TAX REFORM ACT OF 1969

20 32-

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 3 OF 7 PARTS

SEPTEMBER 15, 16, 17, AND 18, 1969

GENERAL OUTLINE OF ORAL AND WRITTEN TESTIMONY IN PART 3:

Capital Gains
Charitable Contributions
Deferred Compensation
Financial Institutions
General
Lump Sum Distributions Under Pension and Profit Sharing Plans
Moving Expenses
Restricted Stock
Stock Dividends

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APPENDIX C

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APPENDIX D

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TAX REFORM ACT OF 1969

MONDAY, SEPTEMBER 15, 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, Byrd, Jr., of Virginia, Williams of Delaware, Bennett, Miller, Jordan of Idaho, and Fannin.

Also present: Senator Cranston.

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

This morning the topic before the committee is the taxation of financial institutions—commercial banks, mutual savings banks, and savings and loan association.

The House bill tightens up on the bad debts reserve deductions taken by all these institutions with respect to their gains and losses on bonds and other corporate and governmental evidences of indebtedness.

While the Treasury Department generally supports the restrictive amendments in the House bill, it has suggested to the committee that a special deduction be made available to banks to encourage them to invest more of their assets in real estate loans.

The first witness this morning is the Honorable Preston Martin, Chairman of the Federal Home Loan Bank Board. Mr. Martin you may proceed with your statement.

STATEMENT OF HON. PRESTON MARTIN, CHAIRMAN, FEDERAL HOME LOAN BANK BOARD; ACCOMPANIED BY ERIC SLATTIN, OFFICE OF EXAMINATIONS AND SUPERVISION

Mr. MARTIN. Mr. Chairman, and members of the committee, it is a privilege to appear to testify on H.R. 13270. I will confine my remarks to the taxation of savings and loan associations. The Federal Home Loan Bank Board ("Board") urges the enactment of a tax incentive on residential real estate loans; a deduction based upon a percent of gross interest income from these loans, the so-called administration proposal.

The Board further suggests the consideration by this committee of a stronger incentive on the same deduction basis, based on gross mortgage income derived from conventional, that is uninsured, mortgage loans to moderate and low income households. If the administration's "5-percent deduction" is adopted, the Board requests consideration of a 10-percent deduction for gross income so derived.

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FHLBB opposes the tax definition of a savings and loan association contained in H.R. 13270. H.R. 13270 first describes a savings and loan as an insured institution or one which is subject to regulatory supervision and examination. The Board believes that this is an adequate definition and that to go further inhibits the adaptability of the savings and loan industry in a changing environment.

The present application of the tax law to "supervisory" mergers or acquisitions of assets instituted by it in the public interest should be relieved in this tax effort.

This Board appreciates that the committee, the Congress, and the administration must act as Solomon in balancing the revenue needs of the Nation with the potential impacts of tax legislation upon the means for obtaining our many national goals. Housing is and should be paramount among these goals, and housing for moderate and low-income households is a goal which is fundamental to our social stability. The Board supports the tax deductions approach based upon a percentage of gross interest income in the taxation of savings and loans. It does so because the deduction approach has those virtues of simplicity and clarity in contrast to the complications and ambiguities of the present "bad debt reserve" approach. The deduction approach has the social virtue of widening the incentives for residential lending to non-savings and loan institutions. It will be 1970 in just 15 weeks. Financing the great housing needs of this Nation in the 1970's of something like 26 million additional units and tens of millions of sales transactions necessary in the existing inventory to move the new units is a task of such herculean magnitude that all lending institutions should be stimulated to participate.

The Federal Home Loan Bank Board is in present dialog with the Treasury as to considerations of the 5-percent deduction rate, its phase-in curve over time, and the deduction percentage which may be recommended as additional incentive for uninsured, unguaranteed loans to moderate- and low-income households.

I respectfully ask the committee that the Board be granted the privilege by the committee of submitting a supplementary statement of the above issues prior to the closing of these hearings.

If I may depart from the prepared text, Mr. Chairman, why continue special tax treatment for mortgage lending but in an improved form? Every developed country in the world has special incentives for housing. We have had in our institutional framework such incentives for over 30 years of our history. Mortgage money will not manage itself, and in the past 10 years the mortgage as an investment has lost out to other investments for financial institutions. It has lost out to business loans. It is easier today to finance inventory or to finance a new plant to produce gadgets or widgets; easier today to finance one more shopping center than it is to finance a neighborhood of homes and apartments for families. The mortgage instrument has lost out to consumer credit instruments. It is easier to finance dancing lessons or a trip to Paris than an inner city housing project for the disadvantaged.

Most of the time investments in mortgages are less desirable to institutional investors because the net yield to them is less, families will pay only so much for housing credit. The money is tied up many times as long by the investors and there is little or no secondary market aside from Fannie Mae, and there only for FHA–VA mortgages. An incen-

tive is required today more than ever because investors turn away from credit for housing in our recurring tight money periods; 1966 and 1969 are the outstanding examples.

Mortgage interest rates on 25- and 30-year mortgages already on the books aren't raised when market interest rates go up. Contrast that with the situation in which most commercial bank loans carry escalation clauses.

You can't expect a lender to tie up his money in a 25-year, 7¾-percent mortgage when he can finance a dealer inventory of color TV's at 9 percent and turn the money over in 6 months. So it is easier to finance that second or third color TV than an apartment to put it in.

H.R. 13270, Mr. Chairman, has a number of tax incentives to individuals and to investors in housing itself. I respectfully ask you to consider how we are going to stimulate large amounts of housing if the incentive is only to that individual or corporation which puts up 5 percent or 10 percent of the development cost, while the financial institution putting up 90 percent or 95 percent (often 100 percent), before the project is completed, has no specific incentive at all. The Federal Home Loan Bank System is currently advancing funds to member institutions so they can finance FHA projects in inner cities. There is not even adequate money for these insured risks at this time. Certainly there will not be funds for quicker, more flexible approaches of the private lender for his community where Federal guarantees and insurance do not have to be waited for. A more generous tax deduction such as 10 percent would do much to provide incentives in this necessary area.

H.R. 13720 proposes to reenact—with modifications—the existing tax definition of a savings and loan association.

H.R. 13720 first describes a savings and loan as an insured institution or one which is subject to regulatory supervision and examination. The Board believes that this is an adequate definition and all that is needed is the tax law. To go further inhibits the ability of the industry to adjust to today's changing consumer demand structures.

Let me make reference to a 3-year study of some 3,500 pages in length chaired by Professor Irwin Friend of the University of Pennsylvania, Wharton School. The Friend study recently completed, has shown that the economics of the industry are changing dramatically and will continue to change in the short term. While the industry has grown throughout the postwar period, profitability has declined from 12.5 percent of net worth in 1962 to 4.1 percent in 1967. During this same time period, the rate of growth of associations' deposits, the rate of growth has continually declined. By the mid-1960's it was well below that of the commercial banks.

Professor Friend also found that there are pronounced economies of scale in the financing of residential mortgages. It is cheaper to finance a lot of mortgages than to finance a few. This lead to the conclusion that mortgage lending can be handled more efficiently by specialized institutions like savings and loan associations, originating volumes of mortgages, than by diverse institutions like commercial banks, which are sporadic mortgage lenders.

All of this evidence of changing economics leads the Board to believe that less rigid definitions are needed rather than more stringent ones.

Rigid definitions of permissible asset percentages also place the Congress in an awkward position in the changing times.

Based on the existing language of the savings and loan definition, the Treasury in 1962 published certain tests—the "gross income" test and the "sales activity" test—to determine whether an association was "investing in loans" as required by the statute. The "gross income" test was conceived when the industry apparently was extremely profitable and was designed to limit availability of the savings and loan tax shelter to income generated by the traditional savings and loan activities. The test is met if 85 percent of an association's income is normal savings and loan operating income.

The sales activity test has further onerous consequences. The test was designed to limit an association's ability to sell loans or loan participations even though the sale may have resulted from a deficiency of demand for loans over savings capital in the association's geographical area. Such a restriction directly conflicts with the public objective of furthering optimal geographical allocation of funds. With a forecast overall shortage of mortgage capital over the next decade, it seems all the more important that the barriers to such funds flows should be removed.

Finally, the proposed tax definition in H.R. 13270 sets forth an elaborate structure as to the mix of assets which a savings and loan association must hold. An association must fall within this framework to maximize its bad-debt deduction under the bill.

The Board sees no need for any asset test in the presence of regulatory limitations for federally chartered associations and cease-and-desist powers to prevent unsafe or unsound concentrations of investment in nontraditional types of assets—generally the types which are now limited in the Board's regulations.

There is a further reason. The "asset tests" included in H.R. 13270 probably would be difficult to change during the next decade. Who can say today what asset will be in the public interest during the 1970's in order to optimize the savings and loan industry's contributions to housing? Mobile home lending is an example of the "forbidden asset" of the 1960's, one of sudden strong growth and of moderate-income service ability today.

The present tax law as it applies to the mergers of savings and loan associations—makes the supervisory merger in many cases very difficult or impossible. Let me explain what I mean by a supervisory merger as opposed to a business merger. A supervisory merger is encouraged or instituted in the public interest by the FSLIC and the FHLBB, involving one or more savings and loans with financial or managerial problems. A business merger is initiated by member savings and loans for objectives like economies of scale or market entry.

Now, it is the application of the tax law to the supervisory merger which concerns the Board. The problem is that under current tax law—including section 593(f)—tax deducted reserves may be subject to recapture; and, if this is the case, the tax must be taken from existing net worth which is usually already too thin. This effectively bars some otherwise desirable merger candidates or unduly limits the available supervisory solutions.

The Board recommends that the tax law be amended to state that there would be no recapture of reserves in a tax-free reorganization for clarification, even though the Internal Revenue Service recently published a ruling which supports the conclusion that there is no restoration required in nontaxable mergers.

If I may digress for a moment, in summary, the Board is arguing for, first, a tax incentive for mortgage lending by any lender. A tax deduction as the approach, not a bad debt allowance.

Second, that incentive be greater for riskier conventional loans to moderate- and low-income families and that that additional incentive be provided for all lenders.

Third, that the definition of a savings and loan for tax purposes be that its accounts are insured by the Federal Savings and Loan Insurance Corporation and that it is subject to supervision and examination.

And fourth, the Board recommends that supervisory mergers, in supervisory mergers that the tax deducted reserve be not subject to recapture.

Thank you very much, Mr. Chairman.

Senator ANDERSON. Senator Williams.

Senator WILLIAMS. Mr. Martin, in the House bill there is no provision for any 5-percent deduction at all, is that correct?

Mr. MARTIN. That is correct, Senator Williams.

Senator WILLIAMS. And you are recommending that it be made 10 percent instead of 5?

Mr. MARTIN. I am recommending, Senator Williams, that this approach, the tax deduction approach be used. The Board is currently working with the Treasury as to the exact percentage. We are recommending for a special class of loans, those are made to moderate- and low-income families, that there be a 10-percent deduction if the committee in its wisdom sees fit to adopt a 5-percent deduction for normal mortgage lending.

Senator WILLIAMS. In principle, what difference would there be in this and in what we allow for depletion allowance?

Mr. MARTIN. This is Mr. Eric Stattin who is head of the Examinations and Supervision Office of the Federal Home Loan Bank Board, a former, I guess I should say a present, CPA, formerly in tax auditing activity with Arthur Anderson & Co.

Mr. STATTIN. Senator Williams, I believe there is no difference in substance or in theory between the deduction, as I understand it, as proposed by the Treasury and the depletion type of deduction that is available in the natural resources or in the oil and gas industry, for example.

Senator WILLIAMS. Comparable in principle.

Now, these mortgages that you are referring to are insured by the Government to begin with, are they not, most of them?

Mr. STATTIN. I don't believe that the bulk——

Senator WILLIAMS. The FHA?

Mr. STATTIN. The bulk of the S. & L. industry's loans are not.

Senator WILLIAMS. The bulk of them would not be?

Mr. STATTIN. Yes.

Senator WILLIAMS. But part of them would be?

Mr. STATTIN. There is an existing stock of mortgages held by the savings and loan industry that are insured or guaranteed.

Senator WILLIAMS. Are they not absorbing any currently that are guaranteed?

Mr. STATTIN. I am sure they are at the present time.

Senator WILLIAMS. So they would be a part, a portion of this?

Would you want that, are you suggesting that, this depletion allowance or this deduction apply to mortgages insured by the U.S. Government as well?

Mr. STATTIN. Well, I would say if you are referring to the 10-percent additional, 5 percent over the administration proposal, that was intended to apply to a special class of loans, that is uninsured and nonguaranteed, I would say the answer to your question is "No."

Senator WILLIAMS. If we adopt your proposal would there be any increase in taxes as far as the savings and loans are concerned as compared with existing law? Wouldn't it result in pretty much a reduction as compared with existing law rather than an increase?

Mr. MARTIN. Senator Williams, if I may speak to that, Senator, I think there are two offsetting effects: If the committee or the Congress were to adopt an additional 5-percent deduction for conventional loans to moderate- and low-income households, I take it that is the thrust of the question. Part of such lending since it would be uninsured and unguaranteed, would be funded by the Federal Home Loan Bank System, and so it is our view, and our projection, that there would be mortgage loans made which would otherwise not be made and so there would be, I think, the offset of additional taxation which arises from the taxation of the income generated by these loans which would be partly offset by the deduction. It is not a 100-percent deduction.

Senator WILLIAMS. I don't want to continue this, but the net effect of adopting all of your recommendations in their entirety, would it not result in a reduction in taxes for this industry rather than an increase?

Mr. MARTIN. Senator, I will have to defer to the Treasury, to the submission of Treasury evidence on this. The Federal Home Loan Bank Board thinks it knows something about mortgage financing but I would hesitate for ours to be the principal testimony on the tax effect, if I may, sir.

Senator WILLIAMS. No further questions.

Senator ANDERSON. Senator Bennett.

Senator BENNETT. No questions.

Senator ANDERSON. Senator Miller.

Senator MILLER. Mr. Martin, I recently met a group of savings and loan people in my State and most of them indicated that under the House bill they would be paying substantially more taxes and that as a result of paying substantially more taxes, they would have to charge more interest. Have you considered the possibility that the impact of the bill might aggravate the high-interest situation for home mortgages?

Mr. MARTIN. Well, I am sure that the savings and loan managers, those savings and loan managers who would find themselves paying more tax, and again I am not an expert on the tax impact on the proposed bill, might try to pass on the additional tax in the form of higher interest rates. I am not sure they would succeed in this, Senator, because, as I said in my testimony, a family will only pay so much for mortgage interest rates.

I think, the Board thinks, that to the extent there is a tax effect it would tend to come from the accumulation of reserves not in the form of higher interest rates or more of it would come out of net profit after tax, which is allocated to the reserves of a savings and loan. I think much less of it would come out of higher rates.

Senator MILLER. Well, they pointed out to me that they are locked in on low-interest loans that are outstanding, and probably will be for another 10 or 15 years, and that this is going to have quite an impact on their operation. It would seem to me that it would be helpful to the committee if you could have your tax counsel provide us with two or three examples of the impact of this bill on a typical S. & L.

Mr. MARTIN. We will be glad to file that testimony, Senator.

(Information subsequently received follows:)

TAX BILL IMPACT ON TYPICAL SAVINGS AND LOAN'S AVERAGES FOR GROUP[1] 1968

[In thousands]

	Small, under 2,500,000	Medium, 10 to 17,500,000	Large, 100,000,000 and over
Savings capital	,286.0	12,918.1	218,599.8
Gross operating income	85.2	873.7	15,771.9
Operating expense	20.9	165.6	2,625.2
Net income before taxes	62.8	694.0	12,499.0
Dividends	55.8	590.0	10,621.2
Net taxable income	7.0	104.0	1,877.8
60-percent deduction	4.2	62.4	1,126.7
Taxes (48 percent)	1.3	20.0	360.5
Net after tax	5.7	84.0	1,517.3
45-percent deduction	3.2	46.8	845.0
Taxes (48 percent)	1.8	27.5	496.2
Net after tax	5.2	76.5	1,381.6
30-percent deduction	2.1	31.2	563.3
Taxes (48 percent)	2.4	34.9	631.0
Net after tax	4.6	69.1	1,246.8
Number of associations	547	912	218

[1] The estimates are based on 1968 operating figures from the "Combined Financial Statements," FHLBB.

Senator MILLER. Now, you referred to this 10 percent additional deduction for moderate- and low-income housing. How do you define moderate and how do you define low income?

Mr. MARTIN. Well, Senator, there are two, basically two, approaches that have been taken in this area. One is that in each city, let's say, in each county and city, that the definition done by the appropriate agency of HUD in that city be used. HUD has already defined these terms for the various areas of the country, and one approach which we would be perfectly willing to do would be to accept the HUD definitions in each place in which they worked.

The approach taken by the State of California in a tax credit and special bad debt deduction for moderate- and low-income housing is an alternative approach which would be acceptable to us. In this particular bit of legislation, legislation in the State of California, it simply uses a definition of average income as provided by the Department of Commerce for the State of California each year, and conventional loans made to families with income below that average qualify for the California tax treatment.

Senator MILLER. As moderate?

Mr. MARTIN. As moderate.

Senator MILLER. Or low income?

Mr. MARTIN. Well, anything below that qualifies.

Senator MILLER. Well, it seems to me that we have such a tremendous task ahead of us with respect to the low-income families and people of this country, that you wouldn't want, at this time to dilute your efforts. Why not limit this 10 percent to the low-income housing?

Mr. MARTIN. Well, because, Senator, there is such a shortage of housing and such a difficulty of financing for the moderate-income family, I mean that many of these families have rather large numbers of children, and they are in the moderate-income class. They are in the $7,000 or $8,000 a year situation, but that is gross before taxes and they have many children to take care of and they have difficulty in finding financing for housing. So I would hesitate to exclude this great bulk of Americans from a special tax treatment, sort of let the middle alone, so to speak.

Senator MILLER. If you are going to set priorities where are you going to go first? If you only have so much in the way of lending capacity, so much in the way of appropriations to cover this 10 percent, doesn't it seem fair that we concentrate on the low-income area first and then after we take care of that move into the next level which is in need. Certainly moderate-income people are not as badly off as the low-income people. That is the reason for the definition, and if I understand some of the statistics we have been receiving in the last 2 or 3 years we have a tremendously long way to go in just the low-income area, let alone diluting our efforts there and moving into the moderate-income area.

Mr. MARTIN. The Senator is certainly right. We have a long way to go in each of these areas.

Senator MILLER. Well then, why not set our priorities and concentrate on the low-income areas first and then when we clean that one up then we can move into the moderate income area, instead of diluting the effort.

Now, if we can do both that is one thing, but if I understand the budget picture we can't, and until we do, I think we should concentrate on first things first, which is the low-income area and then move into the moderate-income area.

Mr. MARTIN. I certainly can understand the set of priorities and appreciate them.

Senator MILLER. Well, I appreciate your understanding of them but we are looking to you for some guidance on this. I think it might be helpful, if you haven't furnished this in your statement, to give us an idea of the areas by volume of mortgage requirements so that we might make a decision on whether or not we can do both.

Mr. MARTIN. We will be glad to furnish that.

Senator MILLER. With the low-income and moderate-income and using HUD definitions perhaps.

Mr. MARTIN. All right, we will be glad to.

Senator MILLER. Thank you.

(Information subsequently received follows:)

MORTGAGE LOAN REQUIREMENTS ON NEW UNITS

[Billions of dollars]

	Assisted		Unassisted	
	1-4 family	Multifamily	1-4 family	Multifamily
1969	0.5	0.6	16.5	5.9
1970	1.2	.8	17.4	6.3
1971	2.4	2.3	17.0	7.2
1972	2.8	2.4	16.5	9.2
1973	3.5	2.7	15.9	11.6
1974	4.7	3.3	15.9	13.9
1975	5.2	3.4	16.4	14.8

Note: We would estimate that the assisted units would all be for low-income families and some fair proportion of the unassisted units would be for moderate-income families. We regret that exact figures on the needs of moderate-income families are not available.

Senator ANDERSON. Senator Jordan.

Senator JORDAN. No questions.

Senator ANDERSON. Senator Byrd.

Senator BYRD. No questions.

Senator ANDERSON. Senator Fannin.

Senator FANNIN. Mr. Chairman, I would like to ask Mr. Martin a question. When we are talking about the low-income families and the needs that exist in this Nation, I don't know whether your particular concern deals in the areas where we have Indian populations, but in my State and Senator Anderson's State we do have a great problem as far as housing is concerned. In fact the greatest need for improvement in housing does exist on the Indian reservation and still we are not in a position presently to provide loans for these Indian citizens.

Do you feel that going as far as a 10-percent deduction on low-income loans would really accomplish anything in this regard?

Mr. MARTIN. I think it would, Senator. In terms of the existing FHA subsidy program, the home loan bank board today has announced a new program to fund those projects through the member institutions around the country, including the States here represented on this committee.

The 10-percent deduction, I think, will stimulate lending in the kind of loan which to management, in their experience, has a higher risk than their ordinary kind of lending, and I believe our job is to fund both a subsidy program which would go to the poorest family and, secondly, to encourage lending on these riskier loans of all kinds.

Senator FANNIN. Well, Mr. Martin, I realize that these loans in most instances would come under the subsidy program. But I am concerned about the loans to individuals as well as the loans that are placed through the tribe, because we are trying to encourage the individuals to come forward and to have a goal that they perhaps can reach. The way it has been in the past the individual Indian citizens did not have any source of loan money, and if we could provide something in this legislation that would assist them, I think it would be very worthwhile. I thought you might have some thoughts in this regard.

Mr. MARTIN. I think the tax credit, Senator—the tax deduction—is the most promising vehicle before us. The difficulty of raising enough subsidy funds is well known and although our board is fully in support of those programs our concern is that there will not be enough subsidy funds, there won't be enough to fill this tremendous housing gap and, therefore, we feel that there needs to be incentives to the conventional loan in the nonsubsidy area, and 10 percent is simply the figure we are discussing with the Treasury with what we have come up here.

What we are really saying to the committee is we are making a plea for additional incentives for low or moderate income lending. It does not have to await the appropriation of subsidy funds so we are open on the percentages. We are simply making a plea there be a higher deduction to encourage this kind of lending.

Senator FANNIN. Mr. Martin, I certainly am in sympathy with what you have stated. I am wondering though if we do have the 10-percent deduction on low-income loans if it will reach this need. How can we assure that it will reach that individual who today is just left not helped.

Mr. MARTIN. Well, our only statement can be from this Board's point of view, Senator, that we are doing everything we can to encourage the member institutions to move more strongly into this area. We will use the facilities of the Home Loan Bank which serves your district to encourage and to give technical advice to savings and loans. We will do everything we can to further this kind of lending. As I say we are embarking on a funding program to channel funds directly in so that the announcement today embodies this action. Only subsidy programs approved by HUD will be eligible for a special kind of advance from the Home Loan Banks. We took this action because we were shown many examples in which funding, mortgage funding, was not available. Equity funds were there, the investor was ready to go but there was no mortgage money and so we have taken that action that will directly go to those subsidy programs.

Senator FANNIN. But that will not be on a percentage basis. You say going directly but how will the amount be determined or is there any formula that would assure that this money would go in that direction?

Mr. MARTIN. Oh, yes. The funds are only available, as I say, for HUD approved subsidy programs.

Senator FANNIN. Yes.

Mr. MARTIN. And the lending institutions, and it looks as though these will be groups of institutions in most cases, not individual institutions, will have to certify and show the project, where it is, show the approval of HUD in the papers they file and certify, the managing officer certify, that the funds will be only used in this subsidy project in a million dollars amount.

Senator FANNIN. Thanks very much.

Senator ANDERSON. Any further questions?

Thank you very much.

Mr. MARTIN. Thank you very much.

(Preston Martin's prepared statement follows:)

STATEMENT OF PRESTON MARTIN, CHAIRMAN, FEDERAL HOME LOAN BANK BOARD

Mr. Chairman and Members of the Committee:

It is a privilege to appear to testify on H.R. 13270. I will confine my remarks to the taxation of savings and loan associations.

SUMMARY

The Federal Home Loan Bank Board ("Board") urges the enactment of a tax incentive on residential real estate loans: a deduction based upon a percent of gross interest income from these loans, the so-called Administration proposal.

The Board further suggests the consideration by this Committee of a stronger incentive on the same deduction basis, based on gross mortgage income derived from conventional mortgage loans to moderate and low income households. If the Administration's "5 percent deduction" is adopted, the Board requests consideration of a 10 percent deduction for gross income so derived.

FHLBB opposes the tax definition of a savings and loan association contained in H.R. 13270. H.R. 13270 first describes a savings and loan as an insured institution or one which is subject to regulatory supervision examination. The Board believes that this is an adequate definition and that to go further inhibits the adaptability of the savings and loan industry in a changing environment.

The present application of the tax law to "supervisory" mergers has been in need of revision. Under current tax law, tax deducted reserves may be subject to recapture upon merger or acquisition of assets. Where this is the case, the tax would be taken from existing net worth, and this estops the merger. The Board believes that, at a minimum, "supervisory" mergers or acquisitions of assets instituted by it in the public interest should be relieved of this tax effect.

STATEMENT

TAX REFORM AND INNER-CITY INVESTMENT

This Board appreciates that the Committee, the Congress, and the Administration must act as Solomon in balancing the revenue needs of the Nation with the potential impacts of tax legislation upon the means for obtaining our many national goals. Housing is and should be paramount among these goals, and housing for moderate and low income households is a goal which is fundamental to our social stability. The Board supports the tax deductions approach based upon a percentage of gross interest income in the taxation of savings and loans. It does so because the deduction approach has those virtues of simplicity and clarity in contrast to the complications and ambiguities of the present "bad debt reserve" approach. The deduction approach has the social virtue of widening the incentives for residential lending to non-savings and loan institutions. Financing the great housing needs of this Nation in the 1970's of something like 26 million additional units and tens of millions of sales transactions necessary in the existing inventory to move the new units is a task of such Herculean magnitude that all lending institutions should be stimulated to participate.

The Board is in present dialogue with the Treasury as to considerations of the 5 percent deduction rate, its phase-in curve over time, and the deduction percentage which may be recommended as additional incentive for uninsured, unguaranteed loans to moderate and low income households.

I respectfully ask that the Board be granted the privilege by the Committee of submitting a supplementary statement of the above issues prior to the closing of these hearings.

FHLBB is certain that H.R. 13270 lacks specific incentive to lending institutions of all kinds for funding the development and redevelopment of Inner-City and other urban housing for moderate and low income Americans. The Board would argue that there are few more pressing, essential needs than housing for these Americans. A most frequently overlooked social relationship is the high correlation between better housing, productivity and social stability. Again and again in our history, ethnic groups have exhibited the upward social mobility which has contributed so much to our culture and our national strength. A better job may be the first step but a better apartment and then a house of your own is certainly the second one. That apartment or that house, in turn, increases a sense of family unity and spurs an adult member of the family group to great economic incentive to further material goals.

H.R. 13270 has a number of tax incentives to individuals and to investors in housing. I respectfully ask you to consider how we are going to stimulate large amounts of housing if the incentive is only to that individual or corporation which puts up 5 percent or 10 percent of the development cost, while the financial institution putting up 90 percent or 95 percent (often 100 percent), before the project is completed, has no specific incentive at all. The Federal Home Loan Bank System is currently advancing funds to member institutions so they can finance FHA projects in Inner-Cities. There is not even adequate money for these insured risks at this time. Certainly there will not be funds for quicker, more flexible approaches of the private lender for his community where Federal guarantees and insurance do not have to be waited for. A more generous tax deduction such as 10 percent would do much to provide incentive in this necessary area.

