLE GIFT ANNUITIES

Present tax treatment when appreciated property is contributed for an annuity should be retained. (Detailed in Rev. Rule 62–136, 1962) If the House Bill's provision on bargain sales is enacted, the law should specifically state that the transfer of appreciated property for a charitable gift annuity is not a bargain sale.

CHARITABLE REMAINDER TRUSTS

Present law provides for no capital gains tax on the transfer of appreciated property to fund a charitable remainder trust; nor is there a capital gains tax if the property transferred is later sold by the trust and the gain permanently set aside for the charity. These rules should be retained. The very complicated provisions for charitable remainder annuity trusts and charitable remainder unitrusts should not be substituted for the widely used and understood charitable remainder trust.

Further, the House Bill allows no estate tax charitable deduction for a charitable remainder trust unless it is a unitrust or an annuity trust. This estate tax change would thus affect the estates of donors dying afer the Bill is enacted. It would even apply to charitable remainder trusts created before the Bill's enactment, no matter how long ago they were created. The retroactive nature of this provision seems so harsh and unfair that we can only feel it must be the result of an oversight. These charitable remainder trusts which the Society has issued in full compliance with the laws in existence at the time the trusts were created, would be basically and radically changed, with disastrous results for the donor as well as for the Society for the Propagation of the Faith. The benefactor who contributed the assets of the trust, relied upon the statements of the Society, which were always based upon existing laws concerning the tax details about the donor's original gift, the transactions occurring in the trust, and the way the trust would affect the donor's estate. Many of these people are elderly, and it is most unfair to submit them to these penalties long after they have entered into the gift.

Also, the charitable deduction for gifts of appreciated property should be based upon the fair market value of the trust at the time of its creation, rather than requiring the donor to base his deduction upon his cost basis, or pay a capital gains tax if he elects to compute his deduction based on the fair market value. Further capital gains incurred by the trust and permanently set aside for charity, should not be taxed.

The Society for the Propagation of the Faith is also seriously concerned about the provisions of the proposed tax legislation which affect outright gifts, especially gifts of appreciated property. We are concerned also with the proposed Allocation of Deductions provision. However, because these are common concerns to so many other religious, educational and charitable organizations, we have limited our presentation to those areas affecting Deferred Giving, in which the Society for the Propagation of the Faith has been somewhat of a pioneer.

THE SOCIETY SUPPORTS

1. The Society supports extending the unrelated business income tax to cover all organizations now exempt.
2. The Society supports taxing organizations on income received from debt-financed investments; for example, Clay Brown transactions.

IMPORTANT, BUT WILLING TO SACRIFICE

1. Two Year Trusts.
2. Appreciated property gifts which would generate ordinary income if sold [e.g., inventory; "Section 306 stock"; property which if sold would generate short term capital gain (held 12 months or less under the House Bill)]
3. The unlimited charitable deduction.
4. Rent-free use of property.

CONCLUSION

The Society for the Propagation of the Faith appreciates greatly the chance that we have had to present our opinions to you. We hope you will permit us to point out the possibility that Government can be excessively preoccupied with abuses of which only a tiny minority of donor-taxpayers are guilty. Thus the possibility of corrective legislation which overcorrects. Such legislation removes not only the abuse but also tax benefits which before were not questioned. The United States Supreme Court has declared that the charitable contribution deductions provided by the Code should be broadly construed. As far back as 1934 it said: "The exemption of income devoted to charity and the reduction of the rate on capital gains are liberalizations of the law in the taxpayer's favor and were begotten from motives of public policy, and are not to be narrowly construed." Throughout the years the courts have liberally construed the Internal Revenue Code provisions in favor of donors and philanthropic institutions. In a good majority of recent litigated cases on charitable deductions, donors have prevailed. However, the mere fact that a donor may have to litigate his right to the charitable deduction in some instances inhibits his generosity in giving. We confidently hope that the current tax legislation will reflect the magnanimity for which there is such well-founded precedent.

Our final appeal is not only for the Society for the Propagation of the Faith, but for all non-profit organizations which are operating in conscientious compliance with our Government's laws and regulations. We are at this point desperately in need of further help. If this help is not given, many of these wonderful institutions may go out of existence, and the burden of continuing the services they are rendering will fall on the Federal Government—and at much greater cost. I pray that the Senate Finance Committee in considering not only our own testimony, but that of all of the other organizations, will come to the conclusion that it is much better let publicly supported organizations continue to handle the problems that they have taken care of up until now with remarkable efficiency, by granting them continued favorable taxation provisions.

SEPTEMBER 30, 1969.

HON. RUSSELL LONG,
Chairman, U.S. Senate Finance Committee,
Washington, D.C.

DEAR SENATOR LONG: I am opposed to the loopholes in H.R. 13270 which excuse labor unions from paying taxes. Under this bill, churches and foundations will be taxed on their unrelated business income, but the unrelated business income of unions will remain untouched.

I am employed as a brakeman by the Baltimore and Ohio Railroad Company, and I am compelled to pay union dues to the tax-exempt Brotherhood of Railroad Trainmen in order to keep my job. This union is guilty of spending compulsory dues for political purposes.

As a veteran railroader, I closely followed the Street case in the courts. It was filed by a group of railroad workers who charged their dues were being spent by union officials for political purposes. Fifteen different tax-exempt labor unions were named as defendants, and their spokesmen admitted the charge made by the plaintiffs.

The U.S. Supreme Court agreed with the argument that a wage-earner's constitutional rights are violated when he is compelled to support political candidates against his will. But, it refused to void the compulsory "union shop" agreements and merely suggested the unions should refund the money used for political purposes over the objections of the plaintiffs.

Instead of revealing exactly what percentage of the dues money was spent for partisan politics, the 15 unions refunded all of the money collected from the employees and released them from the obligations imposed upon them by the compulsory "union shop" agreements.