TAX DEFINITION OF A SAVINGS AND LOAN

H.R. 13720 proposes to re-enact—with modifications—the existing tax definition of a savings and loan association.

H.R. 13720 first describes a savings and loan as an insured institution or one which is subject to regulatory supervision and examination. The Board believes that this is an adequate definition and all that is needed is the tax law. To go further inhibits the ability of the industry to adjust to changing consumer demand structures.

The Friend Study, recently completed, has shown that the economics of the industry are changing dramatically and will continue to change in the short term. While the industry has grown throughout the postwar period, profitability has declined from 12.5% of net worth in 1962 to 4.1% in 1967. During this same period of time, the rate of growth of associations' deposits has continually declined. By the mid-1960's, it was well below that of commercial banks.

Due to the long-term nature of the mortgage instrument, savings and loans cannot adjust to market interest rate changes. In view of their large holdings of older low-interest mortgages, many associations are not always in a position to raise new money whenever it is needed. To counteract this, the Friend Study has suggested that greater flexibility be introduced into association asset-liability structures. They are now borrowing short-term money and lending long-term funds. In order to allow associations to compete with commercial banks for funds, Friend argues that this asset-liability imbalance must be corrected.

Friend also found that there are pronounced economies of scale in the financing of residential mortgages by associations. This leads to the conclusion that mortgage lending can be handled more efficiently by specialized institutions like savings and loan associations than by diverse institutions like commercial banks.

All of this evidence of changing economies leads the Board to believe that less rigid definitions are needed rather than more stringent ones. Rigid definitions of permissible asset percentages also place the Congress in an awkward position. On the one hand Congress rightly charges the FHLBB with certain authority to regulate the savings and loan industry in the public interest. On the other hand, in a search for revenue, it overlaps that authority by imposing a certain rigid limit like the "82% rule."

H.R. 13270 does not stop here, but rather goes on to describe specifically the business and activities of a savings and loan: "substantially all of the business of which consists of acquiring the savings of the public and investing in loans." This re-codification of an apparently "practical" provision presumably continues in effect certain Treasury regulations which may conflict seriously with the Board's housing policy objectives. During periods like 1966 and 1969 of rising interest rates and low savings inflows, long-term lenders should be encouraged to maintain a relatively high velocity of cash flow—to serve their borrwing public—this is generally possible only through a vigorous loan sales or participation program which turns over the mortgage inventory. The "investing in loans" requirement is directly counter to this basic policy objective.

Based on the language of the savings and loan "definition", the Treasury in 1964 published certain tests—the "gross income" test and the "sales activity" test—to determine whether an association was "investing in loans" as required by the statute. The "gross income" test was conceived when the industry apparently was extremely profitable and was designed to limit availability of the savings and loan tax shelter to income generated by the traditional savings and loan activities. The test is met if 85 percent of an association's income is normal savings and loan operating income. Not only is the test difficult to administer,

but an association could be forced beyond the allowable limit by the FHLBB or perhaps a counterpart state regulatory authority—as when required to develop or sell excessive real estate holdings. In many cases, the requirement tends to encourage management decisions which are not in the best long-run interests of the institution.

The "sales activity" test has further onerous consequences. The test was designed to limit an association's ability to sell loans or loan participations even though the sale may have resulted from an excess of demand for loans over savings capital in the association's geographical area. Such a restriction directly conflicts with the public objective of furthering optimal geographical allocation of funds. With a forecast overall shortage of mortgage capital over the next decade, it seems all the more important that the barriers to such funds flows should be removed.

Finally, the proposed tax definition in H.R. 13270 sets forth an elaborate structure as to the mix of assets which a savings and loan association must hold. An association must fall within this framework to maximize its bad-debt deduction. The Board sees no need for any "asset test", in the presence of regulatory limitations for Federally-chartered associations and cease-and-desist powers to prevent unsafe or unsound concentrations of investments in nontraditional types of assets, (generally the types which are now limited in the Board's regulations).

There is a further reason. The "asset tests" included in H.R. 13270 probably would be difficult to change during the next decade. Who can say today what asset will be in the public interest during the 1970's in order to optimize the savings and loan industry's contribution to housing? Mobile home lending is an example of the "forbidden asset" of the 1960's, one of sudden strong growth and of moderate income service ability. With hindsight one could now argue that both the tax law and the National Housing Act should have been changed earlier in recognition of the social need for this type of housing. The Board respectfully submits that Congress and the Board will have a better posture from which to respond to changing circumstances or, perhaps more importantly, to anticipate a need for change without detailed enumeration of assets.

The Treasury proposal would effectively solve most of the problems created by the existing law and those which would be continued by H.R. 13270.

MERGERS

The present tax law—as it applies to the mergers of savings and loan associations—makes the "supervisory" merger in many cases very difficult or impossible. Let me explain what I mean by a "supervisory" merger as opposed to a "business" merger. A "supervisory" merger is encouraged or instituted *in the public interest* by the FSLIC and the FHLBB, involving one or more savings and loans with financial or managerial problems. A 'business" merger is initiated by member savings and loans for objectives like economies of scale or market entry.

Business marger applications are approved or disapproved by the Board depending upon a variety of criteria (such as whether the interests of the consumer—both the saver and the mortgage borrower—are better served by larger size competitors).

It is the application of the tax law to the "supervisory" merger which concerns the Board. The problem is that under current tax law—including Section 593(f)—tax deducted reserves *may* be subject to recapture; and, if this is the case, the tax must be taken from existing net worth which is usually already too thin. This effectively bars some otherwise desirable merger candidates or unduly limits the available supervisory solutions.

First, in a so-called non-taxable or tax-free reorganization—two mutuals merge or two stock associations merge and no cash changes hands—the supervisory agencies usually insist that the parties obtain an Internal Revenue Service ruling that there will be no restoration of the reserves under 593(f). Such a ruling is vital because adverse tax consequences would be disastrous to the adequacy of net worth. However, obtaining a tax ruling is a time-consuming task and in a supervisory merger time can be of the essence.

Therefore, the Board recommends that the tax law be amended to state that there would be no recapture of reserves in a tax-free reorganization for clarification, even though the Service recently published a ruling which supports the conclusion that there is no restoration required in non-taxable mergers.

However, the Board is even more concerned that current tax law would (at least in the Internal Revenue Service's view) subject a savings and loan's reserves to tax in the supervisory merger of a stock association into a mutual or vice versa—even when there is no economic gain to the disappearing shareholders and almost certainly no gain to either of the corporate parties to the merger. This rule in effect eliminates the possibility of a supervisory merger of a "problem" association—either a stock or mutual—into a stronger association which does not operate under a similar charter.

The Board would propose to allow the acquired association to carry over its tax deducted reserves in a supervisory merger provided the consideration paid for the acquired association either: (1) flows from the tax paid earnings of *either* association, or (2) from a non-savings and loan association such as a holding company. However, in no event should there be recapture in excess of the cash consideration paid for the savings and loans. In such a case, the recapture potential would carry over to the acquiring association; but there would be *no* current tax impact or reduction in net worth thereby . . . which is in the public interest.

The Administration proposal, over time, would tend to minimize this problem. Perhaps at some appropriate time a complete examination of the nature of savings and loan reserves and net worth could be undertaken with the objective of clarifying the nature of such accounts and the circumstances under which they may be subject to tax.

Senator ANDERSON. Mr. Alexander.

STATEMENT OF WILLIS W. ALEXANDER, PRESIDENT, THE AMERICAN BANKERS ASSOCIATION

Mr. ALEXANDER. Good morning, Senator Anderson and members of the committee.

I am Willis Alexander, the president of Trenton Trust Co. in Trenton, Mo., and president of the American Bankers Association. I am accompanied to this hearing by Charles McNeill who is the director of our Washington office.

I appreciate this opportunity to testify for the association on the tax reform bill (H.R. 13270). My prepared text, which the committee has received, covers four areas of the legislation: (1) the tax treatment of gains on debt securities, (2) bad debt reserves, (3) certain provisions relating to trusts, and (4) the proposed amendment regarding withholding of interest and dividends.

However, in my statement this morning, I will confine my remarks to two items: the treatment of gains on debt securities and the treatment of bad debt reserves.

From an equity standpoint, making the proposed treatment of gains on securities retroactive raises a serious question. Such securities were purchased with the expectation that the difference between purchase price and redemption value would not be taxed as ordinary income. To change the tax basis of these already committed security transactions to reduce the effective yield basis is inequitable. If this change in tax policy is made, it should not apply to securities acquired prior to July 11, 1969, the date of first notice.

The policy of permitting banks and other depository institutions to treat gains on securities as capital gains dates to 1942, when the financing of World War II required that the banks absorb a large volume of U.S. Government debt at relatively low rates of interest. By permitting banks to charge net losses on securities against current income while treating net gains as capital gains, these institutions were encouraged to acquire Government securities. The House Ways and

Means Committee has argued that the need for this incentive has long since passed. However, today the Federal debt is much larger and its efficient management in the public interest is no less important. The proposed treatment of security gains would, in our opinion, hamper the attainment of this overall objective.

Compelling evidence of this effect may be seen already. The prospect of the termination of the nonparallel treatment of gains and losses will have, in fact has already largely had, three effects: (1) a decrease in demand for long-term and intermediate-term issues relative to demand for short-term issues; (2) a decrease in demand for issues with low coupon rates relative to demand for issues with high coupon rates; (3) through the further depreciation of intermediate- and long-term issues carried in bank portfolios, a reduction in the already low liquidity of the banking system.

The elimination of nonparallel treatment of gains and losses will increase the costs of issuing intermediate- and long-term securities by the Treasury and by State and local governments as well. The net effect could well be that the increased cost of Treasury financing will offset the increased revenue resulting from the ordinary income treatment of gains on securities.

I would like to turn now to loan loss reserves.

Bad debt reserves, gentlemen, are a cushion for loan losses. They are established from pretax income and restricted to this single purpose. Any other use of such funds involves first the payment of income tax on such amounts. Commercial banks are subject now to an industrywide formula which permits transfers to such reserves until the total equals 2.4 percent of eligible loans. This formula was adopted in 1965 after long intensive discussions with Treasury officials.

Historically a fundamental objective of public policy has been the maintenance of a decentralized banking system made up of locally owned and controlled banks. Today we have more than 13,000 commercial banks in the United States; most of them are relatively small enterprises. The opportunity for risk diversification in the smaller bank is more limited than that available to the larger institution. Adequate reserves for loan losses are vital to the safety and solvency of our decentralized banking system.

Moreover, public policy has recognized that public financial institutions have certain features and functions which set them apart from other business enterprises. This distinction, which is presently preserved in the existing authority for bad debt reserves, is significant to decentralized banking system.

The present treatment of bad debt reserves is an expression of these basic public policies. The present formula recognizes that banks have a greater need for bad debt reserves than industry and commerce in general. Moreover, public officials are presently encouraging banks to make loans which will help solve pressing inner-city problems. We recognize that many of these loans are marginal or submarginal with respect to risk and net return. This argues for strengthened, not weakened, bad debt reserve provisions.

The argument for eliminating the present bad debt reserve formula appears to rest upon a contention that the effective rate of taxation of commercial banks is low compared to nonfinancial businesses. The report of the Committee on Ways and Means purports to show that

the effective rate of Federal taxation of commercial banks in 1966 was only 23.2 percent. This percentage, however, significantly understates the incidence of Federal taxation of banks. The main factor accounting for this understatement is that the income base upon which the effective tax rate was calculated includes the earnings received by banks from holdings of tax-exempt obligations of the States and political subdivisions. To argue that bad debt reserves should be reduced or eliminated because banks receive income from certain securities that are tax exempt is not relevant.

The case for or against bad debt reserves cannot be meaningfully argued on the basis of the incidence of Federal taxation on commercial banks vis-a-vis the incidence on nonfinancial corporations. The issue is whether the present formula results in bad debt reserves that are adequate in relation to the public policy objectives to be served.

In discussion with the Treasury over a number of years, we have demonstrated that a bad debt ceiling of at least 2.4 percent of eligible loans is necessary. We believe that the public interest is served by the maintenance of bad debt reserves sufficient to meet sizable loan losses. And, gentlemen, these do occur even in normal years as shown on page 8 of our full testimony.

The provision for a 10-year carryback and 5-year carry-forward of losses on loans, which would be substituted for the present formula, does not afford the same degree of protection as an established reserve.

Our essential point then is that the concept of an adequate established bad debt reserve against outstanding loans should be maintained. This concept for mutual savings banks and savings and loans associations has been recognized in statute, while the concept as applied to commercial banks is the result of Treasury rulings. We believe and urge that the same concept for commercial banks also now be recognized and set forth in statute. That is, the ceiling rate and loan base should be established by legislation.

In his proposals, the Secretary of the Treasury has recommended that commercial banks as well as mutual savings banks and savings and loan associations be permitted, under certain well-defined conditions, to exclude from taxable income an amount equal to 5 percent of the income received from residential mortgages. The Secretary's recommendation should be given thorough consideration. We have not had an opportunity to evaluate its full impact on banks of various sizes and various asset structures. However, we are firm in our belief that the Secretary's recommendation would not result in an effective substitute for bad debt reserves. While it could well serve significantly in directing capital to certain lending areas, we urge that the concept of the bad debt reserve be maintained.

The changes that would be affected by the Tax Reform bill with respect to gains on debt securities and bad debt reserves have adverse implications for the stability and efficiency of our financial markets and for the availability of bank credit. Were this bill to be enacted today, these adverse implications would fall upon a financial system under severe pressures from the counter-inflation program. The present taut situation in the financial system argues strongly for careful consideration of both the short- and long-range impact of these major changes.

Senator WILLIAMS. As I understand, you are advocating the retention of the 2.4 percent for bad debt reserves?

Mr. ALEXANDER. Senator Williams, I am suggesting that a reserve based upon the average of the last 6 years which have been years of unparalleled prosperity is totally inadequate as a loan loss reserve.

Senator WILLIAMS. What has been the actual experience of the banks in the past 6 years or past 10 years as far as bad debt is concerned?

Mr. ALEXANDER. As far as the losses have been concerned?

Senator WILLIAMS. Yes.

Mr. ALEXANDER. The last year for which we have figures, the losses were in the range of about half of the amount transferred to bad debt reserves. This would be roughly in the $400 million range, Senator.

Senator WILLIAMS. Percentagewise?

Mr. ALEXANDER. The last few years have been in the approximate area of two-tenths of 1 percent of the total loans.

Senator Williams. Two-tenths of 1 percent has been the actual experience——

Mr. ALEXANDER. Have been the actual losses.

Senator WILLIAMS. Well, why would it be necessary to carry the 2.4 percent forward then based on your actual experience?

Mr. ALEXANDER. Senator Williams, we are of the opinion that banking has always been, and will probably continue to be, a cyclical business. We certainly have for the past 6 to 8 years been involved in a period of unparalleled prosperity. To base the protection of loan loss reserves on this recent past, and on only 1 year of this, we think is inadequate. It may well be that 2.4 percent, as well as the 6 percent reserve for the mutual savings banks and the savings and loan institutions could be subject to review.

As I indicated in my testimony, the concept of a loan loss reserve adequate to take care of the uncertainties of the future as commercial banks and other financial institutions move into areas of increasing risk is, we think, vital to the economy.

Senator WILLIAMS. Of course, there is this difference. To a large extent more and more of your loans are insured by various Government agencies. But I won't pursue that at this moment.

You mentioned one other change from the House bill. As I understand it under existing law, to use a hypothetical case, a bank can have $100,000 in capital gains; they can also have $100,000 in capital losses the same year, and then they have $100,000 of normal income. Under existing law they can charge heir capital losses 100 percent against their normal income and pay only a capital gains tax on the other $100,000 is that correct?

Mr. ALEXANDER. Any security losses, Senator, may be charged directly.

Senator WILLIAMS. Security losses are what I am speaking of.

Mr. ALEXANDER. May be charged to ordinary income.

Senator WILLIAMS. Ordinary income?

Mr. ALEXANDER. Just a moment. Not in the same year. But if they are in the same year, losses have to first be offset against gains.

Senator WILLIAMS. Yes. Security losses, yes. Under the House bill proposal these would both be treated, capital losses or the capital gains, as normal income, you would pay regular tax; is that correct, and that is what you are protesting under this bill?

Mr. ALEXANDER. We are saying, Senator Williams, that this so-called nonparallel treatment had its rationale in the Treasury argument——

Senator WILLIAMS. I understand that but I am trying to get clear what you are recommending. Is that correct?

Mr. ALEXANDER. Yes, sir.

Senator WILLIAMS. You are protesting the provision in the House bill, which would treat them alike; that is, both capital gains and capital losses would be treated as ordinary income and losses.

Mr. ALEXANDER. Senator, I am suggesting above all else that equity argues if this provision is enacted as proposed that it not be made retroactive since these are already committed transactions that it be applied to future transactions.

Senator WILLIAMS. One other suggestion has been made to the committee that in view of the House proposal, the administration proposal, that both gains and losses be treated the same as they are currently for individuals; that is, the capital gains would have to be offset by capital losses, rather than offset your capital losses against your regular income. Would you care to comment on that?

Mr. ALEXANDER. Any change in this area, Senator, may well have serious implications in terms of the market, intermediate and long-term Treasury and other municipal obligations.

Senator WILLIAMS. I recognize that but I am just asking you if there is going to be a change, what would you think of that change as compared with the change recommended in the House bill, if you had the choice?

Mr. ALEXANDER. I think it would have less impact on these markets than the change proposed in the House bill. However, we still strongly favor the present treatment; or as second best, to treat both gains and losses as ordinary gains and ordinary losses.

Senator WILLIAMS. Yes, sir.

No further questions.

Senator ANDERSON. Senator Byrd.

Senator BYRD. Thank you, Mr. Chairman.

Mr. Alexander, I feel there should be a reasonable and adequate bad debt reserve. The question, as I see it, is whether the 2.4 is too high, and you feel the House recommendation is too low. If the committee is inclined to change the House recommendation do you have a recommendation which you would make to the committee?

Mr. ALEXANDER. Senator Byrd, I do not have at this point a magic number.

Senator BYRD. Thank you. Thank you, Mr. Chairman.

Senator BENNETT. No questions.

Senator ANDERSON. Senator Miller.

Senator MILLER. No questions.

Senator JORDAN. No questions.

Senator FANNIN. Thank you, Mr. Chairman.

Mr. Alexander, when we talk about an average two-tenths of 1 percent bad debt loss, we hear a great deal about the widespread circulation of credit cards and the effect that this may have on the bad debt losses. Do you feel that it is justified to consider there may be additional losses because of those transactions?

Mr. ALEXANDER. Recognizing, Senator Fannin, at this point the relatively small amount of total credit outstanding on credit cards as compared to the total loans to the bank I would suggest the impact has not been a significant one.

Pursuing, if I may, though your point, it is somewhat dangerous and misleading to deal totally in terms of averages of two-tenths of 1 percent; as I indicated this represented the losses in recent years. It covers up the fact that a great many banks, not a great many, but a significant number of banks, even in prosperous years do have losses on their loans, have had losses on their loans which would exceed even a 2.4-percent formula.

I made just passing reference to this study which covered the years 1961 to 1963, in which more than 100 banks in the United States had losses in those years of relative prosperity which would have exceeded a 2.4-percent bad debt reserve formula. So averages tend to be a little misleading.

Senator FANNIN. We have some banks that are very conservative. We have others that are certainly very aggressive in their loaning programs. For instance, I know that the small loans, the loans of clients for new cars and all, was not a factor too many years ago so far as the banks were concerned. Today it is becoming more and more a big percentage of their business dealing.

Do you feel that this average then does not reflect what is happening in many parts of the country?

Mr. ALEXANDER. No.

My point, Senator, is that the averages are accurate national averages.

Senator FANNIN. Yes.

Mr. ALEXANDER. But they do cover up a lot of variations in terms of individual banks. We are talking here about 13,000 banks.

Senator FANNIN. Yes.

We are talking about loans. But really isn't there a risk involved, too, in that two-tenths of 1 percent guaranteed loans?

Mr. ALEXANDER. Well, I think perhaps more point has been made than the facts would bear out as to the amount of the commercial banking industry loans which are in fact guaranteed. While the commercial banking industry does have some $40 billion invested in some form of residential mortgages, the majority of these are not guaranteed; these are conventional loans.

Senator FANNIN. Thank you.

Senator MILLER. May I ask a question, Mr. Chairman?

Senator ANDERSON. Senator Miller.

Senator MILLER. Would you say that in your industry over half of the net income, over half, consisted of tax-exempt interest and long-term capital gains?

Mr. ALEXANDER. I don't have that exact figure, Senator Miller. I have the impression it is not that much.

Senator MILLER. Could you give us a figure at your leisure?

Mr. ALEXANDER. I would be happy to.

Senator MILLER. Yes. For the record.

Mr. ALEXANDER. Thank you.

Senator MILLER. And maybe you could break that down into what percent industrywide is tax-exempt interest and what percent industrywide is long-term capital gain.

Mr. ALEXANDER. I would be happy to.

Senator MILLER. Thank you.

(The material referred to appears below followed by Mr. Alexander's prepared statement:)

In 1968 insured commercial banks had net income before related taxes of $4,693 million, as reported by the FDIC. Of this, about $1,740 million, or 37.1 percent, consisted of tax exempt interest on state and local securities. A total of $98 million, or 2.1 percent, consisted of net long-term capital gains. These two items together accounted for 39.2 percent of 1968 commercial bank income shown above.

PREPARED STATEMENT OF WILLIS W. ALEXANDER, PRESIDENT, THE AMERICAN BANKERS ASSOCIATION

Mr. Chairman and members of the Committee, I am Willis W. Alexander, President of the Trenton Trust Company, Trenton, Missouri, and President of The American Bankers Association. I appreciate this opportunity to testify for the Association on the Tax Reform bill (H.R. 13270). This bill in its entirety and the changes proposed by the Secretary of the Treasury are of interest to the banking community. Federal taxation and expenditure are major forces influencing the growth, stability, and efficiency of our economy. The challange to Federal fiscal policy today is to achieve an ordering of national priorities that is consistent with attainment of the maximum rate of real economic growth that can be sustained without inflation. The American Bankers Association has consistently supported fiscal measures aimed at curbing inflation and at assuring orderly growth of our economy. As much as we would like to comment extensively on the Tax Reform bill, the limitations of time and the urgency with which this bill is being considered dictate that we limit our testmony today to provisions in the bill which are of particular concern to the commercial banking industry.

GAINS FROM DEBT SECURITIES

At the present tme, commercial banks, along with mutual savings banks, savings and loan associations, and small business investment companies, receive nonparallel treatment with respect to capital gains and losses on debt securities. Net gains are taxed as capital gains; net losses are deducted from ordinary income. Under the Tax Reform bill, both net gains and losses would be treated as ordinary income.

In its report on the Tax Reform bill, the Committee on Ways and Means noted that the "nonparallel treatment of gains and losses on bond transactions was adopted in 1942 to encourage financial institutions to support the large new issues of bonds which were then being offered to help finance the war." The history of special treatment of losses on sales of debt securities by banks dates back prior to World War II, but there is little question that the exigencies of wartime finance were the major consideration in the legislative establishment of the nonparallel treatment of gains and losses in 1942.

The present treatment of gains and losses is not an omission or "loophole" where none was intended by the Congress. The argument for reform would appear to rest upon the idea that public policy objectives have long since been achieved. We do not believe this to be the case. The Treasury faces a large and difficult task in the management of the Federal debt, and there is cause for concern that the bond gain provisions will have an adverse impact on the debt securities markets.

Just the prospect of the termination of the nonparallel treatment of gains and losses has already largely had three effects: (1) A decrease in demand for long-term and intermediate-term issues relative to demand for short-term issues. (2) A decrease in demand for issues with low coupon rates relative to demand for issues with high coupon rates. (3) A reduction in the already low liquidity of the banking system. These effects work in the direction of widening swings in prices, which increase the market risk of holding Government securities.

It is elemental that increased risk of fluctuations in the price of a bond means that higher rates of interest must be paid in order to attract purchasers. Moreover, in the face of increased risk of price fluctuations, investors tend to shift to

shorter term issues, on which the potential loss due to fluctuations in price is less than on longer term issues. Hence, elimination of nonparallel treatment of gains and losses will increase the difficulty of the Treasury and state and local governments in issuing intermediate and long-term securities, and will also tend to increase the cost of such financing.

There is little or no basis for estimating the extent of the effect upon cost and average maturity. However, as the pricing mechanism in the Government securities market is a highly efficient one, prices can be expected to adjust to reflect any advantage lost in the termination of nonparallel treatment of gains and losses. The net effect could well be that increased costs of Treasury financing will in due time offset the increased revenue resulting from the taxation of securities gains as ordinary income.

The impact upon the present liquidity of the banking system comes from the fact that termination of the present treatment of gains reduces the effective yield of issues now outstanding and selling below face value. These yields have already largely been brought into line with market rates of interest in general, through declines in the prices of the affected issues. Thus, banks as well as other financial institutions are experiencing further depreciation in the market value of their holdings of securities. The result will be further impairment of the liquidity of these institutions and further impairment of their margins of solvency.

The impact upon liquidity and solvency will, of course, be a transitory one, but it could be a relatively significant one under the presently stringent financial situation. The effect upon the costs of Treasury financing will be long term as well as immediate.

We attach sufficient significance to the long-term effects upon Treasury financing to believe that there continue to be valid public policy objectives for maintaining nonparallel treatment of gains and losses. Moreover, nonparallel treatment has served to facilitate the meeting of credit needs in periods of economic expansion. To obtain funds to meet credit demands, banks must frequently sell securities when prices are depressed. The taking of losses under such circumstances is, in part, mitigated by the prospect that after credit demands slacken, funds can be reinvested in securities which will appreciate in value, thereby providing capital gains. That is, the prospect of future gains, taxable as capital gains rather than as ordinary income, will encourage banks to take the security losses necessary to meet credit demands. Nonparallel treatment of gains and losses has thus enhanced the responsiveness of the banking system in meeting changing credit demands of the economy.

Our last but very essential point with respect to the nonparallel treatment of gains and losses is that termination of such treatment should not be retroactive. That is, it should not alter the effective yields of securities now held by commercial banks and other financial institutions accorded such treatment. Present holdings of securities were acquired on the basis of yields of calculated to include capital gains treatment of the difference between purchase price and face, or redemption, value. It would be inequitable to reduce the effective yields of securities acquired in good faith on the expectation that gains would not be taxed as ordinary income. If nonparallel treatment is eliminated, the legislation should apply only to securities acquired after July 11, 1969, when the proposed change was announced by the House Ways and Means Committee.

BAD DEBT RESERVES

At the present time, commercial banks are subject to an industry-wide formula with respect to the accumulation of bad debt reserves. Each bank is permitted to make transfers to such reserves until the total equals 2.4 percent of eligible loans. Transfers in any single year are limited by certain provisions designed to prevent unduly rapid or large transfers. Eligible loans exclude loans insured or guaranteed by the Federal Government, such as FHA and VA loans, as well as certain other loans deemed by the Treasury to be virtually free of credit risk, such as Federal funds sold.

The present formula was adopted in 1965 after prolonged and intensive discussions between Treasury officials and representatives of the banking industry. Previously, banks could use what has been termed the individual experience method which, omitting a number of technical details, permitted each bank to increase its reserve up to a level equal to three times its annual loss experience averaged over any twenty-year period since 1927. For the banking industry as a whole, this individual experience method was equivalent to a ceiling of 2.4 percent, adopted in 1965 for all banks.

At present, treatment of bad-debt reserves is the result of longstanding regulation and considerable deliberation over the years, it can hardly be regarded as an omission or "loophole" in tax policy. Treatment of bad-debt reserves reflects broad public policy with respect to the structure and functioning of the commercial banking system.

For most of our nation's history, a fundamental objective of public policy has been that there should be a high degree of decentralization in our banking system. That is, the banking system should consist of a large number of locally owned and controlled banks. The result is that today we have more than 13,000 commercial banks in the United States, and the great majority of these banks are small enterprises. Maintenance of the stability and solvency of this system has been a national problem of great and sometimes urgent consequence. I need not recount for this Committee the measures that have, over the years, been taken to assure that our nation will have a safe and sound banking system.

Moreover, public policy has treated commercial banking as having certain features and functions which set it apart from commercial enterprises in general. In other legislation before the Congress at the present time, we are, in fact, grappling with this very question of what constitutes commercial banking, related financial activities, and nonrelated commercial activities.

The present treatment of bad-debt reserves is one expression of the above basic public policies. Bad-debt reserves contribute to the solvency and stability of the banking system. The present formula recognizes that banks have a special need for bad-debt reserves and that satisfaction of this special need requires treatment that differs from that accorded commercial enterprises in general. Additionally, public policy has been increasingly directed to the objective of encouraging banks to make types of loans that are marginal or submarginal with respect to risk and net return, and which therefore require an even stronger bad-debt reserve position.

The argument for eliminating the present bad-debt reserve formula appears to rest upon a contention that the effective rate of taxation of commercial banks is low in comparison to non-financial businesses. The Report of the Committee on Ways and Means purports to show that the effective rate of Federal taxation of commercial banks in 1966 was only 23.2 percent. This percentage, however, significantly understates the incidence of Federal taxation of banks.

The income taxes paid by commercial banks are not the sum total of what might, from the point of view of economic analysts, be regarded as Federal tax levies upon commercial banks. In 1968 insured banks paid $132.4 million to the Federal Deposit Insurance Corporation, and in addition, national banks paid $22.7 million to the Office of the Comptroller of the Currency. These revenues were dedicated to the functions of bank examination and provision of deposit insurance, but though special in nature, they are, in effect, taxes.

More importantly, the Report of the Committee on Ways and Means included in the income base upon which the 23.2 percent was calculated the earnings received by banks from holdings of tax-exempt obligations of the states and political subdivisions. An analysis by the U.S. Treasury Department, which was submitted to this committee, shows that from 1962 through 1966 tax-exempt interest increased from 18.4 percent to 33.2 percent of the "economic income" of commercial banks, whereas the excess of bad-debt deductions over actual losses varied between 9.2 percent and 13.3 percent over this five-year period and stood at 10.7 percent in 1966.[1] It is clear that the major reason for the apparently low incidence of Federal taxation of commercial banks is the existence of tax-exempt income from state and local government securities. Moreover, the decline in incidence in recent years is due almost entirely to expansion of holdings of tax-exempt securities, as banks have responded to meet the financial needs of state and local governments. To argue that bad-debt reserves should be reduced or eliminated because banks receive income from certain securities that are tax exempt is a *non-sequitur*.

We hold that the case for or against bad-debt reserves cannot be meaningfully argued on the basis of the incidence of Federal taxation of commercial banks *vis-a-vis* the incidence of non-financial corporations. The issue is whether special treatment of bad-debt reserves for commercial banks serves established public policy objectives at a reasonable cost to the Treasury. Another way of putting the issue is whether the present formula results in bad-debt reserves that are adequate in relation to the public policy objectives to be served.

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[1] *Tax Reform Studies and Proposals, U.S. Treasury Department*, House Committee on Ways and Means and Senate Committee on Finance, February 5, 1969, Part 3, p. 475.

Data collected in a special study of loan losses in the three years 1961–1963 show that in each of these years 213 banks, on the average, suffered loan losses equal to 2 percent or more of eligible loans.[3] An average of 114 banks each year sustained losses equal to 3 percent or more of eligible loans. On the basis of this evidence we would expect to find that even in a period of reasonable stability in our economy, between 100 and 200 banks will each year suffer loan losses sufficient to wipe out or more than wipe out the maximum bad-debt reserve that can be accumulated under the present formula. Lacking the cushion provided by bad-debt reserves, a number of these banks could suffer such impairment of capital as to force liquidation or reorganization. The distress of bank failures in local communities, even without more far-reaching consequences, is too great to run the risk of a significant increase in the number of failures.

The provisions for a ten-year carry-back and five-year carry-forward of losses on loans, which would be substituted for the present formula, do not impress us as affording the same degree of protection as an established reserve. An established reserve for loan losses is immediately at hand. It is something that the banker knows to be a part of his bank's structure of assets and liabilities and which he can take into account directly in the formulation of his lending policies. The carry-back, carry-forward allowance is something for which he must apply after he has sustained losses. Not being a part of the structure of assets and liabilities of the bank, the allowance is sufficiently remote that it is not likely to be given much weight in the formulation of loan policies.

Our essential point is that the concept of an established bad-debt reserve against outstanding loans should not be abandoned. The concept of a bad-debt reserve for mutual savings banks and savings and loan associations has been recognized in statute. The concept as applied to commercial banks has long standing but is the result of Treasury rulings rather than legislation. The Tax Reform bill would maintain the concept of bad-debt reserves for mutual savings banks and savings and loan associations. We believe and urge that the concept as applied to commercial banks should also be recognized and set forth in statute. That is, the ceiling and the base should be established by legislation.

In discussions with the Treasury over a number of years we have demonstrated that the present bad-debt reserve ceiling of 2.4 percent of eligible loans is not more than adequate. Our position continues to be that a lower ceiling would be less than adequate. We believe that the public interest is served by the maintenance of bad-debt reserves by commercial banks sufficient to meet sizable loan losses. We hope that the Congress will not reduce the emphasis that has been placed upon the objective of assuring that commercial banks have adequate capacity to incur credit risks and sustain loan losses. If, however, a change in emphasis must be made, we strongly recommend that it be effected within the framework of existing policy providing for an established reserve rather than being effected by abolishing for commercial banks the concept of bad-debt reserves.

In his proposals, the Secretary of the Treasury has recommended that commercial banks as well as mutual savings banks and savings and loan associtions be permitted, under certain well defined conditions, to exclude from taxable income an amount equal to five percent of the income received from residential mortgages and other socially desirable loans. The Secretary's recommendation should be given thorough consideration. We have not had an opportunity to evaluate its full impact on banks of various sizes and various asset structures. However, we are firm in our belief that the Secretary's recommendation would not result in an effectual substitute for bad-debt reserves. We urge, as we have said, that the concept of the bad-debt reserve be maintained.

CONCLUDING COMMENT ON SECURITIES GAINS AND BAD-DEBT RESERVES

The changes that would be effected by the Tax Reform bill with respect to gains on debt securities and bad-debt reserves have adverse implications for the stability and efficiency of the Government securities market and for the availability of bank credit. The close interrelationships between financial markets mean that these adverse effects will be felt, too, in such other areas as state and local government financing.

Is now the time to undertake structural changes that will adversely affect already stringent financing conditions? We think not. The provisions of the Tax Reform bill should be given much more thorough study. The need for such

[3] Horvitz and Shapiro, "Loan Loss Reserves," *National Banking Review*, September 1964.

a study and the presently stringent conditions in the financial system argue strongly for more deliberate and extensive consideration than can be given this bill in the time remaining in this session of the Congress.

SECTIONS 341 AND 342 RELATING TO ACCUMULATION TRUSTS

The American Bankers Association strongly opposes the enactment of Sections 341 and 342 of the Tax Reform bill of 1969 relating to accumulation trusts. There has been no evidence of tax avoidance which calls for the enactment of such a highly complex set of rules, which will be difficult to understand by taxpayers, difficult to apply by trustees, and difficult to enforce by the Internal Revenue Service. Enactment of such legislation will result in an unfair and burdensome application of harsh rules to trusts which were created for valid reasons entirely apart from tax considerations. Furthermore, the proposed legislation goes far beyond the indicated areas of potential abuse, which is primarily centered in the multiple trust area. Any capacity for abuse contained in the existing law can be adequately curtailed by existing enforcement procedures or by legislative enactments which would be substantially simpler and not so stringent and far-reaching as the present proposals.

The Tax-Avoidance Argument.—The proposed legislation is apparently prompted by a concern that accumulation trusts may be used by a wealthy taxpayer as a device to minimize income taxes. Specifically, the fear is that such a taxpayer may reduce family income taxes by the creation of numerous trusts for the same beneficiary. However, no such tax abuse has ever been demonstrated. The Treasury report speaks only of a "capacity" for abuse, and indicates a concern that tax avoidance may result in the future by extensive use of multiple trusts.

It is the experience of corporate fiduciaries that accumulation trusts have not been the subject of tax exploitation. The vast majority of accumulation trusts administered by corporate fiduciaries have been established because of the minority or other incapacity of the beneficiary or because the creator of the trust did not wish to place too much income in the hands of the beneficiary for personal reasons. The instances in which such trusts have been created for tax avoidance have been minimal. The experience with multiple trust arrangements is similar. For a variety of reasons, the multiple trust arrangement has rarely been used. The majority of taxpayers are reluctant to engage in tax gimmickry or to become associated with tax schemes which may require litigation to defend. In addition, the very complexity of fiduciary taxation and the vagueness of the law in the area of multiple trusts have created an effective barrier to the use of such arrangements. We submit that no past practice calls for the enactment of the complex type of legislation contained in the Tax Reform bill. Congress is being asked to legislate on the basis of a "potentiality" threat and a few fringe horror examples.

The Complexity of the Legislation.—The principles of fiduciary income taxation are a highly intricate and complicated body of law. The "throwback rule" is particularly complex. The majority of the members of the bar, indeed even those specializing in taxation, are unfamiliar with trust taxation. The experience of many of our member banks is that the audit staff of the Internal Revenue Service is handicapped by a similar lack of knowledge. Needless to say, the taxpayer is completely unable to cope with legislation of this type and will invariably be put to the expense of highly specialized assistance.

The present law contains four exceptions which prevent the application of the throwback rule. These are: (1) accumulations during the minority of a beneficiary; (2) distributions for emergency needs; (3) distributions of $2,000 or less; and (4) final distributions made more than nine years after the trust was created. Heretofore, these exceptions have spared many persons from being involved with this highly intricate statute. The elimination of the exceptions will inflict complexities upon many persons of modest means who will be completely unable to cope with them or who in many instances will be completely unaware of the obligation to pay the required tax. It will be virtually impossible for the Internal Revenue Service to establish an effective enforcement program to prevent the inadvertent avoidance of tax.

A situation which occurs rather frequently in trust practice will serve as an example to illustrate the formidable accounting and other problems inherent in the proposed legislation: The testator leaves the residue of his estate in trust for his two children, a son, A, and a daughter, B, who are respectively sixteen and fourteen years of age at his death. As in many cases, the testator provides that

the income is to be accumulated in each child's share until age twenty-one. Thereafter, income is to be paid to each child. The principal of his share is to be distributed to A at age fifty. The principal of B's share is to be distributed to her issue upon her death. In this fairly common situation, the trustee is required to create and maintain special records of the accumulations for use thirty-four years later in the case of A, and perhaps as much as sixty years later in the case of B. In B's case, his personal tax records must be preserved for thirty-four years. B's tax accountant will be called upon to determine whether the so-called "exact" or the "short-cut" method will be the most economical for his client. He therefore must be familiar with the tax law as it existed some thirty-four years before. The alternative will be to use the "short-cut" method under which the tax rate is determined by assuming that the average annual accumulation was received in the year of distribution and the two prior years. Thus, tax rates determined by A's income when he was 48 to 50 years of age will be applied to determine the rate of taxation upon income earned when he was sixteen to twenty years of age. In B's case, income earned when she was fourteen to twenty years of age will be taxed to grandchildren at rates determined by the three-year period ending with the year of distribution to them—perhaps sixty years later. No alternative method is possible since the beneficiaries were not in existence when the income was earned. It is submitted that consequences such as these represent taxation by chance and have little or no relation to the prevention of tax avoidance.

Although trust institutions would undoubtedly maintain the necessary records to account to beneficiaries for accumulations made over a period of years, it is certain that many individual trustees will not do so. Thus, many beneficiaries, particularly those in modest circumstances, will be subjected to great difficulties in preparing tax returns for years in which trust distributions are received.

Problem May Be Solved By Other Means.—The potential tax avoidance which Sections 341 and 342 seek to prevent primarily springs from the multiple trust arrangement in which a series of trusts is created for the benefit of a single beneficiary. The proposed legislation, however, goes far beyond this and is applicable to a single "spray" or a single accumulation trust. In effect, it would destroy the long-standing principle that a trust may be an independent tax entity. The elimination of the trust as a separate tax entity, not the elimination of multiple trust arrangements, accounts for the $70 million revenue gain which the Treasury estimates will be generated by the proposal. The problem of tax avoidance through the use of multiple trusts can be solved by means far less drastic than the present intricate and hard-to-understand proposal. The courts have sufficient authority to prevent abuse in this area. The Treasury concedes in its Tax Reform Studies (P. 167) that multiple trust "devices are of doubtful validity under present law." It has been successful in striking down multiple trust arrangements in recent cases, E. P. Boyce, 190 F. Supp. 950, aff'd per curiam, 296 F. 2d 731 (5th Cir. 1962); *R. R. Sence*, 68-1 U.S.T.C. #9368 (Ct. Cl. 1968). If the Treasury cannot curb the creation of tax-motivated multiple trusts by an effective enforcement program in the courts, its position may be adequately buttressed by simple legislation containing language similar to that in present Code Section 269 under which multiple trusts would be declared invalid if the principal purpose for their creation is the avoidance of tax. The problem of multiple trusts may also be more simply solved by legislation which would apply the unlimited throwback rule only when more than one trust is created by the same donor for the same beneficiary; the unlimited throwback rule would be applied only to the second and any subsequent trusts.

It is submitted also that the exceptions to the throwback rule contained in the present law should be preserved. Their combined effect is to spare taxpayers from the application of the rule when the reason for the income accumulation is other than tax avoidance. Several of the exceptions of their face are a direct refutation of the tax abuse argument. For example:

1) Little if any tax avoidance can exist with respect to accumulations during the minority of a beneficiary. In most cases, the beneficiary's tax bracket is as low or lower than that of the trustee.

2) No tax avoidance is likely in the case of emergency distributions. If a beneficiary is in the midst of a financial emergency, he is not likely to be a high income tax bracket taxpayer.

3) The exception for *de minimus* distributions of $2,000 or less leaves little room for tax avoidance. The Treasury's Reform Studies (p. 166) assume an unlikely example of a single taxpayer in a high tax bracket. The example involves a fringe situation which is seldom encountered in actual practice.

Effective Date.—It is unfair to apply any legislation modifying the throwback rules retroactively. Trustors have made irrevocable commitments on the basis of the law as it applied to them. Although in discretionary trusts, the trustees may distribute income by the exercise of their discretion (assuming that the circumstances of the beneficiaries are such as to permit such exercise under the terms of the instrument), in many cases the income is required to be accumulated by the terms of the governing instrument. Any modifications of the law should therefore be applied only to trusts created after the effective date of the statute, not to distribution made after the effective date.

SECTION 201 RELATING TO "SPLIT-INTEREST" TRUSTS

The American Bankers Association urges against the enactment of Section 201 of the Tax Reform bill insofar as it requires the establishment of an annuity trust or a unitrust for the allowance of income tax, estate tax or gift tax deductions for "split-interest" gifts to charity.

Despite the fact that some trustees of "split-interest" trusts may have invested trust assets in a manner which favors noncharitable beneficiaries, the problem in this respect has not been so great as to require the extreme approach adopted in the proposed statute. The requirements of the statutory proposal will significantly discourage charitable gifts, particularly gifts of charitable remainders in trust. The new rules are appreciably more complicated than the old, and will not be readily understood by potential donors. In addition, it will be necessary for many testators and trustors to redo wills and trust agreements to conform to the new requirements. The result will be a curtailment of gifts to charity.

The requirement that an annuity trust or unitrust be established is designed to prevent the manipulation of trust investments in favor of noncharitable beneficiaries. However, we believe that any such manipulation has been a fringe problem and not substantial in amount. Most "split-interest" trusts have been created primarily to obtain the advantages of a deferred gift to charity or to reduce the value of a taxable remainder by the creation of an intervening income gift to charity. In short, the primary motivation for the form of the gift has been the tax advantage generated by the combination of the two gifts, not the possibility of advantage derived from investment manipulation. In addition, local law requires that fiduciaries fairly balance the interests of the income beneficiaries and the remaindermen. This overrding fiduciary duty of impartiality to all beneficiaries if sufficient assurance that the vast bulk of such trusts will be properly administered. New and complex legislation should not be enacted in an attempt to penalize fringe violations of established legal principles when in fact the punishment will be inflicted primarily upon the innocent charitable donees.

The proposal would reduce the investment flexibility of trusts having both charitable and noncharitable beneficiaries. The requirement that a predetermined dollar amount to be paid annually to the current beneficiary, regardless of the income earned by the trust assets, may compel sales of assets at undesirable prices—and possibly at distress prices—when the assets are difficult to sell or are not readily marketable. It is likely that trustees will be prompted to maintain investments in high income assets, thereby increasing the investment risk, or alternatively, to maintain a portion of the trust in highly liquid, short-term funds. Statutory tax considerations should influence the form of trust investments only when there is a demonstrated case of significant tax abuse.

The proposed statute would inflict further burdens and expense upon the administration of trusts. It will require additional tax expertise, more frequent investment activity, and yearly valuations of trust assets, which may be an expensive and formidable task when closely-held stock or real estate is involved. The valuation of such assets may involve the trustee in frequent disputes with the Internal Revenue Service.

SECTION 515 RELATING TO DISTRIBUTIONS FROM EMPLOYEE BENEFIT TRUSTS

We also oppose the enactment of Section 515 of the Tax Reform bill under which lump sum distributions from qualified employee benefit trusts would be taxed as ordinary income, and the tax computed in accordance with a complicated averaging device. The capital gains treatment given to such distributions under present law is founded upon the theory that it is unfair to "bunch" all of the income received in such a lump sum distribution and to tax in one year at ordinary income tax rates income which normally accrues over a period of many years. Capital gain treatment is both simple and fair. The five-year forward averaging

device adopted by Section 515 only partially reduces the unfairness of the bunching, since in most cases the income has accrued over an appreciably longer period of time. Section 515 would add substantial complexities to the law and is administratively cumbersome insofar as it permits a recalculation of the tax five years after receipt of the distribution under the so-called "look-back" rule. In the vast majority of cases, the disparity in tax rates between capital gains treatment and the ordinary income treatment adopted in Section 515 is not so great as to warrant the intricate approach adopted.

It is important that an individual be permitted to make adequate provision for his spouse and children at death. Pension and profit-sharing plans are an important source of family security at death and their growth should be encouraged by the tax laws. The primary impact of an increase in the rate of taxation will be upon a decedent's survivors, and the increase will be applicable to modest payments as well as to large ones. For these reasons we oppose the enactment of Section 515.

WITHHOLDING OF INTEREST AND DIVIDENDS

The proposed amendment by Senator Kennedy to H.R. 13270 (Amendment No. 140) would require payers of interest and dividends to withhold from the owners of such interest and dividends 20% on account of income taxes, even though experience shows that a large number of such owners would not be required to pay income taxes.

The American Bankers Association strongly objects to this proposal which would place an onerous burden of work and expense upon banking institutions and other payers of interest and dividends, such as mutual savings banks, savings and loan associations, insurance companies and other corporations. A great deal of study was given to this subject by The American Bankers Association and many conferences were held with officials and staffs of the Treasury Department and the IRS to discuss the difficulties and problems that would be encountered when a similar proposal was advanced during the consideration by the Congress of the Revenue Act of 1962. The Senate rejected the proposal at that time, as it did on previous occasions in 1942, 1950, and 1951.

Senator Kennedy states that the IRS estimates that $4 billion of interest and dividends is not reported by American taxpayers, and that $1 billion in taxes is payable on such income. This is the same as an estimate made by the Treasury Department in 1959 based upon interest payments in 1957. The introduction of the system of information returns in 1962 must have accounted for an increase in the amount of interest income reported on tax returns, even though the amount of interest and dividends paid has increased substantially since that time.

Under the Revenue Act of 1962 banks and other payers of interest and dividends, at great expense to themselves, have annually filed millions of information returns on Form 1099 with the IRS reporting amounts of interest and dividends paid to their customers. To the best of our knowledge and belief only a relatively small percentage of those returns have been used by the IRS to determine whether the amounts reported on Form 1099 have in fact been included in taxpayer returns. Thus, the IRS has for a number of years had the means at its disposal to ascertain the taxpayers who have not reported or paid taxes on such income.

We understood that when banks and other payers of interest and dividends were required under the Revenue Act of 1962 to file information returns with the IRS that those returns would be used to verify the proper reporting of interest and dividends in taxpayer returns.

It is suggested that before the Committee considers the withholding proposal the IRS be required to furnish the Committee information showing the number of Form 1099's received each year under the Revenue Act of 1962, the number of such forms used by the IRS in verifying taxpayer returns, and the amount of unreported income discovered by the use of such information returns. An explanation of the basis of the estimate of $4 billion in unreported interest income should also be furnished. Until the IRS exhausts the information at its disposal to check taxpayer returns, we do not believe there is any valid basis for requiring private industry at great expense to undertake to withhold taxes of this character from their customers.

Senator Kennedy's amendment which merely provides the statutory basis for withholding interest and dividends requires six pages of the Congressional Record to spell out such provisions. It leaves the details of the withholding procedures to be carried out by the IRS in its regulations. The withholding re-

quirements, including the use of exemption certificates, the treatment of interest payments on securities sold or transferred between interest payment dates, are most complex. In addition, a serious problem will be encountered in explaining the new requirements to millions of customers.

It is apparent, therefore, that implementation of any such provision would be a massive undertaking for the Government and for payers of interest and dividends. Accordingly, an effective date of January 1, 1970, if legislative action were to be taken, would be completely unrealistic.

Senator ANDERSON. Mr. Ogilvie.

STATEMENT OF CHARLES H. OGILVIE, CHAIRMAN, THE NATIONAL ASSOCIATION OF BUSINESS DEVELOPMENT CORPORATIONS

Mr. OGILVIE. Mr. Chairman, my name is Charles Ogilvie. I am here representing the National Association of Business Development Corporations, and I wish to thank you for affording us the opportunity to be heard.

Senator BENNETT. Mr. Ogilvie, what is your connection, your private company connection?

Mr. OGILVIE. I am employed as executive vice president of the Industrial Development Corp. of Florida, and I am appearing before you as chairman of the National Association of Business Development Corporations.

Gentlemen, my main point that I hoped to make here is that our type business is mostly unknown and what is known is very often misunderstood.

I wish to begin with a list of States in which corporations are active: Arkansas, Colorado, Connecticut, Florida, Kansas, Kentucky, Maine, Maryland, Missouri, Massachusetts, Nebraska, New Hampshire, New Jersey, New York, North Carolina, three of them in Pennsylvania, Rhode Island, South Carolina, Vermont, Virginia, Washington, and Wyoming. There is enabling legislation on the books, but the corporations are not yet active, in these States: Oklahoma, Louisiana, Iowa, and Utah.

The one word that keynotes our operation is nonbankable.

You all have been hearing about companies and institutions that make loans a certain number of which are substandard. Before any of our corporations can make a loan that loan must be nonstandard, and therein lies our feeling, a very strong one, that we have been placed in the wrong category. We are placed in the category under H.R. 13270 with commercial banks and other institutions, and we feel that the type loans we make justifiy separation from those institutions and deserve different treatment, including a more liberal reserve for loan losses.

Our corporations are formed by having stock subscribed by conventional lending institutions, by public utility companies, and by civic minded citizens of our various States. We have established lines of credit with conventional lending institutions, and we use these lines of credit to fund ourselves, borrowing from 10 to 20 times our paid-in capital. We are highly leveraged.

We can make a loan only if it is adjudged as nonbankable and we usually require a turndown letter from two or three conventional lending institutions to support this requirement.

You may wonder how we believe a loan is feasible when a bank has refused to make it. We can take second mortgages, third mortgages. We can make an open loan if we wish. An insurance company will not usually make a loan unless the applicant has an acceptable 5-year history. We very often go into brand new situations or go into situations that are very weak financially but possess, we feel, good potential. We will make a long-term loan ranging up to 10 years, some of the corporations even go to 25 years, very often accepting subpar collateral to secure the loan.

We help, therefore, the small businesses in this country. All our loans are below par, and we help the very small businesses that we think will help our States grow economically by providing jobs for people and by creating tax paying facilities.

We are widely diversified. We make loans to all types of companies. Just for example, in Florida we made a loan to a packing company which needed to ship beef interstate to meet competition. The plant, of course, had to conform to U.S. Department of Agriculture standards necessitating extensive alteration of the building. Sufficient funds were not available from the local bank. That company would have gone out of business if it had not received the loan from us.

So we made the loan, they modified their building, and are getting along very well. To assist them further, we made an additional loan for the addition of a rendering plant.

When one of our companies gets into trouble, we very often will advance additional funds.

Our national association is small. I have statistics on 15 of the 28 corporations in operation, and the income before any provision for loan losses or taxes, is slightly over a million dollars per year.

We feel our companies as a whole have a great multiplier effect. We feel that the jobs that we create more than pay their way in terms of income that the individuals earn and in helping them, the jobholders, to advance themselves.

Last year there were approximately 25,000 jobs created nationwide by the loans that we made.

Our history shows that approximately 265,000 jobs have been created by all the development corporations and all of this is through use of private money. We get no public funds.

The thing that frightens us, gentlemen, is what I call the wipe-out factor.

Senator ANDERSON. What?

Mr. OGILVIE. Wipe-out, sir. I will enlarge upon that. Our loans usually are made on a 10-year term at the minimum. The maximum term goes up to about 25 years and it is hard to predict what may transpire during such a long time.

Our loans are rather large on the average, ranging from $145,000 to $150,000. The typical company has a portfolio, containing from 25 to 40 loans. On the average, 2½ years of income would just about offset the loss of one loan. So we feel that if we did have a recession or enter a period which would see a curtailment of operations of our borrowers, our business development corporations could get into trouble very rapidly because a couple of losses would more than wipe out reserves. Since our established lines of credit are on a voluntary basis, it would be perfectly natural for the conventional lending institutions

to withdraw them and then we would be shut down, Senator Anderson, be wiped out. That is the idea. If our corporations were to try to operate in times of economic stress without an adequate reserve, we feel disaster could overtake us rapidly.

We feel, on the basis of what I told you, that we should be allowed to retain presently established bad debt reserves built from earnings of our corporations provided that the reserve does not exceed 10 percent of outstanding loans at year-end. Excluded from loans are any parts guaranteed by an agency of the Federal Government and any parts belonging to others through a participation arrangement.