The precedent set by the Street case doesn't offer any real relief to wage-earners who resent the use of their compulsory dues for political programs. That case was in the courts for 12 years. There aren't any employees who will file a lawsuit if they think several years will be required to win it.

We employees are helpless because we don't have enough money to pay legal fees and court costs. On the other hand, the officials of my union control assets totalling more than 12½ million dollars. They have invested more than 10½ million dollars in businesses of various kinds, and the union is not paying taxes on income received from those investments.

I hope the Congress will give us a measure of relief by taking away the tax exemptions from unions whose officials are more interested in politics than in collective bargaining.

Any consideration given this statement by the Senate Finance Committee will be appreciated.

Sincerely yours,

ROBERT ALLEN PANCAKE,
Cumberland, Md.

9/4/69

NEW YORK STATE BAR ASSOCIATION

TAX SECTION

Special Committee on Exempt Organizations

SUMMARY

A. The Committee respectfully suggests that legislation at this time be limited to the problems of self-dealing, and public accountability, and that any broader legislation be deferred until after the Peterson Commission has reported.

B. With respect to the provisions of H.R. 13270, the Committee recommends that:

1. The investment income tax should be reduced and the proceeds earmarked for administration of the private foundation rules; and deductions should be clearly provided for depreciation, interest, casualty losses and other expenses.

2. "Bargain sales" to foundations should be permitted as an exception to the self-dealing rules.

3. Broader deductions should be permitted for the minimum distribution requirement; "private operating foundations" should also include foundations which, although primarily supported by only one or two foundations, expend their grants promptly and directly for exempt purposes.

4. If divestment of controlling interests in business enterprise is to be required, longer and more flexible divestment schedules should apply; and redemptions of stock by the controlled business enterprise should be permitted by relaxation of the accumulated earnings tax rules.

5. Existing rules on legislative activity should be retained; otherwise, clarifying amendments are required; and "expenditure responsibility" should be clarified.

6. The penalty for speculative investments seems unworkable and unnecessary.

7. The disclosure provisions are sound.

8. The sanctions over 100% (self dealers and foundations) and over 50% (managers) should be reduced; abatement of the tax where payment is made to the foundation should be allowed; and rules regarding

the burden of proof should be adopted.

9. Technical amendments are necessary for §§ 507-509.

STATEMENT

DISCUSSION

A. The Committee believes that the provisions of H.R. 13270 relating to private foundations are unnecessarily severe and complex, and that they are inconsistent with our traditional concepts of private philanthropy. It is respectfully suggested that legislation be confined at this time to the problems of self-dealing and public accountability, and that further action might appropriately be deferred until the Peterson Commission can render a report. The substantive provisions and sanctions provided in H.R. 13270 represent a complex and heretofore untried code. They should be subjected to intense study before enactment.

B. The Committee's specific recommendations and comments on the provisions of H.R. 13270 are as follows:

1. Tax on Investment Income

The Committee believes that the 7.5 percent tax on private foundation investment income to be levied by § 506 is inconsistent with the tax exemption embodied in § 501(a). While the complex code governing private foundation activities that H.R. 13290 proposes would require increased audit

and administrative outlays by the Internal Revenue Service, the 7.5 percent tax is not earmarked for administration of the foundation rules and, indeed, the House Report concedes that the tax is only "in part a user fee." H. Rep. No. 91-413 (Part 1), 91st Cong., 1st Sess. (hereafter "H. Rep. (Part 1)"), p. 19. Thus, the tax is as much a revenue raising measure as the taxes levied by § 1 (individuals) and § 11 (corporations). Enactment of the tax would be a significant step toward eliminating private charity; the next step is an extension to all charitable, educational and even religious organizations; the principle, once established, invites state and local governments to adopt such taxes, and all levels of government will find it easy to raise the tax rate a few percentage points at a time.

With respect to the language of § 506, the deductions that are to be allowed in computing "net investment income" should be clarified. As presently drafted, § 506(a)(3) allows "all the ordinary and necessary expenses paid or incurred for the production or collection of gross investment income or for the management, conservation, or maintenance of property held for the production of such income." This language is substantially identical to that of § 212, which allows individuals to deduct expenses that would be

deductible under § 162 but for the lack of a trade or business. Thus, § 506 may be interpreted as permitting only similar deductions. As a result, private foundations would be denied allocable deductions for interest, state and local taxes, depreciation, casualty losses and other outlays ordinarily deductible by individuals and corporations. Indeed, the House Report recognizes the deficiency in the language by expressly stating that depreciation is to be deductible. H. Rep. (Part 2), p. 2. A committee report is not an adequate substitute and the Committee recommends that the provision be rewritten to allow all deductions allowable to a corporation computing its tax under § 11 with specific omissions and additions. Compare the pattern adopted for computing unrelated business income. Code § 512(a) and (b).

2. Self-Dealing

The Committee concurs in the substantive rules adopted to prohibit self-dealing (§ 4941(d)), except for the failure to sanction "bargain sales" of property. Without such an exemption, private foundations may be deprived of a significant source of support, and indeed, this principle should be retained for all charitable gifts. Compare H. Rep. (Part 1), pp. 53-56. The general allocation of basis proposal should, of course, be applied.

As to sanctions, the Committee endorses the principle of penalizing the wrong-doer rather than the charity,

but it has serious reservations about the severity and extent of what is proposed. See Part 8, *infra*, p. 12.