As to the future business development corporations should be allowed a loss reserve, established from 60 percent of pretax income, reducing at the rate of 2 percent per year over a 10-year period to a minimum of 40 percent of taxable income or loss experience based on the current year and the preceding 5 years.

New business development corporations in the first year of operation would commence building reserves with 60 percent of taxable income, reducing to 40 percent as above. In no case would the reserve of any business development corporation be allowed to exceed the 10 percent as mentioned above.

Secretary Kennedy mentioned in his testimony that some special treatment should be given those lenders having some socially significant purpose. We feel, gentlemen, that we do contribute a great deal to the economy of this country by making loans that otherwise would never be made. We feel that this does justify, along with the other data that I have given you, the position that we take on building our loss reserves.

Thank you, sir.

Senator ANDERSON. Do you have any figures on the history of your lending operations?

Mr. OGILVIE. Yes, sir.

We have some. They are not what I would call complete. The oldest corporation is 20 years old. The average age, and I am making a guess, Senator Anderson, is about 4 to 5 years. We don't have what we feel is an adequate period historywise to try to determine exactly what our reserves should be, but all of us are pretty well acquainted with our compa... We know what losses we are looking at and feel that the 10 percent is a reasonable figure. I don't know that I have answered your question——

Senator ANDERSON. Yes, you have.

Senator Williams.

Senator WILLIAMS. What is your average rate of interest on these 10- and 20-year loans? As of today, I mean how would they compare with bank loans?

Mr. OGILVIE. Yes, sir.

They run about two to three points above the prime rate.

Senator WILLIAMS. Do you absorb any Government-guaranteed loans or do you handle only other type loans?

Mr. OGILVIE. We have the right to make a Government loan or rather a loan that carries a Government guarantee and that is why we excluded that from those counted toward the reserve.

Senator WILLIAMS. Yes.

No further questions.

Senator ANDERSON. Senator Bennett.

Senator BENNETT. In the printed copy of your testimony you indicate that the losses of some of your members have been running 5 to 6 percent.

Mr. OGILVIE. Yes, sir.

Senator BENNETT. And that one has failed. What limit does IRS now permit you to set up, actual loss ratio?

Mr. OGILVIE. Senator Bennett, the treatment has varied from one region to another. It has gone all the way from the $10,000 loss reserve permitted one corporation which had incurred a $60,000 loss, all the way up to some that go to 4, 5 percent of loans outstanding. It has varied.

Senator BENNETT. Is there anything that indicates a pattern. I am puzzled by your statement today they would only permit you to deduct or cover $10,000 of a $60,000 loss. But I am talking about the annual amount they allow you to set aside as a reserve unrelated to any actual loss.

Mr. OGILVIE. No, sir; there is no standard treatment.

Senator BENNETT. And it does vary?

Mr. OGILVIE. From region to region.

Senator BENNETT. From region to region?

Mr. OGILVIE. Yes.

Senator BENNETT. This surprises me. Certainly if this bill is passed we should be able to set you up some kind of a standard treatment.

Mr. OGILVIE. This is the first time, if I may say, that we have been recognized as a group. Now that we have been recognized we appreciate it but we feel we are in the wrong slot. [Laughter.]

Senator BENNETT. What slot would you like to be in?

Mr. OGILVIE. Well, like I said, we would like to be broken out of the treatment and the classification assigned to the other lenders and have a little slot of our own, and we unfortunately got a little messed up on getting the amendment to the bill, you gentlemen will have that, it just arrived, we found out and it is not included—yes sir, you have got it, all right, fine, but that sets up a separate category.

Senator BENNETT. Haven't they been allowing you at least 2.4 percent?

Mr. OGILVIE. Not in all cases, no, sir.

Senator BENNETT. Then you have been subject to the whims of the regional directors of IRS?

Mr. OGILVIE. Well, I guess it could be expressed that way, Senator Bennett, yes, sir.

Senator BENNETT. No further questions, Mr. Chairman.

Senator ANDERSON. Senator Byrd.

Senator BYRD. No questions, Mr. Chairman.

Senator ANDERSON. Senator Miller?

Senator MILLER. I am wondering what is the source of the income for the typical development corporation. Is it entirely interest income or are there long-term capital gains involved?

Mr. OGILVIE. Sometimes, Senator Miller, we are able to get stock options and, of course, if it looks good we exercise the option and hope to realize a profit on that.

I would point out, however, that that does contribute a very minor part of our income.

Senator MILLER. What I am wondering is if it would be feasible to gear this recommended bad debt reserve into your interest income activities as distinguished from the long-term capital gain activities?

Mr. OGILVIE. I am not quite certain that I follow you, sir.

Senator MILLER. What I am suggesting is if you have $200,000 of income and $100,000 of it was long-term capital gains and $100,000 was interest income that since the interest income represents a more typical approach to your activity that your deduction for bad debt reserve be tied in with that interest income rather than with the entire amount of income.

Mr. OGILVIE. Well, that does sound logical to me. We recognize that the long-term capital gains which we try to realize from the stock options would be an extraordinary item to us, and it could be that if we were to relate our assignment to the reserve on the income basis that that would be a very logical approach, sir.

Senator MILLER. What I am getting at is that it seems to me that the interest income is related more to the equity aspect whereas your long-term capital gains would be related more to an investment type of approach. I think you could separate out the activity along those lines and then attribute your reduction to your typical lending function.

Mr. OGILVIE. As I say that would be a good approach to it, sir.

Senator MILLER. Thank you.

Senator JORDAN. Do you keep a pretty close surveillance of your outstanding loans? Do you offer counseling service and so on in order to watch your loans?

Mr. OGILVIE. Yes, sir, we do.

Senator JORDAN. Probably more so than an average commercial bank loan?

Mr. OGILVIE. Well, I would hesitate to compare. It is a difficult thing. But I do know that we require, at least in Florida we require, quarterly financial statements from our borrowers, and we have been able to detect trouble very well from them using pretty much a standard approach, and then we undertake to try to counsel with them to help them get straightened around. So at least in my corporation we have done a great deal of it, and in talking with my counterparts in the other States, I have a very strong realization they do the same thing.

Senator JORDAN. What percentage of losses has your corporation experienced?

Mr. OGILVIE. Ours has been exceptionally modest. It has been a very small fraction. It is, I think, eight-tenths of 1 percent. And that is why I have emphasized that while everything has been great in Florida, things can get sour very quickly.

If I may illustrate, sir. I am looking at a $218,000 sour loan right now and I have no collateral. I have none whatsoever, and I haven't figured out yet how to avoid that one.

Senator JORDAN. Your eight-tenths of 1 percent won't last very long.

Mr. OGILVIE. I am afraid not. If I were sitting here a year from today it could well be much greater, and our reserve in Florida is now about $170,000. We built that up over a 7-year period.

Senator JORDAN. What factor do you use in setting aside that reserve, 2.4?

Mr. OGILVIE. No, sir.

We have in Florida, due to this varying treatment we are all sort of groping in the dark, in Florida we just took it on ourselves to set aside an amount equal to 1 percent of the average outstanding loans for the year. In other words, if our portfolio averaged on a month end basis, let's say $3½ million, we would set aside $35,000.

Senator JORDAN. Thank you.

Mr. OGILVIE. Yes, sir.

Senator ANDERSON. Senator Fannin.

Senator FANNIN. Thank you, Mr. Chairman.

Mr. Ogilvie, I am not too sure I understand your statement and your testimony where you say:

> Under the House bill, and we presume under the Administration's proposal, all these institutions would be permitted to keep their present reserves up to these limits.

And then, of course, in the House bill it provides that they do go back to a basis of their own experience, as indicated by losses for the current year and the 5 preceding years. Was that your understanding?

Mr. OGILVIE. If you don't mind, Senator Fannin, you are reading from my statement?

Senator FANNIN. Yes, reading from your statement.

You are discussing the 2.4 reserve by the savings and loan and mutual savings banks have 6-percent reserve and then you say:

> Under the House bill, and we presume under the Administration's proposal, all these institutions would be permitted to keep their present reserves up to those limits.

whereas the House bill does provide that:

> In the future, banks will generally be permitted to add to their bad-debt reserves only the amount called for on the basis of their own experience as indicated by losses for the current year and the five preceding years.

Mr. OGILVIE. Yes, I see your point, sir, that does not hold up.

Senator FANNIN. Well, I didn't mean to make any—I just wondered if that was your conclusion.

Mr. OGILVIE. Yes, it is a confusing statement at best.

Senator FANNIN. Thank you.

Senator ANDERSON. Thank you very much.

(Charles H. Ogilvie's prepared statement and attachment follow:)

STATEMENT OF CHARLES H. OGILVIE, CHAIRMAN, THE NATIONAL ASSOCIATION OF BUSINESS DEVELOPMENT CORPORATIONS

Business development corporations are organized under specific acts of state legislatures for the purpose of promoting, stimulating, developing, and advancing business prosperity and economic welfare of the individual states and their citizens; to strengthen and assist through loans, investments and other business transactions all kind of business activity in order to promote economic development and provide maximum opportunities for employment. This goal is met by making investments in and loans to businesses which have been denied credit by conventional lenders such as commercial banks, savings and loan associations, and insurance companies. The denial of credit by conventional lenders is usually a statutory requirement and a necessary condition to a loan by a business development corporation.

Although altruistic in nature, business development corporations are organized as profit making companies. Almost without exception stock has been subscribed by conventional lending institutions, public utility companies, and public-spirited citizens through a sense of civic responsibility in order to make available a source of loans which otherwise would be denied those small companies in a weak finan-

cial condition but possessing potential, having insufficient collateral with which to secure a conventional loan, or having need of low debt service possible only through long term financing.

The corporations have no depositors, handle no checking accounts, perform no trust functions, nor provide any service normally associated with conventional lending institutions. To reiterate, even the loans made by the corporations must be adjudged unbankable.

As their source of funds the companies utilize lines of credit established with banks, savings and loan associations, and insurance companies. The credit lines are proportioned to the size and type of these institutions and can be unilaterally withdrawn by them at any time with proper notice. Loans to development corporations are uncollateralized, secured only by their notes. Most corporations are highly leveraged, being able, generally, to borrow amounts varying from ten to twenty times paid-in capital.

There are presently twenty eight business development corporations in operation with experience ranging from several months to twenty years. Enabling legislation has been passed in several other states with organization of the corporations yet to be completed. Enabling legislation is necessary to effective operation of the corporations because the loans to them by conventional lenders would otherwise be classified substandard by state and national supervisory authorities. This fact lends emphasis to the risk generally acknowledged by authorities to exist in all loans by the corporations.

The corporations have been operating in a generally favorable buisness environment but, even so, some have sustained losses ranging up to five and six percent of loans outstanding and one has failed. Higher losses can be expected in a recessional period due to loan portfolios being comprised entirely of unbankable loans supported by substandard collateral. Loans by the corporations vary from low five figures to high six figures with the average in the low six figure range. The typical portfolio contains from twenty to forty loans. Thus development corporations are not afforded the spread of risk enjoyed by most conventional lenders. With terms of ten to twenty years business development corporation loans are in a class by themsleves, sensitive even to modest deteriorations in business activity. It should be recognized that the concentration of risk and large amounts involved are indicative of total losses exceptionally high in terms of loans outstanding and paid-in capital.

The management of every corporation has recognized the necessity of building appropriate loan loss reserves; however, no uniform method of allocation exists largely because of variations in treatment by Internal Revenue Service agents in different sections of the country. Present reserve levels vary from one to four percent of loans outstanding due to these variations in treatment. So far as we are aware, we are the only financial institution that has not had a special bad debt reserve recognized by the Internal Revenue Service and created either by statute or regulation. Thus commercial banks have been permitted a reserve of 2.4%, savings and loans and mutual savings banks have a 6% reserve and small business investment companies have been allowed a 10% reserve. Under the House bill, and we presume under the Administration's proposal, all these institutions would be permitted to keep their present reserves up to those limits. No such provision is made for reserves of business development corporations. However, we believe that we are, among all these institutions, the lenders with the least prospect for profit and probably the greatest potential of risk. Furthermore, although technically organized as profit-making organizations, we are actually quasi-public instrumentalities performing, in the words of Secretary Kennedy, "socially preferred functions".

It has been suggested that reserves be established on the basis of loss experience. Due to the precipitate manner in which loans would go bad and due to their size, a corporation would be out of business before the experience could inure to its benefit. In other words, when trouble strikes, it strikes fast and it strikes big. At the same time it is obvious that a 2.4% loss reserve maximum is inadequate. Moreover, the ten-year carryback and five-year carry-forward provisions will not provide an adequate cushion because of the modest profits, if any, generated by the typical corporation. On the average two and one half years of corporate earnings are insufficient to offset the loss of one loan.

Although loss experience, with some notable exceptions, has generally been good to date, two or three losses in any of the corporations could be substantial enough to impair capital. Impairment of capital of our highly leveraged corporations would have a severe psychological impact on the financial institution lenders which provide us money. This impact would manifest itself in their with-

drawing presently available lines of credit so that our corporations would be rendered ineffective at a time when additional funds would be needed to help our borrowers through difficult economic conditions.

Under H.R. 13270, Sub-Title E, Section 585, business development corporations have been treated on a par with commercial banks in all respects, including rules for addition to reserve for bad debts.

Our National Association feels strongly that business development corporations should be placed in a separate category due to the difference in purpose, the difference in types of loans made, and the greater risks involved in making these loans.

In its bill the House has recognized that reserves for losses should bear a relation to the purpose and nature of the institution concerned. We have a socially recognizable purpose of the highest order in that we create jobs and strengthen the financial position of small companies.

We respectfully submit that business development corporations should be allowed to retain presently established bad debt reserves built from earnings of the corporation, provided that the reserve does not exceed 10% of outstanding loans at year end. Excluded from "loans" are any parts guaranteed by an agency of the Federal government and any parts belonging to others through a participation arrangement. As to the future, business development corporations should be allowed a tax-free allocation to the reserve for losses equal to the greater of the following: 60% of pre-tax income, reducing at the rate of 2% per year over a 10-year period to a minimum of 40% of taxable income, or loss experience based on the current year and the preceding five years. New business development corporations, in the first year of operation, would commence building reserves with 60% of taxable income, reducing to 40%, as above. In no case would the reserve of any business development corporation be allowed to exceed 10% as mentioned above.

Alternatively, the committee may wish to adopt a provision relating the bad debt reserve deduction directly to the total loans outstanding at year end. In this case, we would recommend that business development corporations be permitted to deduct from taxable income such amount as would be required to maintain a bad debt reserve in the amount of 10% of outstanding loans at year end.

The staff of the Joint Committee on Internal Revenue Taxation has made a study of our industry and our case for special bad debt treatment. I feel certain that Dr. Laurence N. Woodworth, who heads the committee staff, would furnish you with the results of that study.

To be effective in our sphere of endeavor, which is unoccupied by any other type of institution or corporation, we respectfully request the Committee's favorable consideration of the suggestions herein set forth and formalized in the attached proposed amendment to H.R. 13270.

APPENDIX

Proposed Amendments To H.R. 13270 Re Bad Debt Reserves of Business Development Corporations

A. Add a new Section 445 to Subtitle E of H.R. 13270, providing as follows:

Sec. 445. Bad debt deductions of business development corporations.

Subchapter H of Chapter 1 (relating to Banking Institutions) is amended by adding at the end thereof the following new part:

"Part IV—*Business Development Corporations*

"Sec. 605. Reserves for losses on loans of business development corporations.

"(a) *Institutions to which section applies.*

This section shall apply to any business development corporation, which shall mean a corporation which was created by or pursuant to an act of a State legislature for purposes of promoting, maintaining, and assisting the economy and industry within such State on a regional or statewide basis by making loans which would generally not be made by banks (as defined in section 581) within such region or State in the ordinary course of their business (except on the basis of a partial participation), and which is operated primarily for such purposes.

"(b) *Addition to reserves for bad debts.*

"(1) *In General.*—For purposes of section 166(c), except as provided in paragraphs (4) and (5), the reasonable addition for the taxable year to the reserve for bad debts of any business development corporation described in subsection (a) shall be the amount determined by such business development corporation to be the reasonable addition for such year, but such amount shall not exceed the amount determined under paragraph (2) or (3), whichever amount is the greater.

"(2) *Percentage of taxable income method.*—The amount determined under this paragraph for the taxable year shall be an amount equal to the applicable percentage of the taxable income for such year, determined under the following table:

"For a taxable year beginning after July 11 in	*The applicable percentage under this paragraph shall be*
1969	60
1970	58
1971	56
1972	54
1973	52
1974	50
1975	48
1976	46
1977	44
1978	42
1979 or thereafter	40

but the amount determined under this paragraph shall not exceed the the amount necessary to increase the balance (as of the close of the taxable year) of the reserve for bad debts to 10 per cent of the loans outstanding at such time, exclusive of any portions of such loans, repayment of which is guaranteed by the United States or any agency or instrumentality thereof which is wholly owned by the United States and exclusive of any portions of such loans which are owned by others through participation arrangements. For purposes of this paragraph, taxable income shall be computed—

"(a) without regard to any deduction allowable for any addition to the reserve for bad debts,

"(b) by excluding from gross income an amount equal to the net capital gain for the taxable year arising from the sale or exchange capital assets,

"(c) by excluding from gross income dividends with respect to which a deduction is allowed by part VIII of subchapter B.

"(3) *Experience Method.*—The amount determined under this paragraph for the taxable year shall be computed in the same manner as is provided with respect to additions to reserves for bad debts of financial institutions under section 585(b)(1).

"(4) *New Business Development Corporations.*—In the case of any taxable year beginning not more than 10 years after the day before the first day on which a business development corporation described in subsection (a) commenced operations as such a business development corporation, the reasonable addition for the taxable year to the reserve for bad debts shall be the amount determined by such business development corporation to be the reasonable addition for such year, but such amount shall not exceed the amount determined under subparagraph (A) or (B) below, whichever amount is the greater.

"(A) The amount determined under this subparagraph for the taxable year shall be an amount equal to the applicable percentage of the taxable income for such year determined under the following table:

Taxable year after commencement of operations:	Percent
1	60
2	58
3	56
4	54
5	52
6	50
7	48
8	46
9	44
10	40

but the amount determined under this subparagraph shall not exceed the amount necessary to increase the balance (as of the close of the taxable year) of the reserve for bad debts to 10 percent of the loans outstanding at such time, exclusive of any portions of such loans, repayment of which is guaranteed by the United States or any agency or instrumentality thereof which is wholly owned by the United States, and exclusive of any portions of such loans which are owned by others through participation arrangements. For purposes of this subparagraph, taxable income shall be computed as provided in paragraph (2) of this subsection.

"(B) The amount determined under this subparagraph for the taxable year shall be computed in the same manner as is provided with respect to additions to reserves for bad debts of new financial institutions under section 585 (b)(2), except that the term "all business development corporations described in subsection (a) of section 605" shall be substituted for the term "all institutions described in the applicable paragraph of subsection (a)" in section 585 (b)(2)(i) and for the term "all such institutions" in section 585 (b)(2)(ii).

"(5) *Reserves For Bad Debts For Taxable Years Which Began Prior To July 11, 1969.*—In the case of any taxable year which began prior to July 11, 1969, the reasonable addition for the taxable year to the reserve for bad debts of any business development corporation described in subsection (a) shall be the amount determined by such business development corporation to be the reasonable addition for such year, provided that such amount does not exceed the amount necessary to increase the balance (as of the close of the taxable year) of the reserve for bad debts to 10 percent of the loans outstanding at such time, exclusive of any portions of such loans, repayment of which is guaranteed by the United States or any agency or instrumentality thereof which is wholly owned by the United States, and exclusive of any portions of such loans which are owned by others through participation arrangements.

B. Amend Section 441(b) of H.R. 13270 (relating to net operating loss deduction) by adding "or a business development corporation to which section 605 applies" to subparagraph (F) as set out in said Section, so that said subparagraph (F) reads as follows:

"(F) In the case of a financial institution to which section 585 or 593 applies or a business development corporation to which section 605 applies, a net operating loss for any taxable year after July 11, 1969, shall be a net operating loss carryback to each of the 10 taxable years preceding the taxable year of such loss and shall be a net operating loss carryover to each of the 5 taxable years following the taxable year of such loss."

C. Amend Section 441(a) of H.R. 13270 to strike out paragraph (3) of Section 585(a) as set forth therein (the definition of a business development corporation).

ALTERNATIVE LANGUAGE

(See first full paragraph on Page 6 of Mr. Ogilvie's statement.)

The following are proposed alternatives to Section 605(b)(2) as appearing *supra* on Pages 2-4 in this Appendix, and to Section 605(b)(4)(A) as appearing on Pages 5 and 6 of this Appendix:

Section 605(b)(2):

"(2) *Percentage of Outstanding Loans Method.*—The amount determined under this paragraph for the taxable year shall be such amount as is necessary to increase the balance (as of the close of the taxable year) of the reserve for bad debts to 10 per cent of the loans outstanding at such time, exclusive of any portions of such loans, repayment of which is guaranteed by the United States or any agency or instrumentality thereof which is wholly owned by the United States, and exclusive of any portions of such loans which are owned by others through participation arrangements."

Section 605(b)(4)(A):

"(A) The amount determined under this subparagraph for the taxable year shall be such amount as is necessary to increase the balance (as of the close of the taxable year) of the reserve for bad debts to 10 per cent of the loans outstanding at such time, exclusive of any portions of such loans, repayment of which is guaranteed by the United States or any agency or instrumentality thereof which is wholly owned by the United States, and exclusive of any portions of such loans which are owned by others through participation arrangements."

Senator ANDERSON. Mr. Williams.

STATEMENT OF GEORGE C. WILLIAMS, PRESIDENT, NATIONAL ASSOCIATION OF SMALL BUSINESS INVESTMENT COMPANIES; ACCOMPANIED BY CHARLES M. NOONE, GENERAL COUNSEL

Mr. WILLIAMS. Gentlemen, my name is George C. Williams. I am president of the National Association of Small Business Investment Companies. Accompanying me is Mr. Charles M. Noone, our trade association's general counsel.

Our association represents 225 of the 350 active companies licensed by the Small Business Administration under the Small Business Investment Act of 1958. The member companies of our association account for over 80 percent of the assets committed to the SBIC program.

In the 10 years since the passage of the 1958 act, SBIC's have made over $1.5 billion available to small business concerns in over 30,000 separate financings. At the present time, the active SBIC's have total assets of about $585 million and have disbursed an average of $150 million a year over the past 2 years to small business concerns.

We are particularly concerned with sections 421 and 443 of H.R. 13270 as they would affect the financing activities of SBIC's.

Section 421 of the bill, relating to stock dividends, would, as we understand it, result in taxable income to shareholders of small business concerns financed by SBIC's where there are "disproportionate distributions" by such portfolio companies. I refer specifically to the proposed treatment of convertible preferred stock and changes in conversion ratios and redemption prices.

We have no quarrel with the present law taxing corporate distributions where the shareholders can elect between a stock dividend and

the receipt of cash or other property, but we are fearful that the proposed extension of this principle to convertible securities could produce harmful results for shareholders of our portfolio companies and add considerable complexity to SBIC financing arrangements.

SBIC's are venture capital companies. They are encouraged to provide long-term loan funds and equity capital to eligible small business concerns. The 1967 amendments to the Small Business Investment Act of 1958 encouraged SBIC's to increase their equity-type financing as distinguished from straight lending.

While definitive statistics on the nature of SBIC financings that would be adversely affected by the pending proposals are not available, we estimate that a substantial and significant number of them do include convertible preferred stock or other convertible securities, including warrants or options, in which provisions are made for changes in conversion ratios and redemption prices geared to the holding period on such securities and changes in the earnings or net worth of portfolio companies.

We are particularly concerned that the bill would vest in the Secretary of the Treasury, or his delegate, the authority to determine what types of transactions might be treated as disproportionate distributions. We can see this suggestion leading to considerable confusion and endless litigation.

We urge this committee to amend section 421 of the bill to exempt SBIC financing instruments from the provisions of that section relating to disproportionate distributions. In the alternative, and in lieu of delegating decisions in this important area to the Treasury Department, we urge the committee to write into the bill precise language on which we and our portfolio concerns can rely in providing needed venture capital financing to small business concerns. We further urge that any change of this nature be made effective only with respect to future financing transactions, and that it not apply to outstanding instruments.

Section 443 of the bill would treat gains on securities held by financial institutions as ordinary income. As the reports of the Committee on Ways and Means point out, this particular provision is designed to accomplish parallel treatment for similar types of financial institutions. But the bill would amend only subsection (c) of section 582 of the code and section 1243 relating to SBIC's. If parallel treatment is indeed to be accomplished, we likewise recommend amendment of subsection (a) of section 582.

Subsection 528(a) of the code now permits a "bank" to take an ordinary loss on a debt which is evidenced by a security as defined in code section 165(g)(2)(C). Contrary to the assertion contained in the House committee report relating to this section, SBIC's are not now given similar treatment. We believe they should be given parallel treatment under this section as well as under subsection 582(c).

We would suggest therefore that subsection 582(a) of the code be further amended by striking the word "bank" and by substituting the language now proposed to be included in subsection 582(c), namely "financial institution to which section 585 or 593 applies * * *." Such an amendment would conform to the proposed amendment relating to the heading for section 582 which would substitute the words "financial institutions" for the word "banks."

We were pleased to note the recommendations of Secretary Kennedy and Assistant Secretary Cohen of the Treasury Department in their September 4 statements before this committee where they proposed a special tax deduction of 5 percent of gross interest income from loans for residential construction and "loans guaranteed by the Small Business Administration." We were concerned, however, that Secretary Kennedy particularly seemed to suggest the deduction only for commercial banks, mutual savings banks, and savings and loan associations.

Due to recent budgetary restrictions, the Small Business Administration has been unable to provide any direct financing to SBIC's. As an alternative, the Agency and the SBIC industry have been seeking money needed to continue their financing activities not only from banks but from insurance companies, pension funds and other institutional lenders, these loans to be backed by SBA guarantees. We would hope therefore that the proposed interest deduction on SBA-guaranteed loans, if adopted by the committee, would be available to any lending institution providing funds to SBIC's on loans guaranteed by SBA.

By the same token, SBA has been actively exploring the possibility of guaranteeing SBIC loans in certain areas. We would hope therefore that should such a guarantee program be inaugurated, SBIC's likewise would qualify for the special tax deduction proposed by the Treasury Department.

I am advised that the National Small Business Association has informed your committee by letter of its support of our statement with respect to section 421 of the bill. It is respectfully requested that the letter from the National Small Business Association be incorporated in the record of this proceeding at this point.

We thank you for this opportunity to appear.

Senator ANDERSON. Thank you, and we will print the letter.

(The letter referred to follows:)

NATIONAL SMALL BUSINESS ASSOCIATION,
Washington, D.C., September 11, 1969.

Hon. RUSSELL B. LONG,
Chairman, Committee on Finance,
U.S. Senate, Washington, D.C.

DEAR CHAIRMAN LONG: National Small Business Association supports the statement of Mr. George C. Williams, President of the National Association of Small Business Investment Companies, with respect to Section 421 of H.R. 13270.

The proposed Section 421 would complicate the financing of smaller corporations with respect to convertible stock and securities. In some respects it could preclude the use of such type of financing.

Incorporation of this letter into the record of hearings on H.R. 13270 will be appreciated.

Sincerely,

JOHN LEWIS,
Executive Vice President.

Senator ANDERSON. Any questions?

Senator BENNETT. Mr. Williams, just for the record, can you give us any information which would indicate the proportion of or the relation between your equity capital loans and your direct loans?

Mr. WILLIAMS. You mean the equity type loans as opposed to direct lending?

Senator BENNETT. Yes.

Mr. WILLIAMS. Well, as I recall, Senator Bennett, straight loans are about 40 percent, direct stock ownership about 20 percent, and the balance is in various forms of convertible debentures or equity rights.

Senator BENNETT. Don't you have many of the same problems that Mr. Ogilvie talked to us about?

Mr. WILLIAMS. Yes, sir, we do, some of the same problems.

Senator BENNETT. Aren't both groups really trying to reach the same need in our economy?

Mr. WILLIAMS. That is absolutely true. We are trying to reach the small businessman. We are trying to provide financing for the small business community.

Senator BENNETT. The difference is that you work under the sponsorship and guarantee of SBA while the men in the other group are working out in the open market without that sponsorship.

Mr. WILLIAMS. We have the sponsorship of the Small Business Administration and are permitted to borrow certain funds——

Senator BENNETT. That is right.

Mr. WILLIAMS (continuing). From SBA.

Senator BENNETT. But your problems are essentially the same.

Mr. WILLIAMS. I would say basically; yes, sir.

Senator BENNETT. Thank you.

Senator ANDERSON. Senator Byrd?

Senator BYRD. No questions, Mr. Chairman.

Senator ANDERSON. Senator Miller?

Senator MILLER. Are you, that is, SBIC's in competition with the business development corporations?

Mr. WILLIAMS. No, sir.

I would say we are not in competition with them. We provide a different type of financing, in my estimation.

Senator MILLER. What is the difference?

Mr. WILLIAMS. Sir?

Senator MILLER. What is the difference?

Mr. WILLIAMS. SBIC's look primarily to their profit from the risk they take in financing small business concerns. They sponsor what they hope to be good management. They make investments with good management in a business they hope will prosper. If the company prospers they stand to have a substantial, hopefully substantial, gain through their ownership in that business.

I don't think the development group engages heavily in this type of financing.

Senator MILLER. Thank you.

Senator ANDERSON. Senator Jordan?

Senator JORDAN. No questions.

(George C. Williams prepared statement follows:)

STATEMENT OF GEORGE C. WILLIAMS, PRESIDENT, NATIONAL ASSOCIATION OF SMALL BUSINESS INVESTMENT COMPANIES

Gentlemen: My name is George C. Williams. I am President of the National Association of Small Business Investment Companies ("NASBIC"). Our Association represents 225 of the 350 active companies licensed by the Small Business Administration under the Small Business Investment Act of 1958 ("1958"). The member companies of our Association account for over 80% of the assets committed to the SBIC program.

In the ten years since the passage of the 1958 Act, SBICs have made over $1.5 billion available to small business concerns in over 30,000 separate financings. At the present time, the active SBICs have total assets of about $585 million and have disbursed an average of $150 million a year over the past two years to small business concerns.

We are particularly concerned with Sections 421 and 443 of H.R. 13270 as they would affect the financing activities of SBICs.

We have no quarrel with the present law taxing distribution of property where the shareholders can elect between a stock dividend and the receipt of cash or other property, but we are fearful that the proposed extension of this principle to convertible securities could produce harmful results for shareholders of our portfolio companies and add considerable complexity to SBIC financing arrangements.

SBICs are venture capital companies. They are encouraged to provide long-term loan funds and equity capital to eligible small business concerns. The 1967 Amendments to the Small Business Investment Act of 1958 encouraged SBICs to increase their equity-type financing as distinguished from straight lending.

While definitive statistics on the nature of SBIC financing that would be adversely affected by the pending proposals are available, we estimate that a substantial and significant number of them to include convertible preferred stock or other convertible securities, including warrants or options, in which provisions are made for changes in conversion ratios and redemption prices geared to the holding period on such securities and changes in the earnings or net worth of portfolio companies.

We are particularly concerned that the bill would vest in the Secretary of the Treasury or his delegate the authority to determine what type of transactions might be treated as disproportionate distributions. We can see this suggestion leading to considerable confusion and endless litigation.

We urge this Committee to amend Section 421 of the bill to exempt SBIC financing instruments from the provisions of that section relating to disproportionate distributions. In the alternative, and in lieu of delegating decisions in this important area to the Treasury Department, we urge the Committee to write into the bill precise language on which we and our portfolio concerns can rely in providing needed venture capital financing to small business concerns We further urge that any change of this nature be made effective only with respect to future financing transactions, and that it not apply to outstanding instruments.

Section 443 of the bill would treat gains on securities held by financial institutions as ordinary income. As the reports of the Committee on Ways and Means point out, this particular provision is designed to accomplish parallel treatment for similar types of financial institutions. But the bill would amend only subsection (c) of Section 582 of the Code and Section 1243 relating to SBICs. If parallel treatment is indeed to be accomplished, we likewise recommend amendment of subsection (a) of Section 582.

Subsection 582(a) of the Code now permits a "bank" to take an ordinary loss on a debt which is evidenced by a security as defined in Code Section 165(g) (2)(C). Contrary to the assertion contained in the House Committee report relating to this section, SBICs are *not* now given similar treatment. We believe they should be given parallel treatment under this section as well as under subsection 582(c).

We would suggest therefore that subsection 582(a) of the Code be further amended by striking the word "bank" and by substituting the language now proposed to be included in subsection 582(c), namely "financial institution to which Section 585 or 593 applies . . ." Such an amendment would conform to the proposed amendment relating to the heading for Section 582 which would substitute the words "financial institutions" for the word "banks".

We were pleased to note the recommendations of Secretary Kennedy and Assistant Secretary Cohen of the Treasury Department in their September 4 statements before this Committee where they proposed a special tax deduction of 5% of gross interest income from loans for residential construction and "loans guaranteed by the Small Business Administration". We were concerned, however, that Secretary Kennedy particularly seemed to suggest the deduction only for commercial banks, mutual savings banks and savings and loan associations.

Due to recent budgetary restrictions, the Small Business Administration has been unable to provide any direct financing to SBICs. As an alternative, the

Agency and the SBIC industry have been seeking money needed to continue their financing activities not only from banks but from insurance companies, pension funds and other institutional lenders, these loans to be backed by SBA guarantees. We would hope therefore that the proposed interest deduction on SBA-guaranteed loans, if adopted by the Committee, would be available to any lending institution providing funds to SBICs on loans guaranteed by SBA.

By the same token, SBA has been actively exploring the possibility of guaranteeing SBIC loans in certain areas. We would hope therefore that should such a guarantee program be inaugurated, SBICs likewise would qualify for the special tax deduction proposed by the Treasury Department.

I am advised that the National Small Business Association has informed your Committee by letter of its support of our statement with respect to Section 421 of the bill. It is respectfully requested that the letter from the National Small Business Association be incorporated in the record of this proceeding at this point.

We thank you for this opportunity to appear.

STATEMENT OF ARTHUR T. ROTH, CHAIRMAN, BOARD OF DIRECTORS, THE FRANKLIN NATIONAL BANK, AND COCHAIRMAN, BANKERS COMMITTEE FOR TAX EQUALITY

Mr. ROTH. Mr. Chairman, and gentlemen, my name is Arthur T. Roth, I am chairman of the board of the Franklin National Bank, New York City. I appear before your committee as cochairman of the bankers committee for tax equality. Our committee represents nearly 5,000 commercial banks engaged in commercial and savings banking throughout the United States.

Mr. Chairman, at this time, may I interrupt and be given the opportunity to say a word with regard to small business investment companies? It is not part of my testimony. I did not come here intending to do so but I happen to be chairman of the board of the Franklin Corp., which is a small business investment company, and I thoroughly agree with the statements made by Mr. Ogilvie and Mr. Williams.

We have a serious problem with regard to how much of a loan loss reserve we can set up. Our loans, as has been said to you, are granted to companies and individuals who cannot receive bank credit. I would like to suggest that, just as in the case of commercial lenders and all other types of business corporations, small business investment companies be given the opportunity to use a loan loss reserve equivalent to their average loses for the last 6 years. That has been discussed here and that is what is being recommended for commercial banks also. But in addition to that, as you may know, these same businesses, corporate businesses, also can age their accounts receivable and, based upon an aging of their accounts receivable, set up a reserve which is totally apart and different from the 6-year average.

Now, in the case of a small business investment company we have a loss only when it is a loss, but we have many doubtful loans, loans on which borrowers are not paying current interest; and certainly we should be allowed to set up a reserve against those of, let's say, 50 percent of the amount of the loan.

There are other loans that are substandard in nature. Business is declining, profits are declining, they are starting to run into losses, and so forth. They should be allowed a 25-percent reserve against such loans. And then there are loans that have other weaknesses, definite weaknesses, and they should perhaps be allowed a 10-percent reserve against those loans.

So I would like to say that we be treated the same as all other businesses, and that we be allowed in addition to the 6-year average reserve based on actual losses a reserve based upon an evaluation of each of the loans and a classification of the loans along the lines that I have mentioned.

Shall I proceed now?

Senator ANDERSON. Go right ahead.

Mr. ROTH. First permit us to compliment the Senate Committee on Finance, as well as the rest of the Congress, for their readiness to respond to the public demand for tax reform and tax justice. The House bill that is before you goes a long way toward closing many loopholes that allow some individuals and businesses to avoid, partially or wholly, the payment of taxes. When they do so, of course, others who are fully taxed have to bear more than their fair share of the tax burden. What we term loopholes today were, in the past, in many instances, originally intended to encourage and stimulate certain segments of the economy and were enacted for the public good, but stimulation, like pump priming, is required only until the flow starts and then should be discontinued. We hope that in the future pump-priming subsidy tax legislation will have an expiration date suitable to its purpose.

The principal provision applying to commercial banks in the House bill, if enacted, would result in the collection of additional taxes from commercial banks of approximately $250 million annually. It provides for the elimination of the 2.4-percent bad-debt loss reserve and places the banks on an actual experience basis, and it also gives us a 10-year loss carryback which is extremely valuable. The 2.4-percent loss reserve is the equivalent of an addition of about 8 percent to the capital funds of the bank, which is nowhere near a catastrophic reserve such as we do need and such as we should have. But a loss carryback of 10 years is the equivalent of many times a 2.4 percent loan loss reserve.

Many bankers will feel that unless the savings and loan associations and mutual savings banks are taxed in the same way on their earnings as commercial banks are, tax equality will not have been achieved and an unfair loophole will still exist.

The House bill would in the future base the bad-debt reserves of commercial banks on actual loss experience. It would reduce, over a 10-year period, the special bad-debt allowances now allowed to savings and loan associations and mutual savings banks; it would not eliminate them. Thus, the House bill provides an imperfect solution as far as the commercial banks are concerned.

According to the Ways and Means Committee, the House bill would result in commercial banks paying an effective tax rate of about 31 percent. The reason this rate is computed to be less than the full effective tax rate of about 44 percent paid by industrial corporations is because of the way in which income received from tax-exempt municipal obligations is handled in the computation. The Ways and Means Committee adds the full amount of tax thereon. In real economic terms, this approach is not correct.

Since the municipality pays substantially lower interest than would be paid on a taxable bond, the transaction is the same from an economic standpoint as though the municipality had sold the bond at the going interest rate for comparable taxable bonds, the holder of the bond had paid a tax equal to the difference between the going interest rate

and the lower rate actually paid by the municipality, and this tax had been turned over to the municipality.

Consequently, to correctly compute the effective tax rate of banks holding tax-exempt bonds, it is necessary to add to taxable income the amount the bank would have received had it purchased taxable bonds and to add to the tax paid by the banks the benefit realized by the municipality from the tax subsidy.

On this basis, under the House bill, commercial banks would pay an effective tax rate on their economic income that would be generally comparable to the effective rate paid by industrial corporations.

We were disappointed that the House bill did not equalize the bad-debt loss reserves for the banks on the one hand and the savings and loan associations and the mutual savings banks on the other, although its proposals, with some modifications, would represent improvement over present tax formulas.

The Treasury recommendations relating to financial institutions differ from the House bill. First, they would base future additions to bad-debt reserves of all financial institutions on actual loss experience. This would achieve the full equality of tax treatment that our association has so long supported. Then, the Treasury recommends a special incentive deduction of 5 percent of the interest on certain types of loans which should be encouraged, such as residential mortgage loans, student loans, and SBA loans. This incentive would be available to all financial institutions.

We heartily endorse the policy of the Treasury proposals, both from a tax equality standpoint and from the standpoint of the encouragement it would provide for increased loans where they are needed and where interest rates are now so high.*

I would like to go further and say that hearing about the 10 percent that was proposed for low income housing I would go along with that also.

The membership of the Bankers Committee for Tax Equality comes almost entirely from small commercial banks. On December 31, 1968, 85 percent of all the commercial banks in the United States had deposits of under $25 million and their aggregate deposits equaled 19 percent of total deposits, or $84 billion.

Residential mortgages held by all commercial banks in the United States totaled $41 billion. It is estimated that about a third of the residential mortgages held by commercial banks are held by small banks with deposits under $25 million.

These small banks will benefit more than the larger banks from the Treasury's proposal. Generally, the smaller the commercial bank the greater will be the advantage of the Treasury proposal, because of their higher ratio of residential mortgages.

The effect on earnings of savings and loan associations and mutual savings banks would be much greater, as they have a higher percentage of their assets in residential mortgages.

But the real beneficiary of the Treasury proposal will be the home buyer and residential tenant. The Treasury proposal will increase competition for residential loans and thereby drive down the interest

*The Treasury proposal provides that the new incentive deduction cannot reduce taxable income below 60 percent of taxable income before the incentive deduction, but increased by the amount of tax-exempt interest and the intercorporate dividend deduction.

rate. Indeed, it is possible that the tax subsidy received by the financial institutions will be largely offset by the lower interest rates they will have to charge to compete in the mortgage market.

Now, this morning I was shocked to learn that the proposal of the Treasury with regard to the 5 percent subsidy applies to all mortgages that are on the books of our financial institutions as of the present time even though some of these mortgages may have been made 5 years ago, or even 10, 15, or 20 years ago. I thought that the purpose of such a subsidy is to provide an incentive to make new loans in the future. How can we give a subsidy based upon what has occurred in the past?

We hope, therefore, that your committee will adopt the Treasury proposals, after making this correction. In the event, however, that the committee decides to follow the House approach, we urge the following changes:

1. Under present law, savings and loan associations and mutual savings banks are allowed additions to their bad-debt reserves equal to 60 percent of taxable income. The House bill reduces this to 30 percent over a 10-year period. Since this still would give these institutions a substantial tax advantage over commercial banks, we recommend that this tax subsidy be reduced to 20 percent, or less, by the end of the 10-year period.

2. Present law provides that additions may be made to the bad-debt reserves of mutual thrift institutions until the reserve reaches 6 percent of qualifying real property loans. This ceiling permits the accumulation of excessive bad-debt reserves and should be reduced to 4 percent or less.

3. The House bill permits the full benefit of the special bad-debt reserve provisions to savings and loan associations only if they invest 82 percent of their funds in certain qualifying assets, including residential real property loans. Mutual savings banks must invest 72 percent of their funds in qualifying assets to obtain similar treatment. To assure that these special tax subsidies are limited to cases where the institutions channel their funds into the intended assets, we recommend that both savings and loan associations and mutual savings banks be required to invest 85 percent of their funds in qualifying assets in order to obtain the full tax advantage. Moreover, the definition of "qualifying assets" should be revised so that it does not include cash and Government Bonds. But I want to repeat, we stand for the Treasury recommendations, with the exception that I have noted.

The Bankers Committee for Tax Equality was founded by commercial banks 20 years ago for the sole purpose of helping to create equality of taxation for all types of competing banking institutions. We hope that this year's tax reform will give us equality and that the Bankers Committee for Tax Equality will have completed its task.

Thank you, gentlemen.

Senator ANDERSON. Any questions?

Senator WILLIAMS Mr. Roth, did I understand you to refer to this 5 percent setaside as a retroactive subsidy for the banking industry?

Mr. ROTH. That is what the Treasury told me this morning. I couldn't believe it and I said "You must be wrong. You had better recheck it," and they came back and said "no, that is what we intend, that

it be based upon all the loans as proposed by the Treasury, that are on the books of the institutions at the present time.

Senator WILLIAMS. Do you think that can be justified?

Mr. ROTH. I don't see how an incentive or a subsidy can be based upon what occurred in the past years.

Senator WILLIAMS. Would you have an estimate as to how much money would be involved if that were adopted?

Mr. ROTH. Well, of course, over a period of about 15 years it would be equalized. In other words, the loans that are on the books at the present time will have been amortized and paid off in 15 to 20 years or so and the new loans that have replaced those that have been paid off will all be subject to the 5 percent.

How much would be involved annually? Well, I would say in the case of commercial banks, $90 million—before tax $90 million, after tax close to $40 million. In the case of savings banks and savings and loan associations, four times that amount, maybe $200 million overall involved.

Senator WILLIAMS. Then, in your opinion, this is a subsidy over and beyond the existing law allowances?

Mr. ROTH. That is right.

Senator WILLIAMS. Yes.

No further questions.

Senator ANDERSON. Senator Bennett.

Senator BENNETT. You represent the Bankers Committee for Tax Equality? You heard Mr. Ogilvie this morning say that development companies should be allowed to accumulate a reserve of 10 percent. Do you have any comment on that?

Mr. ROTH. I don't like any across-the-board, industrywide reserve. There are small business investment companies, like some banks, that make very risky loans. Their losses are heavy. There are others that never have a loss. So an industrywide reserve is not good. Banking is the only group that had it and I think it is wrong that we have it. It should be based on experience.

Senator BENNETT. You remember, Mr. Ogilvie said they haven't been there long enough safely to base their reserves on experience. Do you think they might be given a phase-in period?

Mr. ROTH. Well, they were originally given a phase-in period. That phase-in period expired about a year ago. Frankly, I don't think the phase-in period was long enough. I think they should have an extension of it, but I also feel, as I mentioned before, that in addition to a loss reserve based on experience they should also have an alternative based upon an aging of their loans, whether they are doubtful, substandard and so forth.

Senator BENNETT. Well, of course, they say all their loans are substandard by definition before they start.

Mr. ROTH. Yes, that is true. They have to be, because the loans would have to have been turned down by a bank; and for that reason, you have to be more lenient in the loss reserve that you allow them.

Senator BENNETT. How long an additional extension of their aging period do you believe they should have?

Mr. ROTH. Well, I say a minimum of 3 years. It would be more reasonable to let them have 5 years.

Senator BENNETT. Thank you very much.
Senator ANDERSON. Senator Byrd.
Senator BYRD. Thank you, Mr. Chairman.
Mr. Roth, I am not clear as to your position on the 2.4-percent reserve for bad debts.
Mr. ROTH. I feel the banks should not have an industrywide reserve for bad debts. It should be just as I said with regard to small business investment companies. Some banks never have losses on loans. Other banks are more liberal and have heavy losses. Why should there be an industrywide reserve? It should be based on experience. The 6-year loss average is what I would advocate, which is in the House bill.
In addition to that, the House bill allows a 10-year carryback for losses, which is truly a catastrophic reserve. This is what banks do need. They do need it in the public interest and in the interest of the economy of our Nation—a catastrophic reserve. The closing of a bank causes grave consequences.
Senator BYRD. You favor the House position on that?
Mr. ROTH. I favor the House position.
Senator BYRD. Thank you, Mr. Chairman.
Senator ANDERSON. Senator Miller; Senator Jordan.
Senator JORDAN. No questions.
Senator MILLER. I just wanted to comment, Mr. Roth. I can appreciate the refinement that goes into your recommendation for taking a look at different kinds of loans and the different status for various kinds of loans, but I suggest to you that this could be almost an impossible administrative chore to throw on the Revenue Service because this bank or this lending institution here might have a group of officers who decide that this particular loan is in such a category as to want a 25-percent bad-debt reserve and another bank in another part of the country might have a very similar situation where they could perhaps feel that 10 percent is all right, and then you throw it upon the Internal Revenue Agency to make an evaluation. And while I think that within a group of financial experts we might say this is a good approach, I suggest to you that from the standpoint of administration it would be virtually impossible to administer.
Mr. ROTH. I would agree with you, sir, except that when we are examined, whether we are examined by the Comptroller of the Currency, the Federal Reserve, or the Federal Deposit Insurance Corporation, all three agencies classify our loans as lost, doubtful, substandard, special mention. So we can use their classifications for that purpose.
Senator MILLER. Well, if you could break out a classification like that perhaps you have a point. I don't know how current the classification would be, and how recent the classification would have to be.
Mr. ROTH. Well, we are examined——

Senator MILLER. That would certainly help. If that is a feasible thing to do, that would certainly help with the problem I have. How often are you examined as to classification?

Mr. ROTH. At least once a year. Three times in 2 years.

Senator MILLER. In other words, the most recent one would be the basis.

Mr. ROTH. The most recent one would prevail.

Senator MILLER. And you have four different categories?

Mr. ROTH. We have those categories.

Senator MILLER. And you are suggesting separate bad-debt reserve as to each of those four separate categories?

Mr. ROTH. I suggest that the 6-year average be used but that the bank have the option of using these classifications. We have the same thing with regard to any business company. The law doesn't specify—the law specifies the 6-year average but, on the other hand, they are allowed to do an aging of their accounts receivable and set up a reasonable reserve regardless of the 6-year average.

Senator MILLER. Would you furnish to the committee an example of how a particular lending institution would handle such a classification?

Mr. ROTH. Yes, I could.

Senator MILLER. Thank you.

(The committee subsequently received the following letter from Mr. Roth.)

FRANKLIN NATIONAL BANK,
Franklin Square, N.Y., September 18, 1969.

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

GENTLEMEN: When I testified before your Committee on September 15th I was asked to submit some additional information with regard to the recommendation that I made that commercial banks, in addition to being allowed a loan loss reserve equal to the average of its losses for the past six years, be given the option of setting up a loan loss reserve based upon their loans subject to criticism by the Examining authorities.

The six year average loss reserve recommended by the House is based upon past experience in losses. However, it is often much more important that a bank set up reserves based upon what they can expect in the way of losses in the future. This can be determined from the Report of Examination of their supervisory authorities. A bank may have a low loss reserve over the past six years, but its criticized loans may indicate catastrophic losses for the future and they should be in a position to adequately reserve against these coming catastrophic losses.

The recommendation that I made was to the effect that this optional reserve be based upon classifications of criticized loans. Please note that the lower percentage figure is the amount that I stated in my testimony. However, I feel that this is a minimum and, therefore, have included in addition to the minimum percentage of reserve, a second figure which I feel is more realistic especially because of the position of banks in the economy of our nation.

There is enclosed definitions of Sub-Standard and Special Mention loans, together with sample sheets covering these loans, taken from a Report of Examination.

The reserves I recommend to be set up against classified loans are as follows:

[In percent]

	Minimum reserve	Recommended reserve
Doubtful	50	75
Substandard	25	50
Special mention	10	25

I would recommend that the banks be permitted to apply the recommended percentage based upon the last Report of Examination of the bank, (Examinations are made at least once a year) and that this amount may be used for the income tax report at year-end whether or not the criticized loans have been paid or reduced. New criticized loans will have crept in substantially offsetting the reduced criticized loans.

If you would like to have me come to Washington to discuss this in more detail I would be happy to do so.

Cordially,

ARTHUR T. ROTH,
Chairman of the Board.

CHARTER NO. 12997

Amount, maker, endorser, security and comments	Date	Class	Overdue	Substandard	Doubtful	Loss
[Deleted]	July 30, 1968					
[Deleted] Estate's main asset is parcel of land in Florida which is encumbered and which sale has not been possible to date. Remote collection prospects of our loan. Chargeoff agreed.	May 25, 1964	B	70,000			70,000
[Deleted] This is a participation in a $150,000 loan which was purchased from Metropolitan National Bank of Maryland; collateraled by first lien on a parcel of land in Washington, D.C.; appraised at $200,000 by the originating bank. A recent appraisal by a developer valued the property at no more than $75,000. His statement of Feb. 15, 1968 shows a substantial net worth. This is considered unrealistic as he has very little real equity in his realty holdings and he is having difficulty in meeting mortgage payments. He also operates two restaurants which are reported to be successful. Bank plans to foreclose and seek a buyer for the property, and any deficiency judgment would be obtained against Laganas.	Apr. 8, 1967	A	99,000	50,000	49,000	
[Deleted]	Dec. 15, 1967	A	44,700			
[Deleted]	Dec. 15, 1967	A	35,000			
[Deleted] Both companies operating under chapter XI of Bankruptcy Act. A proposed settlement of 35 percent to creditors over a period of years has been made and was informally approved. It is doubtful that operations would permit the corporations to meet the proposed annual creditor payments based on poor experience to date. For the deficiency of 65 percent under the settlement, bank has taken from guarantors a second lien on apartment house valued at $45,000, subject to $20,000 first lien, and also assigned participations in 2 third mortgages, 1 of which is in default. The only portion of the loans which appears collectible is that collateraled by the second lien with $25,000 net equity. Chargeoff of balance of loans agreed.				25,000		54,700
[Deleted.] Unsecured; continuous from September 1966; another bank shares a like amount of credit. Interim statement May 31, 1968 showed working capital of $568,000, current debts of $3,759,000, total debts $4,541,000, and net worth $1,480,000. Company lost $354,000 from operations in the 6-month interim period.	Aug. 14, 1968	B	879,345	879,345		

OTHER LOANS ESPECIALLY MENTIONED—CHARTER NO. 12997

[This schedule includes loans or portions thereof which are superior in quality to those classified substandard, but which, for the reasons indicated, are believed to warrant more than usual management attention.]

[Deleted]	$1,500,000
[Deleted]	−500,000
Total	1,000,000

This bank given $2,000,000 unsecured line; aggregate lines at 15 banks total $52,500,000. Interim statement Aug. 31, 1968, showed equity (net worth plus suoordinated debt) $21,100,000, senior debt $47,600,000. For fiscal year ending May 31, 1968, the company showed a loss of $6,638,000 (before related tax credit), after providing $7,900,000 for reserves against receivables. Actual chargeoffs to the reserves for the fiscal year were $5,600,000 (recoveries were nominal); this included a large third lien on the [deleted]. The $7,900,000 provision made to the reserve account during the year included $6,000,000 primarily for two special situations; the [deleted] group of loans which totaled $10,582,000 and the [deleted] group of loans which totaled $7,703,000. The company's collateral was principally realty equity positions. The C.P.A. has made the special comment that there are uncertainties involved in the realization of the collateral underlying these two large concentrations, and increases in the reserves for losses could possibly be required. The unsoundness of the heavy concentrations in high-risk loan categories involved past management. In early 1968, [deleted] acquired 90 percent ownership, resulting in management and operational changes with a review committee formed to pass on all major transactions and with a policy limit of $2,000,000 in any one situation.

[Deleted.]