3. Minimum Income Distribution

The Committee believes that § 4942 should be clarified to insure that the minimum distribution requirement is applied to the amount of income which a private foundation actually has available for distribution without drawing upon capital. At present "adjusted net income" is computed after the allowance only of (§ 4942(f)(3)(A)) "all the ordinary and necessary expenses paid or incurred for the production or collection of gross income or for the management, conservation, or maintenance of property held for the production of such income." This language may be interpreted to permit only § 212 deductions and, indeed, the House Report finds it necessary to make a clarifying comment about depreciation. (H. Rep. (Part 2), p. 11). As in the case of the 7.5 percent tax (Part 1, *supra*), Section 4942(f)(3) should be amended to permit all deductions allowable to corporations computing their tax under § 11 with specific omissions and additions. Compare Code § 512(a) and (b).

We also urge that an additional category be added to the definition of "private operating foundations", gifts to which are treated as qualifying distributions for the purpose of the minimum distribution. In order to prevent foundations from distributing funds to each other, § 4942(j)(3)(B)

requires a "private operating foundation" to derive its support from five or more private foundations. H. Rep. (Part 1), p.26. Even if this concern is warranted, the Committee is afraid that the broad support requirement will result in (a) the denial of all support to fledgling foundations with an untried idea (e.g., educational television) and (b) evasion of the provision through a pattern of reciprocal grants among foundations. The House's concern and the need for "risk" funding can both be satisfied by waiving the broad support requirement for a private foundation which undertakes prompt and direct expenditure for exempt purposes of its foundation grants. Compare the organizations qualified for the unlimited charitable deduction under § 170(g)(3), and for gifts of appreciated property under § 201(c) of the bill.

4. Business Ownership Limitation

The Committee believes that control of a business by a foundation is not less in the public interest than, say, control by a great university. In any event, it believes that the 2, 5 and 10 year disposition schedule provided by § 4943(c)(4) for existing holdings is unworkable. The exceptions provided for one or two specific cases simply illustrate the fact. Bill § 101(k)(4),(5). Present business holdings vary from publicly traded to closely held corporate stock. In some instances, the limitation may be satisfied by

a quick sale by the foundation or principal donor. In other instances, the only market will be the donor or the corporation itself, and considerable planning and expense will be required to extricate the stock without swamping the market and thus injuring both the foundation's capital and the business. Consequently, the disposition schedule should afford considerable flexibility. A minimum period of 10 years should be provided, with provision for extension by the Commissioner upon a showing of hardship. Contrary to the House Report, market fluctuation should be recognized as a basis for such a showing. In addition, corporations should be allowed to accumulate funds necessary to redeem stock held by foundations free of the accumulated earnings tax.

Consistent with what has been said above, it is believed that a minimum period of 10 years, in addition to a reasonable period of estate administration, should be made available for disposition of excess business holdings acquired by will, and the 10 year period be applied in the case of gifts as well. Under the proposed rules, the conglomerates are likely to gain and charity to suffer. It is noted that under section 4943(c)(5), the 2, 5, 10 year period would apply to bequests under wills executed before July 29, 1969. Otherwise a straight 5 year period applies to gifts and bequests under section 4943(c)(6). The latter provision also seems to contemplate that a redemption from a non-disqualified

person can result in an excess holding subject to 5 year divestiture.

5. Taxable Expenditures

The Committee agrees with the objective of preventing foundation participation in political campaigns. However, it believes that present law regarding legislative activity is preferable to the new proposal. The existing limitation in § 501(c)(3) has been in effect for many years and has been interpreted by numerous judicial and administrative rulings. See St. Louis Union Trust v. United States, 374 F.2d 427 (8th Cir. 1967); and Treas. Regs. § 1.501(c)(3)-1(c)(3). The principal problems in this area have been the weakness of the one sanction -- loss of exemption -- and lack of enforcement. These problems will be substantially eliminated by the multi-level sanction system of § 4945(a) and the expanded audit that will be financed by the net investment income tax. Consequently, the Committee believes that the first sentence in § 4945(c) should be eliminated,* and the second sentence, which exempts from tax activities relating to the foundation's own status, should be redrafted as an exception to subsection (b)(1), which defines as taxable expenditures amounts paid "to carry out propaganda, or otherwise attempts to influence legislation."

* That sentence reads:

(c) CERTAIN ACTIVITIES EXPRESSLY INCLUDED WITHIN SUBSECTION (b)(1).--For purposes of subsection (b)(1), the term 'taxable expenditures' includes (but is not limited to)--

If § 4945(c) is retained, it is suggested (a) that §4945(c) be amended to state that "For the purposes of subsection (b)(1), the term 'taxable expenditures' means --"; (b) that subsection (c)(2) be amended to read "any attempt to influence specific legislation through private communication with (except at the request of) any member or employee of a legislative body, or with any other public official who may participate in the formulation of the legislation"; and (c) that the list of permissible activities in subsection (c) be amended to include "making available the results of non-partisan analysis or research or furnishing technical assistance."

With respect to "expenditure responsibility," the Committee endorses the detailed reporting provisions of § 4945(f), but believes that the requirement of "see[ing] that the grant is spent solely for the purpose for which

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* (Footnote continued)

"(1) any attempt to influence legislation through an attempt to affect the opinion of the general public or any segment thereof, and

"(2) any attempt to influence legislation through private communication with any member or employee of a legislative body, or with any other person who may participate in the formulation of the legislation, other than through making available the results of non-partisan analysis or research.

made" is unworkable. Private foundations cannot be made absolute insurers of their grantees' performance; not only are there reasonable limits on the amount of charitable funds that are to be consumed in administration, but private foundations should not be liable for a tax because of embezzlement or theft. Detailed reporting and interviews are the only effective measures.

6. Use of Foundation Assets

Section 4944 levies a 100 percent excise on a foundation -- and a 50 percent excise on a participating manager -- which invests its funds "in such a manner as to jeopardize the carrying out of any of its exempt purposes." No definition is attempted either in the bill or the House Report. While a similar provision exists in § 504(a)(3), there has been no administrative (Treas. Regs. 1.504-1) and little judicial (Samuel Friedland Foundation v. United States, 144 F. Supp. 74 (N.J. 1956)) development of it. The need to discourage foundation investment in losing businesses, which may have prompted this provision (Treasury Department Report on Private Foundations (G.P.O. 1965), p. 35), will be fulfilled by the limitation on business holdings. Moreover, state enforcement authorities have a responsibility in this area. See generally Cary & Bright, The Law and the Lore of Endowment Funds (Ford Foundation 1969), pp. 56-65. In sum, the provision seems unworkable and, in fact, unnecessary.

33-865 O - 69 - pt. 2--55

7. Disclosure and Publicity

The Committee concurs in the amendments to §§ 6033 and 6652 insofar as they are made applicable to private foundations.

8. Sanctions

Viewed collectively, the sanction system proposed is a highly flexible innovation, but in some respects it is erratic. In summary, the following sanctions are provided:

Level I

(a) Federal

	Foundation Tax			Manager Tax		
Activity	Initial	Add.	Limit	Initial	Add.	Limit
Self-dealing*	5%	200%		2.5%	50%	$10,000
Minimum distribution	15%	100%				
Business holdings	5%	200%				
Taxable expenditure	100%			50%		
Speculative investment	100%			50%		
Reporting	$10/day		$5,000	$10/day		$ 5,000

* The self-dealer, rather than the foundation, is liable for the 5% and 200% excises.

(b) State

Enforcement of charter provisions against self-dealing, etc., required by § 508(g).

Level II

Section 6684 provides a 100% penalty for repeated or "both willful and flagrant" violations by "any person" of §§ 4941-4945, relating to self-dealing, minimum income distribution, excess business holdings, speculative investments, and political and legislative activity.

Level III

Section 508(e) provides for loss of exemption and requires the turnover of foundation assets to the Government or to other charities for either "willful repeated acts" or "a willful and flagrant act" giving rise to liability under §§ 4941-4945, relating to self-dealing, minimum income distribution, excess business holdings, speculative investments, and political and legislative activity.

The first level is questionable in several respectss. First, since protecting the revenue against abuse of exempt status, rather than raising revenue, is the object, the self-dealing excises applicable to the disqualified person and the foundation manager should be abated upon payment of an equivalent amount to the foundation.

Second, the manager taxes raise several problems. Foundation trustees and directors, for the most part, render uncompensated and part-time service, believing that they are performing a public service. The potential liability which

they will risk as the result of the bill will lead to substantial resignations and require foundations to compensate their managers for the risk and work involved.

To minimize this danger, and yet insure manager responsibility, several steps are appropriate: (1) Maximum limitations should be adopted for all of the manager excises, such as those presently provided for the self-dealing excise and the reporting penalty. §§ 4941(c)(2), 6652(d)(2). (2) Consideration should be given to reducing the 50 percent excise applicable under the taxable expenditure (political campaign and legislative activity, and expenditure responsibility) and speculative investment rules. The amount of these excises is in stark contrast to the only 2.5 percent initial manager tax applicable to the equally condemned self-dealing situation and to the absence of any manager levy for excess business holdings and minimum distribution situations. In addition, these excises are applicable to "knowing" violations of the foundation rules and thus may lessen the incentive for managers to give detailed attention to foundation activities. The solution would be to adopt an excise for negligence or for intentional disregard of the foundation rules. Compare § 6653(a) (5% addition to tax for negligence). (3) If the 50 percent manager excises are retained, then the penalty and the act are the equivalent of fraud and the Government should have the burden of proving such acts. Compare § 6653(b)

(50% fraud addition to tax) and § 7454(a) the burden of proving fraud is on the Government).

Third, no excise should exceed 100 percent. The 200 percent "additional" self-dealing and business ownership levies are excessive. Payment to the Government of the amount uncorrected satisfies the need to protect the revenue and is sufficient to negate the possibility that some may view payment of the tax as a "cost" of the transaction. The additional penalty has no place in a civil statute.

9. Foundations Defined; Termination of Status

The Committee suggests that consideration be given to changing the "substantially more than half of the assets" test for operating foundations to the test of "a substantial part". A foundation that has a "substantial part" of its assets devoted to the active charitable activity, and spends substantially all of its income each year directly for the conduct of such activity, would appear to be a legitimate "operating" foundation; and it does not appear that it should be disqualified merely because it has a substantial investment portfolio representing more than 35% of the value of its total assets. The 65% rule for "substantially more than half" suggested in the House Report could in any event create confusion for a foundation whose investment portfolio may be above the line one year and below the line in another.

The committee suggests a technical amendment to clarify the qualifications for broadly supported organizations covered by § 509(a)(2). It is not clear whether contributions which exceed 1 percent of a foundation's support may be taken into account in any respect. Accordingly, § 509(a)(2)(A)(ii) should read -- "not including the portion of such receipts from any person * * * which are in excess of 1 percent." Similar treatment is presently provided for publicly supported charities for the purposes of the unlimited charitable deduction. Treas. Regs. § 170-2(b)(5)(iii)(b). Apparently capital gains are not to be included for purposes of determining normal "support", but it is suggested that the proposed statutory language of section 509(a)(c)(A) and (B) be clarified in this regard.

Section 508 contains several relatively unrelated provisions and it is suggested that they be redistributed as follows:

Subsections (a), (b) and (c), which require § 501 (c)(3) organizations to register with the Commissioner and presumes them to be private foundations until a contrary showing is made, is applicable to all charitable organizations. Accordingly, it should be placed in Part I as a new § 504.

Subsections (d) and (e) deal with termination of private foundation status and should be joined to Section 507.