(1) Demand unsecured loan on which $50,000 monthly reductions are being made	350,000
(2) Time unsecured continuous since September 1967 with a high of $1,030,000 in 1968	650,000
(3) Unsecured term loan payable monthly through June 1969	17,464
(4) Unsecured advance to affiliated [deleted] unchanged at present amount since inception Aug. 31, 1967	40,000
Total	1,057,464

Interim statement July 31, 1968, showed W/C $1,500,000; current debts $5,981,000; total debts $6,492,000; N/W $5,995,000. Operating results have been unsatisfactory over the past 3-year period. In fiscal year ending Oct. 31, 1966, profit was only slightly above break even; there was an operating loss of $1,900,000 (before related tax credit) in fiscal 1967; and for the 9-month period in the current year losses continued with $333,000 operating deficit. Management anticipates that the full current year may show a break-even result. Problems have been reported due to low bidding and the lack of proper job supervision. Management brought in a new comptroller early this year in order to effect a tighter rein on costs.

[Deleted.]

(1) Unsecured advance originated May 14, 1968, at $100,000 and increased to present amount Oct. 1, 1968	200,000
(2) Unchanged at present amount since inception November 1967 and supported by various liquid collateral valued at $40,000 (amount not extended). Further supported by second liens on three parcels of real estate located in less than desirable sections of New York City. Bank, however, places no value on this collateral at the present. Fiscal statement Dec. 31, 1967, shows a highly leveraged position with total debts $4,459,000 and N/W $683,000. Operations for the period ending statement date indicated profits of $206,000 before withdrawals of $84,000. Bank's advances were used to finance various acquisitions and in several construction projects. Repayment is anticipated from various projects now in progress if sufficient profit is realized. One venture reportedly has encountered extraordinary expenses early in the construction stage which may curtail the profit margin	175,000
Total	335,000

Senator ANDERSON. Senator Jordan.

Senator JORDAN. No questions.

Senator BENNETT. Mr. Chairman, did we for the record establish Mr. Roth's connection with a bank, his personal connection rather than his relationship with the committee?

Mr. ROTH. Yes.

I am chairman of the board of the Franklin National Bank, New York City, 18th largest bank in the United States.

Senator BENNETT. Thank you.

Senator ANDERSON. Thank you very much.

Mr. OGILVIE. Mr. Chairman, may I be recognized to clarify one point. My name is Ogilvie, I testified just a moment ago and I think there may be——

Senator ANDERSON. Let's not have a debate but make a statement.

Mr. OGILVIE. Yes, sir.

Business Development Corp. have not been phased-in. We have had no allocation as to the amount of reserve that can be established, and I believe Mr. Roth at least gave that impression.

Mr. ROTH. For small businesses.

Mr. OGILVIE. Small business Investment Corps. have but Business Development Corps. have not.

Senator BENNETT. Thank you.

(Arthur T. Roth and L. Shirley Tark's prepared statement follows:)

STATEMENT OF ARTHUR T. ROTH AND L. SHIRLEY TARK ON BEHALF OF THE BANKERS COMMITTEE FOR TAX EQUALITY

My name is Arthur T. Roth. I am chairman of the board of directors of the Franklin National Bank, New York City. I appear before your committee as co-chairman of the Bankers Committee for Tax Equality. With me is my fellow co-chairman, L. Shirley Tark, chairman of the board of directors of the Main State Bank, Chicago, Illinois. Our committee represents nearly 5,000 commercial banks engaged in commercial and savings banking throughout the United States.

First permit us to compliment the Senate Committee on Finance, as well as the rest of the Congress, for their readiness to respond to the public demand for tax reform and tax justice. The House bill that is before you goes a long way toward closing many loopholes that allow some individuals to avoid, partially or wholly, the payment of taxes. When they do so, of course, others who are fully taxed have to bear more than their fair share of the tax burden. What we term loopholes today were, in the past, in many instances, originally intended to encourage and stimulate certain segments of the economy for the public good. But this stimulation, like pump priming, is required only until the flow starts and then should be discontinued. He hope that in the future pump-priming subsidy tax legislation will have an expiration date suitable to its purpose.

THE PRINCIPAL PROVISION APPLYING TO COMMERCIAL BANKS

The principal provision applying to commercial banks in the House bill (H.R. 13270), if enacted, would result in the collection of additional taxes from commercial banks of approximately $250 million annually. It provides for the elimination of the 2.4-percent bad-debt loss reserve and places the banks on an actual experience basis.

Many bankers will feel that unless the savings and loan associations and mutual savings banks are taxed in the same way on their earnings as commercial banks are, tax equality will not have been achieved and an unfair loophole will still exist.

The House bill would in the future base the bad-debt reserves of commercial banks on actual loss experience. It would reduce, over a 10-year period, the special bad-debt allowances now allowed to savings and loan associations and mutual savings banks; it would not eliminate them. Thus, the House bill provides an imperfect solution as far as the commercial banks are concerned.

According to the Ways and Means Committee, the House bill would result in commercial banks paying an effective tax rate of about 31 percent. The reason this rate is computed to be less than the full effective tax rate of about 44 percent paid by industrial corporations is because of the way in which income received from tax-exempt municipal obligations is handled in the computation. The Ways and Means Committee adds the full amount of tax thereon. In real economic terms, this approach is not correct.

TAX-EXEMPT INTEREST AND THE EFFECTIVE TAX RATE

Since the municipality pays substantially lower interest than would be paid on a taxable bond, the transaction is the same from an economic standpoint as though the municipality had sold the bond at the going interest rate for comparable taxable bonds, the holder of the bond had paid a tax equal to the difference between the going interest rate and the lower rate actually paid by the municipality, and this tax had been turned over to the municipality.

Consequently, to correctly compute the effective tax rate of banks holding tax-exempt bonds, it is necessary to add to taxable income the amount the bank would have received had it purchased taxable bonds and to add to the tax paid by the banks the benefit realized by the municipality from the tax subsidy.

On this basis, under the House bill, commercial banks would pay an effective tax rate on their economic income that would be generally comparable to the effective rate paid by industrial corporations.

THE HOUSE BILL DOES NOT EQUALIZE BAD-DEBT LOSS RESERVE

We were disappointed that the House bill did not equalize the bad-debt loss reserves for the banks on the one hand and the savings and loan associations and the mutual savings banks on the other, although its proposals, with some modifications, would represent improvement over present tax formulae.

TREASURY RECOMMENDATIONS

The Treasury recommendations relating to financial institutions differ from the House bill. First, they would base future additions to bad-debt reserves of all financial institutions on actual loss experience. This would achieve the full equality of tax treatment that our association has so long supported. Then, the Treasury recommends a special incentive deduction of 5% of the interest on certain types of loans which should be encouraged, such as residential mortgage loans, student loans, and SBA loans. This incentive would be available to all financial institutions.

We heartily endorse the policy of the Treasury proposals, both from a tax equality standpoint and from the standpoint of the encouragement it would provide for increased loans where they are needed and where interest rates are now so high.*

EFFECT ON SMALLER BANKS

The membership of the bankers committee for tax equality comes almost entirely from small commercial banks. On December 31, 1968, 85% of all the commercial banks in the United States had deposits of under $25 *million* and their aggregate deposits equaled 19% of total deposits, or $84 *billion*.

Residential mortgages held by all commercial banks in the United States totaled $41 billion. It is estimated that about a third of the residential mortgages held by commercial banks are held by small banks with deposits under $25 million.

These small banks will benefit more than the larger banks from the Treasury's proposal. Generally, the smaller the commercial bank the greater will be the advantage of the Treasury proposal.

The effect on earnings of savings and loan associations and mutual savings banks would be much greater, as they have a higher percentage of their assets in residential mortgages.

But the real beneficiary of the Treasury proposal will be the home buyer and residential tenant. The Treasury proposal will increase competition for residential loans and thereby drive down the interest rate. Indeed, it is possible that the tax subsidy received by the financial institutions will be largely offset by the lower interest rates they will have to charge to compete in the mortgage market.

The Treasury estimates that the benefits of this incentive would approximate the revenue loss resulting from the removal of the bad debt reserve provisions.

IF THE HOUSE BILL'S APPROACH IS FOLLOWED

We hope that your committee will adopt the Treasury proposals. In the event, however, that the committee decides to follow the House approach, we urge the following changes:

1. Under present law, savings and loan associations and mutual savings banks are allowed additions to their bad-debt reserves equal to 60 percent of taxable income. The House bill reduces this to 30 percent over a 10-year period. Since this still would give these institutions a substantial tax advantage over commercial banks, we recommend that this tax subsidy be reduced to 20 percent, or less, by the end of the 10-year period.
2. Present law provides that additions may be made to the bad-debt reserves of mutual thrift institutions until the reserve reaches 6 percent of qualifying real property loans. This ceiling permits the accumulation of excessive bad-debt reserves and should be reduced to 4 percent or less.

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*The Treasury proposal provides that the new incentive deduction cannot reduce taxable income below 60 percent of taxable income before the incentive deduction, but increased by the amount of tax-exempt interest and the intercorporate dividend deduction.

3. The House bill permits the full benefit of the special bad-debt reserve provisions to savings and loan associations only if they invest 82 percent of their funds in certain qualifying assets, including residential real property loans. Mutual savings banks must invest 72 percent of their funds in qualifying assets to obtain similar benefits. To assure that these special tax subsidies are limited to cases where the institutions channel their funds into the intended assets, we recommend that both savings and loan associations and mutual savings banks be required to invest 85 percent of their funds in qualifying assets in order to obtain the full tax advantage. Moreover, the definition of "qualifying assets" should be revised so that it does not include cash and Government bonds.

CONCLUSION

The Bankers Committee for Tax Equality was founded by commercial banks 20 years ago for the sole purpose of helping to create equality of taxation for all types of competing banking institutions. We hope that this year's tax reform will give us equity and that the Bankers Committee for Tax Equality will have completed its task.

Senator ANDERSON. Mr. Clark.

STATEMENT OF EDWARD P. CLARK, PRESIDENT, ARLINGTON FIVE CENTS SAVINGS BANK OF ARLINGTON, MASS., AND CHAIRMAN, COMMITTEE ON TAXATION OF THE NATIONAL ASSOCIATION OF MUTUAL SAVINGS BANKS; ACCOMPANIED BY DR. GROVER W. ENSLEY, EXECUTIVE VICE PRESIDENT, NATIONAL ASSOCIATION OF MUTUAL SAVINGS BANKS

Mr. CLARK. Mr. Chairman, my name is Edward P. Clark and I am president of the Arlington Five Cents Savings Bank of Arlington, Mass., and chairman of the Committee on Taxation of the National Association of Mutual Savings Banks.

With me are Dr. Grover Ensley, executive vice president of the association, Dr. George Hand, director of research; and Mr. Jack S. Older, assistant general counsel.

There are now before you two proposals to revise the tax treatment of financial institutions—the one included in H.R. 13270, the other included in the administration's statement to this committee on September 4. Although different in basic approach, the proposals have in common an especially harsh impact on mutual thrift institutions and, hence, on mortgage and housing markets. Thus, while their stated intent is to stimulate, their effect is to reduce, the flow of credit into housing and other socially desirable uses.

In addition to this intent, the administration proposal attempts to achieve equity of taxation between mutual thrift institutions and commercial banks. It fails on both counts.

The proposal gives with on hand a "special tax deduction" related to the gross income from designated, socially desirable investments, while with the other hand takes away the bad debt reserves allowance currently permitted thrift institutions. The taking away far more than offsets the giving, and hence materially discourages residential lending. We agree with the American Bankers Association on the need of financial institutions for a statutory bad debt reserve allowance.

The proposal—however well-intended backfires because thrift institutions need no special "incentives" to channel funds into areas such as housing where they are already heavily invested. Savings banks have 75 percent of their assets in mortgage loans, and of the mortgage

loans, about 30 percent is on properties located in the 32 States which do not have savings banks. It backfires because, without a realistic bad debt reserve allowance to protect against potential losses, prudent thrift institutions must seek less risky investments, and ultimately many would convert into commercial banks to gain broader powers.

The proposal backfires, moreover, because the special deduction is so circumscribed as to limit its usefulness to many savings banks, and so designed as to fall with widely varying impact on individual institutions, not necessarily in relation to their residential lending activity. The savings bank industry, as a whole, would qualify (after the transition period) for a special deduction of less than 10 percent of "economic income," while roughly half of all savings banks would have no special deduction at all. This, in spite of the fact that the bulk of savings bank assets would be in socially desirable loans, as defined by the administration.

The administration proposal could be modified to achieve its stated objective with respect to mutual savings banks, but not without altering its basic structure. This is so because (1) a realistic bad debt reserve provision would need to be included, along the lines of the present law or of the proposed House bill with appropriate changes, and (2) the 60-percent limitation would need to be eliminated or substantially reduced.

No one can quarrel with the concept of equity as a basic objective of tax legislation. But equitable tax treatment does not necessarily mean identical treatment. In fact, when applied to unequal institutions, identical treatment is inequitable. This is the effect of the administration proposal to tax thrift institutions and commercial banks under the identical formula. The intent of the proposal may be to achieve tax equity; the result, in fact, would be to aggravate already existing competitive inequalities stemming from the substantially broader range of powers, greater flexibility and profitable use of interest-free demand deposits enjoyed by commercial banks.

Equality of tax treatment without equality of competitive opportunities does in fact place a disproportionately heavy tax burden on thrift institutions. The burden is even heavier than it appears from the administration statement, because the effective tax rate for mutual thrift institutions would be higher if "economic income" reflected realistic deductions for potential long-term mortgage portfolio losses.

Such realistic bad debt reserve allowances recognize the greater reserve needs of institutions whose assets are dominated by long-term loans, than of commercial banks with predominantly short-term loan portfolios. To be sure, mortgage loan losses have been unusually low during the postwar inflationary economic boom. But history indicates that losses tend to be concentrated and substantial during short periods of time. Such losses generally occur during economic recessions and declining values, but could also occur when real estate values and prices are relatively stable, rather than rising as in recent years. Surely, prudent lenders must be prepared for such an eventuality.

Heavier tax burdens imposed on mutual thrift institutions would clearly weaken their ability to compete with commercial banks and hence reduce the supply of funds for housing and inner city rebuilding. In sum, administration fears that the House-passed tax revisions would limit "free and open competition between thrift institutions

and commercial banks" more aptly apply to its own proposals. If the Congress, however, decides to impose excessively burdensome tax provisions on thrift institutions, then the Congress should also permit mutual savings banks the powers to compete effectively with commercial banks.

Of the two proposals before this committee, the House bill with modifications, would be less harmful.

One objection to the House bill is that it imposes a relatively narrow investment standard on mutual savings banks. The need for investment flexibility for mortgage-oriented institutions is widely recognized as essential to strengthening their ability to attract savings and generate an expanded supply of mortgage credit over the economic cycle. By liquidating nonmortgage investments, savings banks were able to channel an amount equivalent to 108 percent of deposit growth into mortgage loans during the 1966 credit crunch, and over 100 percent in the first 7 months of 1969. The importance of such flexibility was reemphasized in a major congressionally authorized study just completed for the Federal Home Loan Bank Board under the direction of Prof. Irwin Friend. It seems clear that the objective of encouraging expanded mortgage flows can be better accomplished by not establishing narrow investment standards. Furthermore, flexible powers for financial institutions are better geared to meeting the Nation's changing social and economic priorities over the years, and this was confirmed by Chairman Martin of the Federal Home Loan Bank Board this morning.

We do, of course, understand that the objective of the House measure is to relate bad debt reserve allowances to investments in specific types of assets. The House does, however, recognize the need of mortgage-oriented thrift institutions for bad debt reserve allowances different from those of nonmortgage-oriented commercial banks. If the Congress feels that an investment standard should be imposed on savings banks for the first time, we urge that it be broadened to include all types of mortgage lending, which are essential to the rebuilding of our urban areas.

We urge additional revisions in the House bill. Our recommendations in this respect are detailed in the comprehensive statement submitted to this committee which we request be included in the printed record of these hearings. In particular, we strongly believe that the present 60 percent maximum percentage of income bad debt reserve allowance be retained, rather than reduced to 30 percent, in order to avoid a further major reduction in housing credit.

All things considered, the savings bank industry fairly believes that the present tax provisions for mutual savings banks accomplish for housing exactly what the Congress intended—a strong stimulus to residential mortgage flows. The proposed changes, if enacted would be particularly unfortunate at the present time when housing and mortgage credit are already depressed and likely to deteriorate further. It is important to note that current tax obligations of savings banks are rising and will rise significantly further without changing the present tax laws.

If the Congress, nevertheless, decides to change the law, it must consider: who will ultimately bear the increased burden? The answer seems clear—it will be the American family, whether homeowner or

tenant. Residential borrowing costs will rise, because the supply of mortgage credit will be reduced, and because prudent lenders will have to provide for bad debt risks out of aftertax dollars. With mortgage credit becoming ever scarcer and more expensive, adoption of either the administration proposal or the House bill in its present form, will add another dimension to the present mortgage and housing crisis, as well as permanently increase the costs of housing America. Whether, or by how much, these costs are increased, is for the Congress to decide.

Thank you, Mr. Chairman.

Senator ANDERSON. Any questions.

Thank you very much.

(Edward P. Clark's prepared statement follows:)

STATEMENT OF EDWARD P. CLARK, CHAIRMAN, NATIONAL ASSOCIATION OF MUTUAL SAVINGS BANKS

SUMMARY

Mr. Chairman and members of the Committee, my name is Edward P. Clark. I am President of the Arlington Five Cents Savings Bank of Arlington, Massachusetts, and Chairman of the Committee on Taxation of the National Association of Mutual Savings Banks. With me are Dr. Grover W. Ensley, Executive Vice President of the Association; Dr. George Hanc, Director of Research; and Mr. Jack S. Older, Assistant General Counsel.

There are now before you two proposals to revise the tax treatment of financial institutions— the one included in H.R. 13270, passed by the House on August 7, the other included in the Administration's statement on this bill, presented to this Committee on September 4. Although different in basic approach, the proposals have in common an especially harsh impact on mutual thrift institutions and, hence, on mortgage and housing markets. Thus, while their stated intent is to stimulate, their effect is to reduce, the flow of credit into housing and other socially desirable uses.

THE ADMINISTRATION PROPOSAL

In addition to this intent, the Administration proposal attempts to achieve equity of taxation between mutual thrift institutions and commercial banks. It fails on both counts. The proposal gives with one hand a "speical tax deduction" related to the gross income from designated, socially desirable investments, while with the other hand takes away the bad debt reserve allowance currently permitted thrift institutions. The taking away far more than offsets the giving, and hence materially discourages residential lending.

The proposal—however well-intended—backfires because thrift institutions need no special "incentives" to channel funds into areas such as housing where they are already heavily invested. It backfires because, without a realistic bad debt reserve allowance to protect against potential losses, prudent thrift institutions must seek less risky investments, and ultimately many would convert into commercial banks to gain broader powers.

The proposal backfires, moreover, because the special deduction is so circumscribed as to limit its usefulness to many savings banks, and so designed as to fall with widely varying impact on individual institutions, not necessarily in relation to their residental lending activity. The savings bank industry, as a whole, would qualify (after the transition period) for a special deduction of less than 10 per cent of "economic income," while roughly half of all savings banks would have no special deduction at all. This, in spite of the fact that the bulk of savings bank assets would be in socially desirable loans, as defined by the Administration.

The Administration proposal could be modified to achieve its stated objective with respect to mutual savings banks, but not without altering its basic structure. This is so because: (1) a realistic bad debt reserve provision would need to be included, along the lines of the present law or of the proposed House bill with appropriate changes, and (2) the 60 per cent limitation would need to be eliminated or substantially reduced.

No one can quarrel with the concept of equity as a basic objective of tax legislation. But equitable tax treatment does not necessarily mean identical

treatment. In fact, when applied to unequal institutions, identical treatment is inequitable. This is the effect of the Administration proposal to tax thrift institutions and commercial banks under the identical formula. The intent of the proposal may be to achieve tax equity; the result, in fact, would be to aggravate already existing competitive inequalities stemming from the substantially broader range of powers, greater flexibility and profitable use of interest-free demand deposits enjoyed by commercial banks.

Equality of tax treatment without equality of competitive opportunities does in fact place a disproportionately heavy tax burden on thrift institutions. The burden is even heavier than it appears from the Administration statement, because the effective tax rate for mutual thrift institutions would be higher if "economic income" reflected realistic deductions for potential long-term mortgage portfolio losses.

Such realistic bad debt reserve allowances recognize the greater reserve needs of institutions whose assets are dominated by long-term loans, than of commercial banks with predominantly short-term loan portfolios. To be sure, mortgage loan losses have been unusually low during the postwar inflationary economic boom. But history indicates that losses tend to be concentrated and substantial during short periods of time. Such losses generally occur during economic recessions and declining values, but could also occur when real estate values and prices are relatively stable, rather than rising as in recent years. Surely, prudent lenders must be prepared for such an eventuality.

Heavier tax burdens imposed on mutual thrift institutions would clearly weaken their ability to compete with commercial banks and hence reduce the supply of funds for housing and inner city rebuilding. In sum, Administration fears that the House-passed tax revisions would limit "free and open competition between thrift institutions and commercial banks" more aptly apply to its own proposals. If the Congress, however, decides to impose excessively burdensome tax provisions on thrift institutions, then the Congress should also permit mutual savings banks the powers to compete effectively with commercial banks.

THE HOUSE-PASSED PROPOSAL

One objection ot the House-passed tax provision is that it imposes a relatively narrow investment standard on mutual savings banks. The need for investment flexibility for mortgage-oriented institutions is widely recognized as essential to strengthening their ability to attract savings and generate an expanded supply of mortgage credit over the economic cycle. By liquidating nonmortgage investments, savings banks were able to channel an amount equivalent to 108 per cent of deposit growth into mortgage loans during the 1966 credit crunch, and over 100 per cent in the first seven months of 1969. The importance of such flexibility was reemphasized in a major Congressionally authorized study just completed for the Federal Home Loan Bank Board under the direction of Professor Irwin Friend. It seems clear that the objective of encouraging expanded mortgage flows can be better accomplished by not establishing narrow investment standards. Furthermore, flexible powers for financial institutions are better agreed to meeting the nation's changing social and economic priorities over the years.

We do, of course, understand that the objective of the House measure is to relate bad debt reserve allowances to investments in specific types of assets. The House does, however, recognize the need of mortgage-oriented thrift institutions for bad debt reserve allowances different from those of non-mortgage-oriented commercial banks. If the Congress feels that an investment standard should be imposed on savings banks for the first time, we urge that it be broadened to include all types of mortgage lending, which are essential to the rebuilding of our urban areas.

We urge additional revisions in the House bill. Our recommendations in this respect are detailed in the comprehensive statement submitted to this Committee, which we request be included in the printed record of these hearings. In particular, we strongly believe that the present 60 per cent maximum percentage of income bad debt reserve allowance be retained, rather than reduced to 30 per cent, in order to avoid a further major reduction in housing credit.

CONCLUSION

All things considered, the savings bank industry firmly believes that the present tax provisions for mutual savings banks accomplish for housing exactly what the Congress intended—a strong stimulus to residential mortgage flows. The proposed changes, if enacted, would be particularly unfortunate at the present time when housing and mortgage credit are already depressed and likely to deteriorate further. It is important to note that current tax obligations of savings banks are rising and will rise significantly further without changing the present tax laws.

The National Association of Mutual Savings Banks has given careful consideration to the two proposals before this Commitee to revise the tax treatment of financial institutions. We believe that, contrary to their own stated objectives, they would have a seriously adverse effect on the flow of credit into housing and other socially desirable uses. Of the two, however, we believe the House-approved measure as modified in our statement, would be less harmful to housing.

STATEMENT

Mr. Chairman and members of the Committee, my name is Edward P. Clark. I am President of the Arlington Five Cents Savings Bank of Arlington, Massachusetts, and Chairman of the Committee on Taxation of the National Association of Mutual Savings Banks.

I am accompanied by Dr. Grover W. Ensley, Executive Vice President of the National Association of Mutual Savings Banks; Dr. George Hanc, Director of Research; and Mr. Jack S. Older, Assistant General Counsel.

The National Association of Mutual Savings Banks represents substantially all of the nation's 500 mutual savings banks. These banks are located in 18 states. Since 1816, when the first savings banks were founded, they have pursued two main functions: (1) to encourage and protect the savings of individuals; and (2) to channel these savings into productive investments, mainly mortgage loans.

Today, mutual savings banks have over $73 billion in total assets (Table 1). Seventy-five per cent of their total assets, or over $54 billion, is in mortgage loans, and, of this $54 billion, over one-half is in FHA and VA mortgage loans. Besides serving local mortgage credit needs in their communities, savings banks hold about $15.1 billion in loans on properties in the 32 nonsavings bank states where demands for housing credit have been especially strong (Table 2). Moreover, mutual savings banks are the leading private institutional lenders under the basic FHA urban home renewal and redevelopment programs.

TABLE 1.—COMPOSITION OF ASSETS AND LIABILITIES OF MUTUAL SAVINGS BANKS, JUNE 30, 1969

[Dollar amounts in millions]

Assets and liabilities	Amounts	Percent of assets	Assets and liabilities	Amounts	Percent of assets
Cash	$865	1.2	Other loans	1,633	2.2
U.S. Government securities	3,618	4.9	Other assets	1,306	1.8
Federal agency securities	1,939	2.6			
State and local government securities	192	.3	Total assets	73,316	100.0
Corporate and other bonds	6,983	9.5	Deposits	66,243	90.4
Corporate stock	2,107	2.9	Other liabilities	1,664	2.3
Mortgage loans	54,672	74.6	General reserves	5,409	7.4
FHA	15,910	21.7			
VA	12,356	16.9			
Conventional	26,407	36.0	Total liabilities and reserves	73,316	100.0

Note: Breakdown of mortgage holdings is partially estimated on the basis of data for the end of 1968.

Source: National Association of Mutual Savings Banks.

TABLE 2.—MORTGAGE LOANS HELD BY MUTUAL SAVINGS BANKS IN SELECTED NONSAVINGS BANK STATES, OCT. 31, 1962, AND SEPT. 30, 1968

[Amounts in millions of dollars]

State	Oct. 31, 1962	Sept. 30, 1968	State	Oct. 31, 1962	Sept. 30, 1968
California	2,196	4,725	New Mexico	126	171
Texas	987	1,483	Utah	98	151
Florida	1,070	1,462	Kentucky	84	135
Virginia	604	1,176	Arkansas	24	82
Georgia	361	722	Kansas	68	81
Louisiana	251	465	Nebraska	34	73
Michigan	340	456	Idaho	4	27
Tennessee	221	412	Iowa	13	25
Arizona	351	364	Montana	2	8
Illinois	163	342	Other nonsavings bank states	958	2,211
Oklahoma	194	280	Total nonsavings bank states	8,290	15,078
Missouri	141	228	Total mortgage holdings	31,583	52,410

Source: National Association of Mutual Savings Banks.

Accomplishments of the 1962 Tax Law

As we testified before the House Ways and Means Committee, we believe that the present provisions of the Internal Revenue Code affecting mutual savings banks, which were enacted in 1962, accomplished for housing exactly what the Congress intended—a strong stimulus to residential mortgage flows.[1] They have permitted mutual savings banks to establish realistic bad debt reserve allowances in light of the risks incurred by mortgage-oriented thrift intsitutions which "borrow short and lend long," primarily on residential real estate. In this regard, Treasury Department data indicate that mutual savings banks since 1962 have actually had smaller bad debt reserve deductions, relative to loan growth, than either savings and loan associations or commercial banks (Table 3).

The strong stimulus provided by the present law to the flow of mortgage credit, particularly for FHA and VA mortgage loans and for urban revitalization programs, is indicated by the record of the savings bank industry since 1962. From the end of 1962 to the end of 1968, mutual savings banks increased: (1) their total mortgage holdings by $21 billion; (2) their overall ratio of mortgage loans to total assets from 69.5 to 74.9 per cent (Table 4); and (3) their FHA and VA mortgage portfolios by $8.6 billion, far more than the combined expansion in FHA and VA mortgage holdings for all other private institutional lenders (Table 5). By liquidating nonmortgage investments, mutual savings banks were able to channel into mortgage loans an amount equivalent to 108 percent of their deposit growth during the credit crunch of 1966. More recently, in the first seven months of 1969, another period of mortgage credit stringency, mortgage holdings of mutual savings banks rose by $1.6 billion, an amount equivalent to over 100 per cent of their deposit growth.

TABLE 3.—DEDUCTIONS FOR BAD DEBTS RELATIVE TO GROWTH IN "ELIGIBLE" OR "QUALIFYING" LOANS—MUTUAL SAVINGS BANKS, SAVINGS AND LOAN ASSOCIATIONS, AND COMMERCIAL BANKS 1963-66

[Dollar amounts in millions]

	Mutual savings banks	Savings and loans	Commercial banks
1. Deductions for bad debts for tax purposes, 1963-66	$431	$1,991	$2,862
2. Increase in "eligible" or "qualifying" loans, 1963-66	15,137	35,677	81,251
3. Ratio of number 1 to number 2 in percent	2.85	5.58	3.52

Note: Data for number 1 are from "Tax reform studies and proposals, U.S. Treasury Department," Committee on Ways and Means of the U.S. House of Representatives and Committee on Finance of the U.S. Senate, 91st Cong., first sess., Feb. 5, 1969, pt. 3, table 3, p. 473. Data for number 2 refer to the increase in eligible loans of commercial banks from the same source, table 4, p. 474, and to increases in mortgage loans held by mutual savings banks and savings and loan associations, as reported in the "Federal Reserve Bulletin."

[1] See *Tax Reform, 1969*, Hearings Before the Committee on Ways and Means, House of Representatives, 91st Congress, 1st Session, Part 10, March 24, pp. 3469–3507, hereinafter referred to as "Tax Reform Hearings."

[Dollar amounts in millions]

	Mortgage holdings	Total assets	Mortgage-asset ratio (percent)	Net increase in mortgage holdings	Gross mortgage acquisitions
1962	$32,056	$46,121	69.5	$3,155	$6,245
1963	36,007	49,702	72.4	3,951	7,706
1964	40,328	54,238	74.4	4,322	8,500
1965	44,433	58,232	76.3	4,105	8,654
1966	47,193	60,982	77.4	2,759	7,066
1967	50,311	66,365	75.8	3,118	7,417
1968	53,286	71,152	74.9	2,798	7,015

Note: Data on mortgage holdings, total assets and mortgage-asset ratio are as of year end.

Source: National Association of Mutual Savings Banks.

TABLE 5.—HOLDINGS OF FHA AND VA MORTGAGE LOANS BY MAIN TYPES OF INSTITUTIONAL LENDERS, 1962-68

[Amounts in millions of dollars]

	Total institutional lenders	Mutual savings banks	Commercial banks	Savings and loan associations	Life insurance companies
Holdings, end of year:					
1962	56,256	19,025	9,174	11,486	16,571
1963	59,954	21,174	9,967	11,656	17,157
1964	62,929	23,408	10,057	11,577	17,887
1965	65,486	25,199	10,390	11,543	18,354
1966	66,094	25,971	10,143	11,428	18,552
1967	67,707	26,869	10,405	12,150	18,283
1968	69,903	27,602	10,634	13,670	17,997
Change in holdings, 1963-68:					
Amount	13,647	8,577	1,460	2,184	1,426
Percentage distribution	100.0	62.8	10.7	16.0	10.4

Note: Data on changes in holdings are for the period from the end of 1962 to the end of 1968.

Source: Board of Governors of the Federal Reserve System.

Furthermore, tax payments of mutual savings banks are rising and will continue to rise without any change in the present law because of the declining importance of the largely temporary factors that reduced tax payments in past years. These factors were: (1) the widespread use of the present 3 per cent bad debt reserve provision which allows mutual savings banks, in general, to deduct 3 per cent of mortgage loan growth; (2) huge losses on the sale of bonds undertaken to meet liquidity needs and provide funds for mortgage lending; and (3) sharp increases in interest payments to depositors.

Many mutual savings banks, however, are shifting from the 3 per cent method to the 60 per cent of income method because their mortgage-asset ratios are now stabilizing at high levels. Losses on bond sales should assume smaller proportions as mortgage-asset ratios stabilize. As mortgage repayments are reinvested at higher interest rates, net earnings are increasing. And savings banks are seeking to strengthen their total general reserves through increased earnings retention. All of these factors are contributing to increased taxable incomes and tax payments under the present law.

Impact of Proposed Tax Changes

Before this Committee now are two proposals for revising the tax treatment of financial institutions—sections 441–443 of the House-passed Tax Reform bill (H.R. 13270) and the Administration proposal presented to this Committee on September 4. These proposed changes differ in certain basic respects. *As between the two proposals, we believe that the House bill, despite its serious adverse effects on housing credit, would provide a better basis for the taxation of mortgage-oriented thrift institutions, assuming that the Congress decides that the present tax law must be changed.* This is because it would appear to be more feasible to modify the House bill, as indicated later in this statement, in order to reduce its harmful impact on housing and urban revitalization programs, while, at the same time, significantly increasing tax payments of all financial institutions. As also noted later, the modifications needed to reduce the Admin-

istration proposal's adverse impact on housing credit would require basic changes in its structure.

It should be reemphasized, however, that, in our judgment, both proposed changes—especially the Administration proposal, but also the House bill if our suggested modifications are not adopted—would have similar, harmful effects on mortgage oriented thrift institutions, savings depositors and housing and urban revitalization programs.

First, in view of the much broader powers enjoyed by competing commercial banks, enactment of either proposal would place a disproportionate burden of increased tax payments on mutual thrift institutions, the main source of housing credit. Commercial banks presently have powerful competitive advantages, including a wider range of financial services, authority to make high-yield business and consumer loans, the greater flexibility inherent in short-term lending, the ability to acquire capital through the sale of stock, ability to tap wide sources of loanable funds, and the profitable use of interest-free demand deposit and money creation powers. If mutual thrift institutions pay taxes at the effective rates contemplated by these proposals, they would be placed at a serious competitive disadvantage relative to commercial banks. In this regard, the House bill is apparently designed to raise the effective rate of taxation more sharply for thrift institutions than for commercial banks. With respect to the Administration proposal, Assistant Secretary Cohen indicated in response to questioning by Committee members, that thrift institutions and commercial banks would all pay taxes at an effective rate of about 29 per cent of "economic income" (assuming that they have sufficient gross income from residential mortgages and other qualifying loans under the 5 per cent provision discussed later).

In actuality, such comparisons of effective rates of taxation, based on so-called "economic income," greatly underestimate the increased tax burden on mutual thrift institutions, and, therefore, the harmful consequences for housing. "Economic income," greatly underestimate the increased tax burden on muaual thrift institutions, and, therefore, the harmful consequences for housing. "Economic income," as used by Treasury officias, is not defined in the tax law. It does not reflect any deduction for bad debt reserves (except as determined by recent loss experience). If a realistic allowance for potential mortgage losses were deducted, projected tax payments could then be related to a more meaningful and considerably lower amount of "economic income." The resulting effective tax rates of thrift institutions would then be even higher than Treasury officials suggest.

Such a realistic bad debt reserve allowance would reflect the greatly different reserve needs of mutual thrift institutions whose assets are dominated by long-term mortgage loans. It would also reflect accurately the potential losses on mortgage loans. To be sure, losses have been unusually low during the inflationary postwar economic boom, reflecting in large part the sharp and prolonged rise in real estate values and burgeoning housing demands since the end of World War II. In a period of serious economic decline, or even a period of extended stability in real estate values and overall prices, however, greater losses can be anticipated. Mortgage losses during the depression of the 1930's were extremely high. Massachusetts savings banks during the 1931–45 period sustained mortgage losses equivalent to 17.4 per cent of average mortgage holdings for the period, and 14.3 per cent of holdings as of the end of 1930.[1] While a depression of the magnitude experienced in the 1930's is not expected, a future severe recession, accompanied by significantly increased losses on mortgage loans, cannot be ruled out. Furthermore, it must be recognized that in a period of relatively stable prices and real estate values, which we hope can be achieved, greater mortgage losses must be expected.

Thus, the proposed tax changes would impose levels of taxation on thrift institutions that: (1) ignore the broader powers and competitive advantages of commercial banks; and (2) are in actuality considerably higher than is suggested by "economic income" comparisons. The increased tax burden imposed by these proposals would weaken the ability of mutual thrift institutions to compete with nonmortgage-oriented commercial banks. It would also reduce their ability to maintain adequate reserve needed for protection against potential losses on long-term residential loans and to meet requirements of supervisory authorities. Unlike commercial banks which have the option of selling new stock to acquire additional capital, mutual savings banks can accumulate protective reserves only through the retention of earnings.

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[1] *Tax Reform Hearings*, p. 3488.

Second, enactment of either the provisions in the House bill in its present form or the Administration proposal would reduce, rather than stimulate, the supply of mortgage credit for housing and urban revitalization programs. This reduction would result from a combination of forces stimulated in varying degrees by the two proposals. The weakened competitive position of mutual thrift institutions would lead to a diversion of the flow of saving to nonmortgage-oriented commercial banks. As discussed more fully later, the Administration proposal would eliminate any bad debt reserve allowance (other than that provided by recent loss experience) and deny to many savings banks the "special deduction" proposed as a substitute. The resulting reduced ability of mutual thrift institutions to set aside realistic bad debt reserve allowance for-term mortgage loans would stimulate shifts of funds to less risky nonmortgage investments. Ultimately, many thrift institutions would be compelled by competitive pressures to convert into commercial banks, and adopt their nonmortgage lending pattern. Even if there should be any increase in mortgage lending by commercial banks—which is doubtful because of their basic, short-term nonmortgage orientation—this would be far outweighed by reduced mortgage flows from thrift institutions. Reflecting fundamental differences in investment orientation, mortgage loans represent about 75 per cent of mutual savings bank assets, compared with only 14 per cent of commercial bank assets.

The resulting reduction in funds for housing and urban revitalization would represent a cost to the nation which, in our judgment, would far outweigh any immediate increase in the tax payments of mutual thrift institutions. Moreover, due to their weakened competitive position and reduced ability to set aside needed reserves for future mortgage losses, we doubt that mutual thrift institutions in the long-run would be able to attract the volume of saving apparently expected. With reduced rates of growth in resources, their taxable incomes and tax payments could fall short of projected amounts. Estimates of increased revenue resulting from enactment of these proposals apparently assume continuation of strong rates of growth at these institutions. It is hazardous to make any such assumption in view of the fierce competition for savings. We are not attempting here to make any revenue estimates, but we feel it is reasonable to believe that if the present law were retained, and mutual thrift institutions were allowed to compete more effectively for savings, there would be more money for housing, higher incomes for thrift institutions, and an increasing volume of tax payments by thrift institutions in the years ahead.

We recognize, however, that there are strong pressures for changes in the tax treatment of financial institutions, including mutual savings banks. If this Committee, after considering the harmful effects on housing, concludes that mutual thrift institutions should be taxed more heavily, we urge that certain modifications in the House bill be adopted to reduce its adverse consequences for housing and urban revitalization programs.

Needed Modifications in the Provisions of the House Bill

As passed by the House, section 442 of H.R. 13270 would make the following changes in the bad debt reserve provisions of mutual savings banks:

1. Repeal the present 3 per cent provision which permits these institutions, in general, to deduct 3 percent of the growth in their mortgage holdings as an addition to bad debt reserves; and
2. Reduce the alternative percentage of income bad debt reserve allowance by:
   a. Lowering the maximum allowance from 60 per cent of taxable income to 30 per cent over a ten year transition period;
   b. Permitting mutual savings banks to qualify for the maximum allowance only if they have 72 per cent of their total assets in certain specified types of qualifying assets;
   c. Lowering the maximum allowance for mutual savings banks that do not meet the 72 per cent standard according to a sliding scale provision; and
   d. Denying any percentage of income deduction to mutual savings banks that have less than 60 percent of their total assets in qualifying assets.

Similar changes were made in the bad debt reserve provisions of savings and loan associations. Under section 441 of the House bill, commercial banks would no longer be permitted to accumulate bad debt reserves up to 2.4 per cent of eligible loans and would be required to deduct additions to bad debt reserves on the basis of actual loss experience only.

The modifications we urge in the House bill are as follows:

1. Eliminate the 72 per cent investment standard;

2. If elimination of the investment standards is contrary to Congressional policy, then change the standard in these three ways:

a. Broaden the list of qualifying assets to include all mortgage loans which are essential to residential living and the rebuilding of our decaying urban centers;

b. Revise the sliding scale provision which requires a reduction of the percentage of income bad debt deduction for each percentage point a savings bank is below the 72 per cent standard in order to reduce the penalty imposed in the earlier years for which the new provisions will be effective; and

c. Eliminate the provision which denies any percentage of income deduction to savings banks with less than 60 per cent of their total assets in qualifying assets; and

3. Retain the 60 per cent maximum percentage of income deduction rather than reduce it over a ten-year period.

Elimination of the 72 per cent investment standard for savings banks would be consistent with widespread, bipartisan, public and private recognition that increased investment flexibility for mortgage-oriented thrift institutions is the best means of strengthening their ability to attract savings and generate an expanded long-run supply of mortgage credit.[3] The importance of investment flexibility for mortgage-oriented thrift institutions was demonstrated dramatically during the 1966 mortgage credit crisis. Because of their broader investment powers, mutual savings banks were better able than savings and loan associations to compete for savings, meet liquidity pressures and satisfy local mortgage credit demands. Flexible investment powers, moreover, have permitted mutual savings banks to adjust their lending policies to meet the nation's continually changing social and economic priorities. The importance of investment flexibility was reemphasized in a major, Congressionally-authorized study just completed for the Federal Home Loan Bank Board under the direction of Professor Irwin Friend.[4]

As Secretary Kennedy testified before this Committee on September 4:

> Investment restrictions limit the ability of the thrift institutions to compete for savings during periods of tight money. They also fail to recognize other important national goals.

While we strongly believe that elimination of the 72 per cent investment standard is desirable, we recognize that the House sought to to relate the percentage of income bad debt reserve allowance to investments in certain types of assets. If this requirement is retained, the list of assets qualifying under the 72 per cent standard should be broadened to include all mortgage loans, which are essential in rebuilding our urban centers. At the very least the standard should include the types of loans indicated below.

The House bill now includes loans made to improve commercial property in urban renewal and Model Cities areas and loans secured by educational, health, and welfare facilities. It does not go far enough, however, since numerous other supplementary and supportive facilities are essential adjuncts to family living in all areas. Individuals and families must have ready access to shopping and service facilities for food and clothing, as well as facilities for the repair and servicing of household appliances and automobiles. Moreover, in urban renewal and Model Cities areas, there is a critical need for job-creating facilities, such as factories, office buildings, warehouses, industrial parks and transportation facilities.

Furthermore, the House bill includes mobile homes not used on a transient basis, but does not include the mobile home parks in which qualifying mobile homes will be located. In many sections of the country the development of mobile home parks is vital in helping to provide low-cost housing sites.

Individuals and families transferring to new areas because of better job opportunities often need to use transient living facilities when permament facilities are not immediately available. Thus, hotels and motel facilities are also essential parts of the total living environment in our society which is marked by a high degree of mobility and wide ranging opportunity.

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[3] Tax Reform Hearings, pp. 8491 and 8492.

[4] Irwin Friend, *Study of the Savings and Loan Industry: Summary and Recommendations*, Prepared for the Federal Home Loan Bank Board, Washington, D.C., September, 1969.

Therefore, we suggest that the list of assets qualifying for purposes of meeting the 72 percent investment standard be broadened to include all mortgages, particularly the following:

1. Loans secured by shopping and service facilities;
2. Loans secured by property in any urban renewal area (as defined in section 110(a) of the Housing Act of 1949, as amended) or in any area covered by a program eligible for assistance under section 103 of the Demonstration Cities and Metropolitan Development Act of 1966, as amended. This would be in addition to loans for the improvement of such properties already included in the bill;
3. Loans secured by mobile home parks; and
4. Loans secured by hotels and motels.

In addition, several technical problems must be solved in drafting a final version of the investment standard. These problems are discussed in the Appendix following the statement.

As to the revision of the sliding scale provision, the House bill provides that a mutual savings bank with less than 72 percent of its total assets in qualifying assets would be required to reduce the maximum percentage of income bad debt deduction by a certain number of percentage points for each percentage point that its ratio of qualifying assets falls below the standard. In the first two years for which the new law would be effective, the reduction in reserve allowances is two percentage points for each one percentage point below the 72 per cent standard. For the next five years the reduction would be 1½ points for each point below the standard, and thereafter the reduction would be on a one-for-one basis. A sliding scale is essential if the 72 per cent standard is retained since about one-fifth of the savings banks have qualifying asset ratios below 72 per cent of total assets. It is clear, however, that the specific sliding scale provision in the House bill works a greater hardship on mutual savings banks in the initial years for which the new provision would be effective.

This is neither reasonable nor equitable. Many mutual savings banks would seek to alter the composition of their assets to meet the investment standard. As long-term lenders, they would need many years to make the necessary changes, and should not be penalized while attempting to shift their assets in line with the objectives of the bill. Thus, it would be more equitable to revise the sliding scale provision so that the reduction would be permanently one percentage point in the reserve allowance for each one percentage point that an institution's qualifying asset ratio is below the 72 per cent standard.

Deletion of the provision denying the percentage of income bad debt reserve deduction to savings banks with less than 60 per cent of total assets in qualifying assets is desirable since, otherwise, these institutions would be allowed bad debt deductions only on the same basis as commercial banks, without having the broad powers and competitive advantages enjoyed by commercial banks. They might be forced to convert into commercial banks in order to preserve their competitive viability. While the number of mutual savings banks involved is small, a significant reduction in housing credit could result in certain local market areas. Our recommended deletion would provide some small percentage of income deduction for these mutual savings banks below 60 per cent, while they seek to increase their mortgage holdings and qualify for higher reserve allowances.

Finally, we believe that the present reserve allowance of 60 per cent of income is justified for all mortgage-oriented thrift institutions, and should not be reduced to 30 per cent as provided in the House bill. As long-term lenders, both mutual savings banks and savings and loan associations are especially vulnerable to large-scale losses in a severe economic recession, depite the favorable experience of recent time. They must accumulate adequate reserves during periods of prosperity to meet the losses that can occur if real estate markets undergo a severe decline.

The need for adequate reserves would not be obviated by the provision in the House bill permitting financial institutions to carry back net operating losses for ten years, rather than three years as in the present law. While this provision is desirable for the long run and should be retained, it would have little practical application in the immediate future. Taxable incomes of mutual savings banks have been small in relation to loan holdings, and tax refunds would not compensate for potential loan losses.

Retention of the present 60 per cent bad debt reserve allowance would permit savings banks to compete more effectively for savings and provide more mortgage credit, while generating an increasing volume of tax revenue. Recently available

industrywide figures suggest that savings banks, operating increasingly under the 60 per cent provision in the present law, expect to pay four or five times as much tax in 1969 as in 1967, without any change in the present law.

The Administration Proposal

The Administration proposal provides a basically different approach to the taxation of financial institutions than the House bill. As Treasury officials testified before this Committee, the Administration proposal would:

1. Eliminate any bad debt reserve allowance for thrift institutions (other than that provided by recent loss experience) and substitute a "special deduction" for thrift institutions and commercial banks of 5 percent of gross interest income on residential and certain other loans;
2. Limit this special deduction so that it could not reduce taxable income below 60 percent of taxable income adjusted to include the full amount of dividend income and tax-exempt interest; and
3. Phase in the increased tax burden on mutual savings banks and savings and loan associations over a five-year period, instead of the ten-year transition period provided in the House bill.

Commercial banks would tend to be more lightly taxed under the Administration proposal than under the House bill. Among thrift institutions, the burden of increased taxation would tend to be shifted under the Administration bill toward institutions that have utilized flexible investment powers, contrary to the stated objective of the Administration as indicated by Secretary Kennedy before this Committee.

The special deduction is designed to encourage the flow of funds into residential construction and other socially preferred uses. In view of their basic, long-standing mortgage orientation, mutual savings banks need no special inducement to invest in residential mortgage loans. Nor do they seek any such inducement. Rather, as indicated earlier, mutual savings banks seek a bad debt reserve allowance that will realistically reflect the risks involved in long-term mortgage lending. A realistic reserve allowance—that would enable thrift institutions to set aside needed reserves in the light of potential mortgage losses. and enable them to compete effectively for savings—is a far better means of encouraging an adequate flow of mortgage credit.

Even apart from these considerations, the special deduction would provide a highly imperfect incentive for channeling funds into these uses because of the 60 percent limitation. It would vary widely in a manner unrelated to the institution's residential mortgage lending activity. Two institutions having identical proportions of assets in mortgages and experiencing identical rates of growth in mortgage holdings might qualify for greatly different special deductions. The highly variable incentive for residential mortgage lending provided by the special deduction proposed by the Administration contrasts with the present law, since bad debt reserve deductions under the 3 percent provision are geared precisely to mortgage growth and under the percentage of income allowance are limited by the ceiling of 6 percent of real property loans.

Based on published balance sheet data and reasonable assumptions regarding yields on various types of assets, the savings bank industry as a whole would qualify (after transition periods are completed) for a special deduction of less than ten percent of "economic income." Indeed, many savings banks—as a rough estimate, about one-half of our institutions—would have no special deduction under the Administration proposal. Despite the fact that the overwhelming proportion of their assets are in residential mortgage loans, these institutions would be taxed in the same manner as nonfinancial corporations and would be denied the special deduction designed by the Administration specifically for financial institutions and to encourage real estate lending. In contrast, under the House bill, only about 2 percent of the savings banks would be denied the percentage of income bad debt reserve deduction.

Enactment of the Administration proposal in the form presented to this Committee would lead to major changes in assets and structure by many mutual savings banks. Denied both a realistic bad debt reserve deduction, and in many cases, the proposed special deduction, many institutions would shift funds from mortgages into less risky investments. Ultimately, many mutual thrift institutions would convert into commercial banks in order to acquire the broader powers commercial banks enjoy. State laws of many savings bank states already permit such changes. Indeed, the second largest mutual savings bank in New Hampshire, motivated, in part, by apprehension regarding rumored savings bank tax changes,

has already taken steps to convert into a commerical bank. Where present legal authority is lacking, permissive legislation would undoubtedly be sought.

The result of such changes, both immediately and in the long run, would be a reduction in the flow of mortgage credit into housing and urban revitalization programs, as some mutual thrift institutions shift funds to nonmortgage investments and others convert into commerical banks and adopt their nonmortgage lending pattern. As noted earlier, the increased overall tax burden on mutual thrift institutions, in the face of the competitive advantages of commercial banks, would further reduce the supply of housing credit. Taking all these effects into account, we believe that the Administration proposal would fail to achieve its stated objective of encouraging the flow of funds into residential mortgages and other loans made pursuant to national objectives. It would certainly result in major changes in our industry's financial structure.

We do not believe that the Administration proposal can be modified in a manner that would result in realistic tax provisions for mutual thrift institutions, while retaining its present structure, because it has two principal defects:

1. The fact that the Administration proposal does not provide a realistic bad debt reserve provision for mortgage-oriented thrift institutions; and
2. The fact that the special deduction proposed as a substitute for a bad debt reserve allowance would not be available, in practice, to many savings banks.

To correct the first defect, it would be necessary to adopt an approach similar either to the present law or to the House bill with the modifications we have suggested. To correct the second defect, it would be necessary to remove the 60 per cent limitation, or reduce it to a considerably lower figure, and to make additional changes in the 5 per cent provision. A major restructuring of the Administration proposal would be necessary, therefore, to provide a reasonable basis for taxing mutual thrift institutions. Such a major restructuring seems impractical. Therefore, we believe that the House bill, despite its seriously adverse effects on housing credit, could provide a better basis for the taxation of mortgage-oriented thrift institutions, assuming that the Congress decides that the present tax law must be changed.

Conclusion

The savings bank industry reiterates that the present law enacted in 1962 accomplished for housing exactly what the Congress intended—a strong stimulus to residential mortgage flows—and will provide an increasing flow of tax revenue from thrift institutions in future years. We recognize that the Congress may, nevertheless, decide to impose heavier taxation on thrift institutions. Therefore, we have suggested what we believe to be constructive recommendations for modification of the House bill which would reduce the harmful impact on housing and other vital national programs.

If the Congress, however, decides to impose excessively burdensome tax provisions on thrift institutions—especially the Administration proposal, but also the House provisions without the modifications suggested in this statement—then the Congress should also permit mutual savings banks the powers needed to compete effectively with commercial banks.

Appendix

TECHNICAL CONSIDERATIONS RELATING TO SECTION 442 (MUTUAL SAVINGS BANKS, ETC.) OF H.R. 13270

Section 442(a) of H.R. 13270 (Tax Reform Act of 1969) would change section 593(b) of the Internal Revenue Code of 1954 which provides rules for the allowance of tax deductible bad debt reserve additions by mutual savings banks and savings and loan associations. There are basically two changes: (1) repeal of the 3 percent method which allows thrift institutions to deduct 3 percent of their mortgage loan growth, and (2) modification of the percentage of taxable income method which allows them to deduct 60 percent of taxable income. The modification of the percentage of taxable income method, as set forth in section 442, presents certain technical problems.

Section 593(b) (2) and (3) of the Code would be amended to permit a mutual savings bank to take the maximum percentage of taxable income deduction only if 72 percent of its total assets are assets described in section 7701(a)(19)(C) of the Code. Section 442(b) of H.R. 13270 would amend section 7701(a)(19)(C) of the Code to describe the assets which must comprise 72 percent of total assets.

It should be noted that the purpose of section 7701(a)(19) is to define a "Domestic Building and Loan Association," and that mutual savings banks are for the first time affected by subparagraph (C) of section 7701(a)(19) for purposes of an investment standard rather than a definition. This necessitates some clarification to make sure that mutual savings banks are given equitable treatment with respect to determining the qualifying assets they hold for purposes of the investment standard.

For example, section 7701(a)(19)(C)(iv) as amended, refers to "loans secured by a deposit or share of a member." It should be made clear that loans secured by a deposit in a mutual savings bank, as well as a savings and loan association, are in this category. Mutual savings banks do not have members, and recently, savings and loan associations were permitted to amend their charters to have their account holders denominated as depositors rather than members.

Section 7701(a)(19)(C)(x) refers to "property used by the association in the conduct of the business described in subparagraph (B)." It should also be made clear that property used by a savings bank in the conduct of its business qualifies.

Furthermore, section 7701(a)(19)(C)(v) refers to "loans secured by an interest in real property which is . . . residential real property . . ." Savings banks make loans secured by large apartment houses. These apartment houses often contain space for stores or offices which are essential adjuncts to residential living in urban areas and often occupy space unsuitable for residential dwelling purposes. As a result, there may be some uncertainty in determining the portion of this kind of loan which qualifies under the 72 percent standard.