Subsection (g), which denies §501(c)(3) treatment to private foundations which do not have charter provisions incorporating the rules regarding self-dealing, income distribution, business holdings, speculative investment, and political and legislative activities, should be added to §509, which defines private foundations.

The Committee suggests that the operation and distribution rules for abatement of the tax on termination of foundation status be made parallel. Under § 507(e), the tax may be abated either by distribution to a § 170(b)(1)(B) organization or by operation for 5 years as either a § 170(b)(1)(B) organization, a broadly supported foundation (§ 509(a)(2)), or a satellite of one of the foregoing (509(a)(3)). Broadly based organizations are similar, but not identical, to § 170(b)(1)(B) organizations and distribution to one should occasion abatement. Charitable trusts should be entitled to abatement upon distribution to such foundations also. Compare §§ 4947(b)(5).

In allowing the Commissioner discretion to abate the termination tax, the statute provides no standard for withholding abatement. Either a standard should be added or the word "shall" should be substituted for "may" in the second line of § 509(e).

STATEMENT ON THE EFFECT PROPOSED CHANGES IN THE TAX LAW MIGHT HAVE ON SUCH NONPROFIT ORGANIZATIONS AS THE CENTER FOR INFORMATION ON AMERICA, INC., WHICH ENGAGE IN CIVIC EDUCATION

The Articles of Association of the Center for Information on America, incorporated in 1952 pursuant to the statute laws of the State of Connecticut, declare its objects and purposes to be:

"To foster, promulgate and disseminate among Americans generally of this state and other states American culture and ideals, a knowledge and understanding of American history, its meaning and purpose and its guarantees of personal and individual rights and privileges;

"To gather, compile and distribute information about all aspects and phases of life in America, and to make such information available by any means to educational or other institutions of any kind, for the purpose of carrying on studies of life in America."

". . . To gather, compile and organize such information by any and all means of research, study and recording, and to publish, print, circulate, distribute and disseminate such information by any and all means of communication, transmission and transcription."

An important part of this area is Civic Education.

Under date of May 22, 1953, the Center for Information on America, Inc., received from the Office of the Commissioner of Internal Revenue, U.S. Treasury Department, a letter stating that "It is the opinion of this office, based upon the evidence presented, that you are exempt from Federal income tax under the provisions of section 101(6) of the Internal Revenue Code, as it is shown that you are organized and operated exclusively for educational purposes." This became Section 501(c) (3) after the adoption of the Internal Revenue Code of 1954.

The Center's Editorial Advisory Committee (list of present membership appended), under whose general supervision its materials are produced, has maintained a policy of scrupulous objectivity, non-partisanship, and scholarly accuracy. Its success in living up to these standards is attested to by the comments listed in the accompanying exhibit, "*As Others See Us.*"

There are sections in H.R. 13270 which, in not modified in their wording by the Senate, could work great harm to non-profit, nonpartisan corporations dedicated to civic education even though, like the Center for Information on America, Inc., they have been classified as 501(c) (3) by the U.S. Treasury Department under the Internal Revenue Code.

As I understand the legislation, H.R. 13270 imposes a 100% tax on a foundation, and 50% tax on its trustees and officers who act knowingly, on the amount of any grant which carries out voter education or registration projects (unless grants are made to a 501(c) (3) organization, whose principal activity is nonpartisan political activity and which operates in five or more states, receives support from five or more organizations, no one of which provides more than 25% of its support, and does not receive funds earmarked for use in a particular area).

The Center carries out voter education, is completely non-partisan, operates in five or more states, may or may not receive support from five or more organizations, could receive more than 25% of its support from one organization, and has and could receive funds earmarked for use in a particular area such as health, conservation, civic curriculum in schools, etc.

If passed by the Senate, restrictions such as these could so influence Foundations that they would cease support even to organizations like the Center classified as 501(c) (3). Lack of such support would close the Center, putting and end to an organization which, over the past twenty years, has been producing excellent material for use in schools, colleges, libraries, government agencies, and industry. The Library of Congress, for example, rates our material highly and orders large quantities.

Such phrases as "attempts to influence legislation," or the carrying out of "voter education" could even be applied adversely to every university that has a Department of Political Science, for it is impossible to study the processes of government without including thought on ways of improving government. Surely the survival of our great experiment of self-government in the United States depends on an informed and conscientious citizenry. To borrow President George Washington's phrase, "It is essential that public opinion should be enlightened," and he advocated founding of institutions and academies, like the Center, devoted to that very objective.

The more the American people cultivate an intelligent understanding of public affairs, the greater is the likelihood that freedom and democracy will prevail and

flourish. To threaten the very existence of educational organizations devoted to civic education by laying obstacles in the way of their receiving foundation grants should not be the result, however unintentional, of any legislation.

Respectfully submitted,

TOWNSEND SCUDDER,
President, Center for Information on America, Inc.

CENTER FOR INFORMATION ON AMERICA,
Washington, Conn.

EDITORIAL ADVISORY COMMITTEE

James W. Fesler, Professor of Government, Yale University.
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W. Wingate Snell, Commission on American Citizenship, Catholic University of America.
Robert Spiller, Professor Emeritus of English, University of Pennsylvania, and Past-President of the American Studies Association.

INTERNATIONAL READING ASSOCIATION,
Newark, Del., August 27, 1969.

Hon. RUSSELL B. LONG,
U.S. Senate,
Senate Office Building,
Washington, D.C.

DEAR SENATOR LONG: A minor provision of the Tax Reform Bill recently passed by the House of Representatives (HR 13270) warrants careful scruitiny by the Senate Finance Committee before the bill is acted upon by the Senate.

The International Reading Association is one of the small professional educational organizations whose purpose is the improvement of reading instruction in schools. We are called upon frequently by government agencies for information, for assistance on projects, for the dissemination of information to our members and the general public. These services of the Association cost the government nothing.

Our income is derived from dues paid by our teacher-members, from advertising in our journals, from registration and exhibit fees at meetings we sponsor, and from the sale of our publications. We have taken scrupulous care that advertising and exhibits are directly related to the purposes for which our Association was granted exemption from income tax under PL 501 (C) 3.

The new bill specifies that all advertising and other income is unrelated business, with no possible recourse. We do not believe this is just. Distinctly unrelated income should properly be taxed. We believe that best interests of the country would be served by continuing the tax exemption on income which is specifically related to the not-for-profit purposes of an association. To do otherwise would be breaking faith with the many groups who collectively play an important part in our democratic society.

One solution might be to tax distinctly related income only after it reaches a substantial amount. This would not penalize groups like ours.

Our 35,000 members have a large stake in the upgrading of American education. We hope that you will recognize the injustice of this section of the Tax Reform Bill of 1969 and take steps to amend it. The cost to government in lost services from professional associations is likely to be far more than the monies brought in under this section.

Very truly yours.

RALPH C. STAIGER,
Executive Secretary-Treasurer.

MADONNA HOME,
Lincoln, Nebr., September 26, 1969.

Senator RUSSELL B. LONG,
Chairman, Senate Finance Committee,
Senate Office Building, Washington, D.C.

DEAR SENATOR LONG: I would like to express to you my concern over parts of the "Tax Reform Act of 1969" H.R. 13270.

While agreeing that tax reform measures are long overdue and being in full agreement with most of the Bill, such as taxation of unrelated business income, I do feel that the Bill can be improved by additions or changes in some areas.

I would suggest that non-profit nursing homes, skilled nursing homes, long term care institutions and homes for the aging should be specifically exempted by their inclusion as a 170(b) (1) (B) type exempt organization, just as hospitals are to be exempted. Any other approach would appear unreal and rather discriminatory as these facilities are providing a service equally as important as are the hospitals.

I also feel that a donor should be allowed to deduct the full present value of any property given to those institutions mentioned above, and that the donor should pay no capital gains tax on any appreciation of the property since its purchase.

Madonna Home is now in the process of building a $2,500,000 replacement facility to house 132 skilled nursing home residents. Had it not been for a gift of almost $400,000, which Madonna is using as its share to obtain Hill-Burton funds, we not only could not build the new building but the home would be forced to close its doors as the ancient facilities would no longer meet fire and health requirements. Were Madonna to close there would be some 115 residents with no place to go. Also almost 100 employees would be without jobs.

It is my opinion that this gift would not have been made had Bill H.R. 13270 been law at that time.

It would be my opinion that such charitable gifts should be encouraged, if for no other reason than to save the taxpayer money by furnishing funds for the care of the aged, which otherwise would probably have to come from one body of government or another.

Further improvements in other areas of the Bill could be made by following the suggestions to be made by Mr. Eugene Hackler when he represents the American Association of Homes for the Aging before the Senate Finance Committee on October 7, 1969.

Your attention to these matters will be greatly appreciated by those of us trying to serve the aged of the United States, and by the aged themselves who will be either the aided or the injured depending on your actions.

Sincerely,

WILLIAM A. SONDEREGGER,
Acting Administrator,
Madonna Home, Inc.

HYSTER CO.,
Portland, Oreg., September 22, 1969.

Hon. RUSSELL B. LONG,
Chairman, Senate Finance Committee,
Senate Office Building, Washington, D.C.

MY DEAR SENATOR LONG: I am writing you with respect to the Tax Reform Bill, H.R. 13270. I am sure you know a great deal more about the problems involved than I do but I cannot help urging that you and the other members of the Committee give serious thought to the inequity of the tax loopholes enjoyed by labor unions, specifically the exemption given to unions on their investment income and the exemption of all income of unions which is used in any kind of political activity.

This matter is of concern not only to manufacturers but to everyone in the United States. This is one place where a real attack on inflation can be made. I don't know of any better evidence than the folowing quotation from the Foreword of Donald R. Richberg's book, "Labor Union Monopoly":

"Americans are more out-of-date and ill-informed concerning the realities of the labor movement in the United States than they are in any other area of public interest. Fifty years ago, the picture of a labor union as a weak, idealistic organization of downtrodden workers struggling against an oppressive concentration of property power was often accurate. Any such picture of an estab-

lished union today is not merely ridiculous; it is willfully or ignorantly untruthful.

"Today the greatest concentrations of political and economic power in the United States of America are found—not in the over-regulated, over-criticized, over-investigated, and over-taxed business corporations—and certainly not in their hag-ridden, brow-beaten, publicity-fearful managers. The greatest concentrations of political and economic power are found in the under-regulated, under-criticized, and under-investigated, tax-exempt, and specially privileged labor organizations—and in their belligerent, aggressive, and far-too-often lawless and corrupt managers."

As you know, Donald Richberg was a labor lawyer and I believe wrote the Railway Labor Act of 1923 so he can scarcely be called prejudiced.

I sincerely hope the Committee will give very careful thought to this phase of the Bill.

Sincerely,

ERNEST G. SWIGERT.

SOUTHERN STATES INDUSTRIAL COUNCIL,
Nashville, Tenn., September 10, 1969.

Hon. RUSSELL B. LONG,
Chairman, Senate Finance Committee,
Washington, D.C.

DEAR SENATOR LONG: The most glaring loophole in the federal income tax law is the exemption given to the income of labor unions. Nothing was done to close this loophole in H.R. 13270, the House-passed tax reform bill which is now being considered by the Senate Finance Committee.

Labor unions have been the most vociferous of all organizations in demanding tax reform and the closing of tax loopholes. The reforms unions demand are aimed at further increasing the heavy tax burden borne by American business, and the so-called loopholes on which unions have concentrated their attacks are those applying to business, such as the investment tax credit, real estate depreciation write-offs, and the oil depletion allowance. Such tax provisions were placed in the law to stimulate investment by private enterprise so as to strengthen the national economy and provide more jobs and more goods and services for the American people.

Unions, through dues extracted from working men and women—frequently against their will, have amassed billions of dollars which they have invested in all types of income-producing property and enterprises—income that is tax exempt under present law. It has been estimated that the tax exempt income of unions amounts to about $3,000,000,000 per year, about half of it from the dues and fees paid by working people, and about half from unions' investments.

There is no justification for tax exemption of union investment income. H.R. 13270 would make the investment income of churches and foundations and other exempt groups subject to taxation for the first time. Why churches, but not unions?

Furthermore, the House bill makes 100% of the income of foundations which engage in political activities subject to federal income taxes. The same standard should be applied to labor unions which engage in political activities, which includes almost every union without exception. The use by unions of their tax exempt income from both dues and investments for direct contributions to favored political candidates and to maintain elaborate and expensive lobbying apparatus in Washington is highly improper.

Union officials and lobbyists have been completely silent on the inequitable tax advantages enjoyed by their organizations, while leveling their criticism at the tax structure for non-union businesses. The House Ways and Means Committee, unfortunately, let them get by with it.

The Southern States Industrial Council, representing approximately 3,000 business and industrial firms, urges the Senate Finance Committee to amend H.R. 13270 to eliminate the tax exemption presently given to the investment income of labor unions and remove the tax exemption from unions which make political contributions, attempt to influence legislation, or engage in any form of political activity.

Respectfully yours,

W. L. THORNTON, *President.*

AMERICAN SOCIETY OF CIVIL ENGINEERS,
New York, N.Y., August 14, 1969.

COMMITTEE ON FINANCE, WASHINGTON, D.C.

GENTLEMEN: In 1968 the Internal Revenue Service made certain arbitrary changes in the Income Tax Regulations under Sections 513 and 512 of the Internal Revenue Code which will result in the imposition of income taxes on advertising carried in our monthly technical and professional magazine, *Civil Engineering*. We are now greatly concerned with the import of certain provisions of the Proposed Tax Reform Act of 1969, H.R. 13270, which would justify the definition of our advertising revenue as "unrelated income" [Section 278 (5)(c)] and possibly impose taxes on our modest income from investments.

We can well understand the desire of the Congress and IRS to close tax loopholes that have favored certain self-interest foundations and organizations. It is most unfortunate, however, that these moves are encompassing many altruistic public service organizations—such as this Society—which are hard pressed to find adequate financial resources.

It has always been our philosophy that the tax exemption privilege that we enjoy should be earned by service in the public interest. To this end we have attempted wherever and whenever possible to provide assistance and advisory guidance to legislative bodies, on issues related to civil engineering, with a view toward the public welfare.

It is particularly important at this time that the unbiased viewpoint and judgment of the civil engineering profession be utilized in consideration of the vital urban environment problems that are plaguing our nation. We are now planning more effective means of mobilizing the technological brainpower resource that is represented by our 63,000 members—who represent the finest civil engineering talent in the world. By so doing we hope to be able to serve even more effectively in an advisory capacity to legislative bodies and to public agencies.

It is hardly logical, therefore, that our capacity to render public service should be limited by the recent moves to erode our tax exemption status. Certainly the tax income so generated will be minimal in comparison to our public service potential.

It is respectfully requested, therefore, that your Committee initiate amendments to the Tax Reform Act of 1969 that will (1) eliminate technical and educational organizations from the classification of "private foundations" for the purpose of this legislation, and (2) exempt from the definition of "unrelated income" any advertising or other income that is directly associated with the publication of technical and professional development material.

We earnestly believe that these recommendations are very much in the interests of our nation and its people.

Sincerely,

WILLIAM H. WISELY,
Executive Secretary.

THE CHILDREN'S AID SOCIETYY,
New York, N.Y., September 17, 1969.

Hon. RUSSELL B. LONG,
Chairman, Committee on Finance,
U.S. Senate, Washington, D.C.

DEAR SENATOR LONG: Because time limitations have not permitted us to prepare our testimony by the "cut-off" date, we have decided to waive the opportunity to testify on HR 13270, but request that you and your committee consider the following comments (and place them in the record) before reporting out the Senate bill.

For the reasons hereinafter set forth, we think the enactment of Title I (Tax Exempt Organizations) of the Tax Reform Act of 1969 ("the Bill")[1] at this time would have a burdensome, socially undesirable effect on our organization and many other public charities which the Bill is not intended to affect and might well result in increased public expenditures for services now carried by the voluntary sector. We, therefore, respectfully request that Title I be deleted from the Bill, and be scheduled for consideration in 1970.

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[1] All references to the Bill are to the form in which it passed the House.

From its inception in 1853,[2] the Society has been concerned with the plight of the urban poor and the basic causes which give rise to social disorders. The Society has responded to the needs of underprivileged, disadvantaged and deprived children and families of the New York metropolitan area through a success of programs both preventive and rehabilitative in nature.

Enclosed is a copy of the 1967-1968 report to the public which gives in some detail financial and other data pertaining to the Society.[3] The following is summary of the highlights.

The Society in its fiscal year ending 6/30/68[4] expended a total of $4,715,202 for its charitable purposes. All these expenditures were made in the operations of the Society, with few exceptions, by "direct expenditure" to or for the benefit of the assisted children. During the year the Society received income of $4,285,-659, and made up the deficit of $429,543 by withdrawals from unrestricted reserves. Included in the income of the Society was $1,816,361 received from the City of New York and other public sources as reimbursement for foster care of children under various statutory provisions and $167,556 in payments for children's care. The Society's income included $548,588 from donations for general purposes and $361,971 from donations for special purposes from approximately 60,000 doners. The Society received $1,067,378 from investments of unrestricted funds and $274,000 from investments of restricted funds. During the year the Society received an aggregate of $258,724 in bequests from 25 different donors, the largest of which was $101,400 and the smallest was $16.70. The number and size of bequests varies greatly from year to year. A list of these bequests appears in the enclosure.

The Society's services and charitable activities during its fiscal year ended 6/30/68 encompassed the following:

Children's Centers.—Recreational and educational help for needy and deprived children. In the wholesome environment of 7 Centers, children living in deprived areas feel that they are wanted and accepted. 99,832 children participated.

East Harlem Family Service Center.—4,268 persons were served from this Center in a blighted area.

Head Start Program.—The Society conducted 16 classes, served 260 little children in its Centers.

Child Adoption Service.—Through the Society's assistance, 242 children were served and 95 were adopted.

Foster Home Care.—560 children were cared for in foster homes.

Bowdoin and Vanderbilt Camps.—915 children were able to participate in summer camping on 327 wooded acres overlooking the Hudson River.

Wagon Road Camp.—253 physically handicapped were served at this camp.

Mental Health Service.—126 children were assisted who would otherwise be deprived of this service.

Health and Dental Services.—8,999 examinations, 13,837 visits and consultations and 56,582 dental treatments.

Vocational Guidance and Employment.—4,120 young adults and 1,142 job placements made.

Based on its activities, no one familiar with the Society would think it was not a "public charity." Although our counsel advise that we probably would be classified as a "public charity" under the Bill, the amount of our investment income, the varying proportion of our income received from contributions each year, and the restrictions imposed on grants by many donors, may raise a question as to whether or not the Society is a "private foundation" within the meaning of the Bill. Unless Title I is deleted, as we think it should be, we hope the Bill will be modified to make very clear that organizations such as ours will not be subject to the punitive taxes and procedures to be imposed on private foundations.

The proposals of the Bill (particularly those which would adversely affect the tax deduction for contributions of appreciated property, and which would place a burden on "private foundations" to ascertain whether donees are "public charities") would greatly impede and stifle our fund raising efforts. If the proposals in the Bill are enacted, we feel that our charitable activities in behalf of underprivileged children in the metropolitan New York area would have to be greatly curtailed and restricted at a time when the need and demand for such activities is greatly expanding.

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[2] The Society was incorporated in New York in 1855.
[3] The report was made a part of the official files of the committee.
[4] Data for the fiscal year ending 6/30/69 is not yet available.

A few years ago we received a $4,000,000 grant from the James Foundation. This foundation had been created by Arthur Curtiss James under his will. Under the provisions of the James Foundation's charter, it was required to liquidate at the end of 25 years, which it did. During the 25 year period of existence, substantially all of its net income (excluding capital gains) was distributed to operating charities and educational institutions including our organization. On termination, all of its assets were distributed among the charities and universities which participated in income distributions during the 25 year operating period. In addition to the Society, many universities and other public charities were the beneficiary of approximately $100,000,000 when it was terminated. This gift was placed in our endowment funds and has greatly assisted us in our expansion of services in the New York area. We think that the provisions of the Bill would foreclose the possibility of any such gifts in the future. If enacted, Title I of the Bill would also greatly undermine and perhaps curtail many gifts which we now receive from private foundations in the metropolitan area.

The proposed 7½% (or 2%) tax on investment income of charitable organizations is particularly iniquitous and would be a great burden. We think it is not justified by the asserted need to pay for examination and audit of charitable organizations. In our case, for example, we are now audited by the City of New York as well as by public accountants. Other, less injurious, devices exist or can be established to obtain compliance from private foundations. For example, the publication of full financial reports, distribution of reports to all donors, and tax return forms requiring more complete information to be filed with the Internal Revenue Service would go far to meet this need. Audit by independent accountants might reasonably be required.

For the foregoing reasons, we urge the Committee to defer any final action on Title I until 1970, after it has given full opportunity to all charitable organizations to consider the proposals and to present their views on the impact of the Bill. In this connection, it should be kept in mind that the Bill did not become generally available until late in August, when many persons concerned with this matter were on vacation.

In the event the Committee does not accept our recommendation and does include Title I in its proposals for recommendation this year, we hope the definition of "private foundation" will be modified and narrowed. As a possible clarification, we suggest that any organization which normally receives more than 10% of its funds from bequests and donations, if the total number of donors exceeds, say, twenty-five (counting each family as one) should be considered a "public charity." This category should be added to those enumerated in section 507(a) (as contained in section 101 of the Bill).

Section 201 of the Bill would amend section 170(b) (1) of the Code by redefining 30% organizations. Section (1) (B) (VI) reads: "an organization referred to in subsection (c) (2) which normally receives a substantial part of its support (exclusive of income received in the exercise or performance by such organization of its charitable, educational, or other purposes or function constituting the basis for its exemption under section 501(a) from a governmental unit referred to in subsection (c) (1) or from direct or indirect contributions from the general public."

The parenthetical remark in the above section "exclusive of income received in the exercise or performance by such organization of its charitable, educational, or other purpose or function constituting the basis for its exemption under section 501(a)" first appeared when this section was inserted by the Revenue Act of 1963. We find the meaning of this parenthetical remark, as applied to our activities ambiguous and unclear, and request that the Committee delete or clarify it. The existing regulations fail to adequately clarify its meaning, and the 1963 Committee report is not helpful in this respect.

With gratitude for your consideration of our request and with kindest personal wishes.

Sincerely,

MORGAN DIX WHEELOCK, *Chairman.*

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