The Treasury regulations under present section 7701(a)(19) recognize this problem and provide a rather complicated rule for determining the portion of a mixed loan which qualifies for definitional purposes. *Reg. § 301.7701-13(k)* deals with amount and character of loans, and it requires a comparison based on the loan value of qualifying property to the amount of the loan involved. In the interest of easier administration of the law and better taxpayer understanding it would be appropriate to provide a statutory rule which is less complicated than the current regulations. For example, it would be simpler and more equitable to allow a loan secured in part by residential property to qualify in total if more than 50 percent of the property securing the loan is used on a space basis for residential purposes.

Another problem relating to "loans secured by an interest in real property which is . . . residential real property . . ." is whether redeemable ground rents are to be included in this category. In the state of Maryland, private homes are often sold subject to so-called ground rents under which the home buyer assumes an obligation to pay a fixed amount per year on the property and 5 years after the creation of the ground rent, he may redeem the ground rent by paying an amount computed by capitalizing the rental payment at a 6 percent rate. Mutual savings banks in Maryland purchase redeemable ground rents thereby making it possible for more individuals to afford to buy homes. These ground rents make up about 7 per cent of savings bank assets in Maryland.

The Congress recognized that redeemable ground rents are in the nature of mortgage loans when it enacted P.L. 88-9 in 1963, adding section 1055 to the Internal Revenue Code of 1954 and amending Code section 163 to provide for the deduction of annual or periodic rental payments under a redeemable ground rent as interest on an indebtedness secured by a mortgage. Moreover, the present Internal Revenue Regulations relating to both mutual savings banks and savings and loan associations define the term "loan" to include a redeemable ground rent. *Reg. § 1.593-11(a); Reg. § 301.7701-13(j)(i)*. It is submitted, therefore, that section 7701(a)(19)(C)(v) of the Code, as amended by section 442(b) of H.R. 13270, should be changed to specifically refer to redeemable ground rents on residential property as "loans secured by an interest in residential real property."

Senator ANDERSON. Mr. Bliss.

STATEMENT OF GEORGE L. BLISS, PRESIDENT AND MANAGING DIRECTOR, COUNCIL OF MUTUAL SAVINGS INSTITUTIONS

Mr. BLISS. My name is George L. Bliss. I reside in Mount Vernon, N.Y., and I am president and managing director of the Council of Mutual Savings Institutions.

It is our position that section 442(a) of the House bill should be withdrawn and set aside for further study and hearings, or the alternative hereinafter proposed should be substituted.

The practical effect of section 442(a) is to nearly double the tax payments required of these mutual institutions, which they can meet only by either reducing the rate of interest-dividends paid on the accounts of their savings members, or by increasing the rate of interest charged to their borrowing members.

At the end of 1968, the average size of the approximately 5,250 mutual institutions was $23 million.

Based on Treasury Department figures in the Ways and Means Committee report, they paid taxes in 1966 of about $735 per million dollars.

From a random sample of 20 such institutions, we estimate that section 442(a), when fully effective, will cost them an additional $595 per million dollars. The fact that such an increase is spread over 10 years makes it no less painful than to cut off a dog's tail by inches.

Because these mutual institutions have no capital stock, but disburse all of their earnings after establishing required loss reserves, there is no source for such an increase except (a) by reducing the interest-dividends paid on accounts of savings members, or (b) by increasing the interest charged to borrowing members.

The 6 percent ceiling in the "Reserve for Losses on Qualifying Real Property Loans" is completely unrealistic. The mutual savings banks entered the 1929–32 depression with loss reserves in the range of 12 percent to 14 percent. They came through that experience practically unscathed. The mutual savings and loan associations confronted that crisis with loss reserves that averaged no more than 5 to 6 percent. Their survival rate was approximately one-half, that is, some 6,000 survived out of 12,000, or so. In 1951, when the Revenue Act of 1951 was pending, the State supervisors testified that these institutions should be permitted to accumulate aggregate loss reserves of 15 percent. The Congress set the figure at 12 percent. The ceiling decrease to 6 percent was effected by the 1962 amendments. In consequence, the ratio of loss reserves has been steadily decreasing, as is shown in the following table—available data includes both mutuals and nonmutuals. At the end of 1941, the loss reserve ratio was 7.9 percent of resources.

At the end of 1951, it was 7.6 percent; at the end of 1962, it was 7 percent; and at the end of 1968, it was 6.7 percent.

There is a chart attached to our statement which shows the ratio of loss reserves from 1941 through 1968 and, on the copy I hold in my hand, I have drawn a red line which indicates the year that each of these tax amendments took effect. As you will observe, if you draw a line at that point, the loss reserves decreased thereafter in each instance.

Whereas the Internal Revenue Code provides that any taxpayer may deduct authorized losses either on a direct charge-off basis or by the reserve method, all mutual institutions must use the reserve method, for these reasons:

(*a*) By statute or regulation, every mutual institution, without exception, must allocate a portion of earnings, before credit of interest-dividends to its savings members, to reserves for possible future losses. Following is an excerpt from a typical State law. [Condensed and numbering added for clarity.]

When the net profits have been determined, if its loss reserves do not equal 10 percent of savings and 50 percent of book value of real estate held—(1) one-twentieth of such net profit shall be credited to such loss reserve. (2) The balance, together with any amounts remaining from previous periods, shall constitute the undivided profits. The directors may transfer additional amounts to loss reserves or continue to carry as undivided profits such sum as they deem wise. (3) The undivided profits shall be available for dividends, which shall be apportioned upon the dues and dividends credited to members. Section 387 of the New York Banking Law.

A similar law is to be found in the laws of practically every State. The regulations of the Federal Home Loan Bank Board with respect to Federal savings and loan associations are substantially the same.

In addition, such institution, if its accounts are insured by the Federal Savings and Loan Insurance Corporation, must meet the requirements of FSLIC regulations for allocations to loss reserves which, under certain circumstances, may amount to 10 percent of net earnings, before interest-dividends.

(b) Required to use the reserve method, by statute, regulation or the need for survival, these institutions are further confronted by a formula inconsistent with the basic principle of mutual operation, in that the code—since the 1962 amendments—requires that both operating expenses and the distribution of interest-dividends be first deducted, and a tax imposed on a portion of the remainder.

(c) A further inequity exists in that the bill leaves unchanged the requirement, first imposed in the 1962 amendments, and increases the amount of tax on amounts so set aside and available only to meet losses which are deductible under the direct charge-off basis, thereby burdening these institutions with a tax on their losses—a condition which we do not find paralleled in the case of other taxpayers.

It is not in the public interest that supervised financial institutions should be subject to inconsistent or conflicting requirements arising out of differing statutes under the jurisdiction of separate branches of Government. This fact was recognized by the Congress when it passed the 1951 act. The Congress concluded, and this was agreed to by those representing the affected institutions, that taxes should be paid on amounts carried to surplus or undivided profit, and on any allocations to loss reserves which exceed the bounds of reason. As earlier noted, the supervisory authorities recommended deductible allocations to loss reserves until they equal 15 percent of savings, and the Congress agreed to the principle, but established the ceiling at 12 percent.

(a) Much has been said about the fact that but a modest amount of taxes were collected, in consequence. The fact is, and the Congress has recognized it in its application to other mutual and cooperative organizations, that these mutual institutions do not have any "taxable

income" in the ordinary sense of the word. This is demonstrated by the following table, citing typical figures of a mutual institution with, say, resources of $23 million.

Gross earnings	$138,000
Less—operating expense	26,000
Net income	112,000
Less—10 percent to loss reserves	11,200
Less—interest-dividends	100,000
Total	111,200
Balance to undivided profits (taxable)	800

"Tax equality," which has been the loudly proclaimed objective of the commercial bankers for so many years, is a meaningless shibboleth, unless accompanied by "investment equality." For 138 years, these mutual institutions have operated to provide a specialized community service. Organized not for private profit but owned by those they serve, they originated the monthly payment installment mortgage which has made this country a nation of homeowners. They originated installment savings plans. Today, there are 5,250 of these mutually owned thrift and home-financing institutions, located in every State, 2,000 of which are federally chartered and supervised, and another 3,250 are State-chartered and supervised.

(a) The distinguished Secretary of the Treasury has recommended certain revisions in subtitle E (comprising secs. 441, 442, and 443) of the pending bill, emphasizing the Treasury Department's objective to "create tax equity among these competing institutions." Whether the Treasury's contemplation of "tax equity" is the same as "tax equality" is not clear to us. It is our view that tax equity prevailed under the 1951 act, but that it was materially upset by the 1962 amendments—because they failed to recognize the specialized character of mutual thrift institutions, as distinguished from privately owned financial institutions and, in the absence of capital stock on the part of the mutuals, their need for a reasonable allowable deduction for withholding a portion of earnings for possible future losses.

(b) On the other hand, if "tax equality" (in the fashion sought by the commercial bankers) is accepted by the Congress as a commendable and equitable objective, very obviously these mutual institutions should have equality of investment opportunities, in order to make available to them the more lucrative fields available to the privately owned financial institutions.

(c) The Treasury Secretary has, further, outlined a "special tax deduction" to be granted to the several types of financial institutions to encourage "the flow of credit * * * into uses determined by the Congress to be socially preferable." It has for many years been the position of the Federal Government that the development of member-owned mutual or cooperative organizations warrants particular encouragement by statutory enactment. Most certainly, a change in emphasis, such as the Treasury proposes, would constitute a major change in course and warrants widespread study and consideration before legislative action.

Unfortunately, the 1951 act, which made "domestic building and loan associations" and "cooperative banks" subject to the corporate

rate of income tax, after appropriate credits to loss reserves, contained a major defect—in that it failed to differentiate between the mutual institutions and the nonmutuals. This deficiency was perpetuated in the 1962 amendments. Accordingly, we urge these steps:

(a) That section 442(a) be deleted from the pending bill, and

(b) As an alternative, that sections 593 and 7701(a) be revised in a manner which (i) recognizes the distinctive character of all mutual savings institutions, (ii) accords them comparable tax status to that of other mutual or cooperative organizations, and (iii) conforms to their basic operational requirements by establishing reasonable allowable deductions for allocations to loss reserves, with ceilings of not less than 10 percent in the case of a "Reserve for Losses on Qualifying Real Property Loans" and of not less than 5 percent in the case of a "Reserve for Other Losses."

(c) A draft of amendments to the code to implement the recommendations of the preceding paragraph if appended.

Senator ANDERSON. Any questions?

Thank you very much. You have a very nice paper, too.

(George L. Bliss' prepared statement and attached chart and table follow:)

BRIEF OF THE COUNCIL OF MUTUAL SAVINGS INSTITUTIONS, SUBMITTED BY GEORGE L. BLISS, PRESIDENT

Section 442(a) of H.R. 13270 is unrealistic and inequitable insofar as it relates to *mutual* savings, building or homestead associations and co-operative banks—an alternative proposal is submitted.

1. *Section 442(a) of the bill should be withdrawn and set aside for further study and hearings*—or the alternative hereinafter proposed should be substituted.

2. *The practical effect of Section 422(a) is to nearly double the tax payments required of these mutual institutions, which they can meet only by either reducing the rate of interest-dividends paid on the accounts of their savings members, or by increasing the rate of interest charged to their borrowing members.*

At the end of 1968, the average size of the approximately 5,250 mutual institutions was $23,000,000.

Based on Treasury Department figures in the Ways & Means Committee report, they paid taxes in 1968 of about $735 per million dollars.

From a random sample of 20 such institutions, we estimate that Section 442(a), when fully effective, will cost them an additional $595 per million dollars. The fact that such an increase is spread over ten years makes it no less painful than to cut off a dog's tail by inches.

Because these mutual institutions have no capital stock, but disburse all of their earnings after establishing required loss reserves, there is no source for such an increase except (a) by reducing the interest-dividends paid on accounts of savings members, or (b) by increasing the interest charged to borrowing members.

3. *The 6% ceiling in the "Reserve for Losses on Qualifying Real Property Loans" is completely unrealistic.*—The *mutual* savings banks entered the 1929–32 depression with loss reserves in the range of 12% to 14%. They came through that experience practically unscathed. The *mutual* savings and loan associations confronted that crisis with loss reserves that averaged no more than 5% to 6%. Their survival rate was approximately one-half, i.e., some 6,000 survived out of 12,000 or so. In 1951, when the Revenue Act of 1951 was pending, the State supervisors testified that these institutions should be permitted to accumulate aggregate loss reserves of 15%. The Congress set the figure at 12%. The ceiling decrease to 6% was effected by the 1962 amendments. In consequence, the ratio of loss reserves has been steadily decreasing, as is shown in the following table (available data includes both mutuals and non-mutuals):

RATIO OF RESERVES, SURPLUS AND UNDIVIDED PROFITS TO RESOURCES

	Percent	Percent of decrease
End of 1941 (earliest date readily available)	7.9	
End of 1951 (preceding effective date of 1951 act)	7.6	3.8
End of 1962 (preceding effective date of 1962 act)	7.0	7.9
End of 1968	6.7	4.3

Note: See appended chart.

4. *Whereas the Internal Revenue Code provides that any taxpayer may deduct authorized losses on a direct charge-off basis or by the reserve method, all mutual institutions must use the reserve method*, for these reasons:

(a) By statute or regulation, every mutual institution, without exception, *must* allocate a portion of earnings, *before credit of interest-dividends to its savings members*, to reserve for possible future losses. Following is an excerpt from a typical State law (condensed and numbering added for clarity):

"When the net profits have been determined, if its loss reserves do not equal 10% of savings and 59% of book value of real estate held—(1) one-twentieth of such net profit shall be credited to such loss reserve. (2) The balance, together with any amounts remaining from previous periods, shall constitute the undivided profits. The directors may transfer additional amounts to loss reserves or continue to carry as undivided profits such sum as they deem wise. (3) The undivided profits shall be available for dividends, which shall be apportioned upon the dues and dividends credited to members." (New York Banking Law, Section 387)

In addition, if its accounts are insured by the Federal Savings & Loan Insurance Corporation, it must meet the requirements of its regulations for allocations to loss reserves which, under certain circumstances, may amount to 10% of net earnings, before interest-dividends.

(b) Required to use the reserve method, by statute, regulation or the need for survival, these institutions are further confronted by a formula inconsistent with the basic principle of mutual operation, in that the Code—since the 1962 amendments—requires that both operating expenses and the distribution of interest-dividends be first deducted, and a tax imposed on a portion of the remainder.

(c) A further inequity exists in that the bill leaves unchanged the requirement, first imposed in the 1962 amendments, and increases the amount, of tax on amounts so set aside and available *only* to meet losses which are deductible under the direct charge-off basis, thereby burdening these institutions with a tax on their losses—a condition which we do not find paralleled in the case of other taxpayers.

5. *It is not in the public interest that supervised financial institutions should be subject to inconsistent or conflicting requirements arising out of differing statutes under the jurisdiction of separate branches of government.*—This fact was recognized by the Congress when it passed the 1951 Act. The Congress concluded, and this was agreed to by those representing the affected institutions, that taxes should be paid on amounts carried to surplus or undivided profits, and on any allocations to loss reserves which exceed the bounds of reason. As earlier noted, the supervisory authorities recommended deductible allocations to loss reserves until they equal 15% of savings, and the Congress agreed to the principle, but established the ceiling at 12%.

(a) Much has been said about the fact that a modest amount of taxes were collected, in consequence. The fact is, and the Congress has recognized it in its application to other mutual and cooperative organizations, that these *mutual* institutions do not have any "taxable income" in the ordinary sense of the word. This is demonstrated by the following table, citing typical figures of a mutual institution with, say, resources of $23,000,000:

Gross earnings	$138,000
Less operating expense	26,000
Net income	112,000
Less:	
10 percent to loss reserves	11,200
Interest-dividends	100,000
	111,200
Balance to undivided profits (taxable)	800

6. *"Tax equality," which has been the loudly-proclaimed objective of the commercial bankers for so many years, is a meaningless shibboleth, unless accompanied by "investment equality."*—For 138 years, these mutual institutions have operated to provide a specialized community service, organized not for private profit but owned by those they serve. They originated the monthly-payment, installment mortgage which has made this country a nation of home-owners. They originated installment savings plans. Today, there are 5,250 of these mutually-owned thrift and home-owning institutions, located in every State, of which some 2,000 are federally-chartered and supervised, and another 3,250 are state-chartered and supervised.

(a) The distinguished Secretary of the Treasury has recommended certain revisions in Subtitle E (comprising Sections 441, 442 and 443) of the pending bill, emphasizing the Treasury Department's objective "to create tax equity among these competing institutions." Whether the Treasury's contemplation of "tax equity" is the same as "tax equity" is not clear to us. It is our view that *tax equity* prevailed under the 1951 Act, but that it was materially upset by the 1962 amendments—because they failed to recognize the specialized character of *mutual* thrift institutions, as distinguished from *privately-owned* financial institutions and, in the absence of capital stock on the part of the mutuals, their need for a reasonable allowable deduction for withholding a portion of earnings for possible future losses.

(b) On the other hand, if "tax equality" (in the fashion sought by the commercial bankers) is accepted by the Congress as a commendable and equitable objective, very obviously these mutual institutions should have equality of investment opportunities, in order to make available to them the more lucrative field available to the privately-owned financial institutions.

(c) The Treasury Secretary has, further, outlined a "special tax deduction" to be granted to the several types of financial institutions to encourage "the flow of credit . . . into uses determined by the Congress to be socially preferable."

It has for many years been the position of the Federal Government that the development of member-owned, mutual or co-operative organizations warrant particular encouragement by statutory enactment. Most certainly, a change in emphasis, such as the Treasury proposes, would constitute a major change in course and warrants wide-spread study and consideration before legislative action.

7. *Unfortunately, the 1951 Act, which made "domestic building and loan associations" and "cooperative banks" subject to the corporate rate of income tax, after appropriate credits to loss reserves, contained a major defect—in that it failed to differentiate between the mutual institutions and the non-mutuals.*—This deficency was perpetuated in the 1962 amendments. Accordingly, we urge these steps:

(a) That Section 442(a) be deleted from the pending bill, and

(b) *As an alternative*, that Sections 593 and 7701(a) be revised in a manner which (i) recognizes the distinctive character of *all mutual* savings institutions, (ii) accords them comparable tax status to that of other mutual or co-operative organizations, and (iii) conforms to their basic operational requirements by establishing reasonable allowable deductions for allocations to loss reserves, with ceilings of not less than 10% in the case of a "Reserve for Losses on Qualifying Real Property Loans" and of not less than 5% in the case of a "Reserve for Other Losses."

(c) A draft of amendments to the Code to implement the recommendations of the preceding paragraph is appended.

Proposed Revision of Section 7701 and Section 593 to recognize the distinctive character of *mutual* savings, building or homestead associations and cooperative banks, particularly with respect to their need for reasonable and adequate allowable deductions for additions to loss reserves—and to accord them treatment comparable to that accorded to other mutual and cooperative organizations.

(a) That an additional category, to be known as "domestic mutual savings institutions" be added to the Code by an appropriate amendment to subsection (a) of Section 7701, reading substantially in this manner:

"(35) Domestic Mutual Savings Institution.—The term 'domestic mutual institution' means a savings bank, cooperative bank, savings association, savings and loan association, homestead association, building association or building and loan association which is domestic, without capital stock and organized and operated for mutual purposes and without profit."

(b) That the title and subsection (a) of Section 593 be amended to read as follows (new language italicized):

"SEC. 593. RESERVE FOR LOSSES

"(a) Organizations to Which Section Applies.—This section shall apply to any mutual savings bank not having capital stock represented by shares, domestic building and loan association, or cooperative bank without capital stock organized and operated for mutual purposes and without profit, *except that subsection (g) and paragraph (4) of subsection (b) hereof shall apply only to a domestic mutual savings institution.*"

(c) That subparagraph (A) of paragraph (1) of subsection (b) of Section 593 be amended to read as follows (new language italicized):

"(A) the amount determined under section 166(c) to be a reasonable addition to the reserve for losses on nonqualifying loans, *or the amount determined under subsection (g) hereof to be a reasonable addition to the reserve for other losses*, plus"

(d) That subsection (b) of Section 593 be amended by designating paragraph (4) as paragraph (5), by designating paragraph (5) as paragraph (6), and by inserting new paragraph (4) to read as follows:

"(4) Calculation method.—The amount determined under this paragraph for the taxable year shall be an amount equal to the amount necessary to increase the balance (as of the close of the taxable year) of the reserve for lossees on qualifying real property loans to 10 percent of the unpaid balance of such loans."

(e) That paragraph (1) of subsection (c) of Section 593 be amended to read as follows (new language underlined):

"(1) Establishment of reserves.--Each taxpayer described in subsection (a) which uses the reserve method of accounting for bad debts shall establish and maintain a reserve for losses on qualifying real property loans, a reserve for losses on nonqualifying loans (*or a reserve for other losses as provided by subsection (g) of this section*), and a supplemental reserve for losses on loans. For purposes of this title, such reserves shall be treated as reserves for bad debts *and for other losses*, but no deduction shall be allowed for any addition to the supplemental reserve for losses on loans."

(f) That Section 593 be amended by inserting the following new subsection (g) after subsection (f), to read as follows:

"(g) Reserves for other losses.

(1) In lieu of any authorized deduction for losses other than for bad debts on qualifying real property loans, a taxpayer to whom this subsection applies shall be allowed a deduction for a reasonable addition to a reserve for other losses, which shall in no case be less than the amount determined by the taxpayer as the reasonable addition for such year; except that the amount determined by the taxpayer under this subsection shall not be greater than the lesser of—

(A) the amount of its taxable income for the taxable year, computed without regard to this subsection, or

(B) the amount by which 5 percent of the total of its resources, exclusive of its qualifying real property loans, at the close of such year exceeds the balance in such reserve at the beginning of the taxable year.

(2) Any reserve established pursuant to this subsection shall include the entire balance of any reserve previously established pursuant to subparagraph (A) of paragraph (1) of subsection (b) of this section."

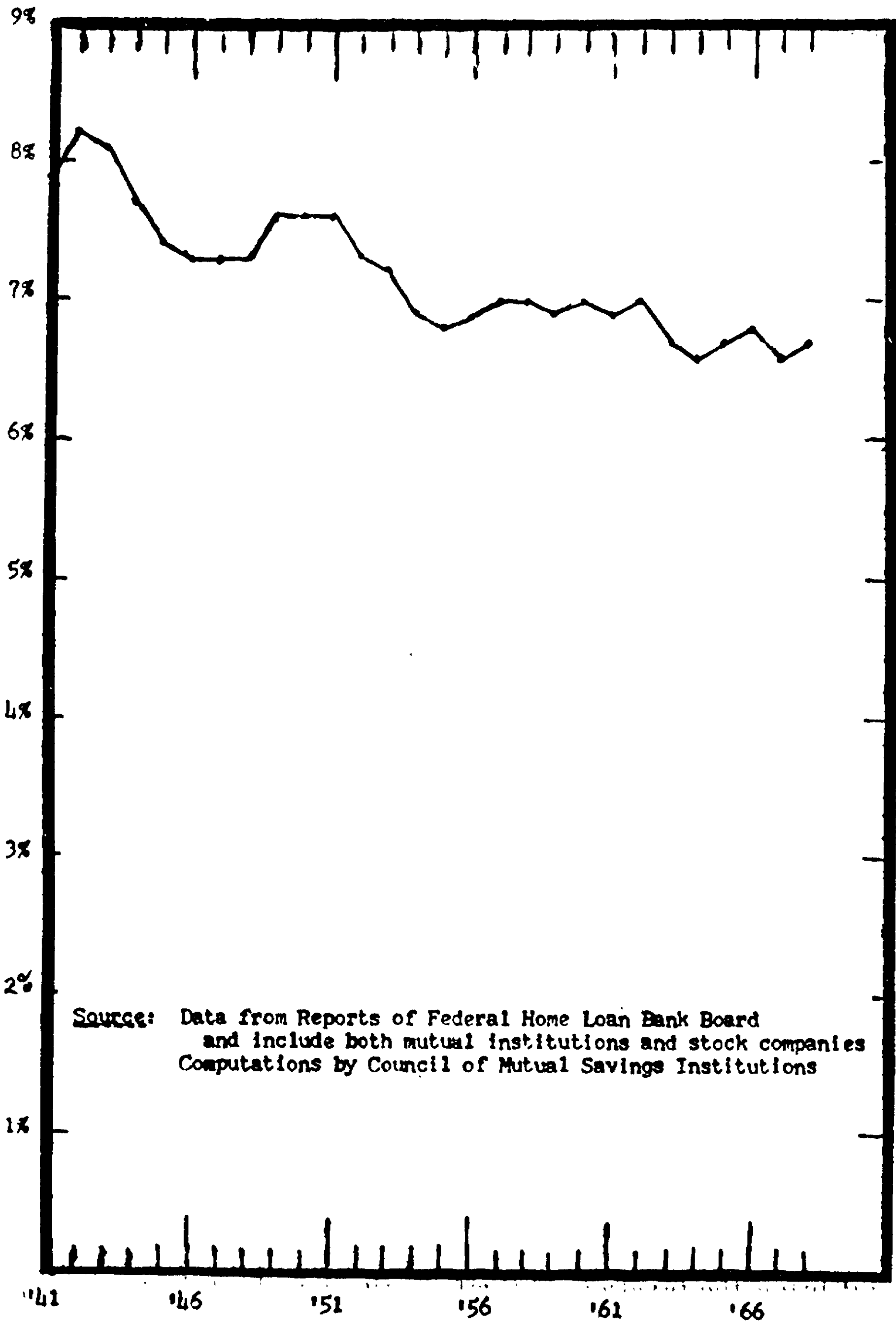
DISTRIBUTION OF MUTUAL SAVINGS, BUILDING OR HOMESTEAD ASSOCIATIONS, AND COOPERATIVE BANKS, BY STATES, BASED ON SUPERVISORS' 1967 REPORTS

State	Federal	State	Total mutual	Non-mutual
Alabama	48	8	56	0
Alaska	3	0	3	0
Connecticut	18	20	38	0
Delaware	3	27	30	0
District of Columbia	8	14	22	0
Florida	129	6	135	0
Georgia	100	6	106	0
Iowa	45	47	92	0
Kentucky	88	46	134	0
Louisiana	36	69	105	0
Maine	9	20	29	0
Massachusetts	35	163	198	0
Michigan	38	32	70	0
Minnesota	52	24	76	0
Missouri	45	95	140	0
Montana	9	7	16	0
Nebraska	21	27	48	0
New Hampshire	7	18	25	0
New Jersey	25	345	370	0
New York	84	124	208	0
North Carolina	37	147	184	0
North Dakota	7	7	14	0
Oklahoma	30	28	58	0
Pennsylvania	134	561	695	0
Puerto Rico	9	0	9	0
Rhode Island	2	6	8	0
South Carolina	47	28	75	0
Tennessee	68	0	68	0
Vermont	2	6	8	0
Virgin Islands	0	0	0	0
West Virginia	23	15	38	0
Wisconsin	44	101	145	0
Arizona	2	0	2	11
Arkansas	40	5	45	18
California	71	12	83	180
Colorado	20	13	33	23
Guam	0	0	0	1
Hawaii	2	5	7	6
Idaho	8	1	9	10
Illinois	139	361	500	74
Indiana	102	105	207	2
Kansas	29	25	54	46
Maryland	66	222	288	12
Mississippi	31	10	41	39
Nevada	1	0	1	5
New Mexico	10	11	21	16
Ohio	138	286	424	111
Oregon	18	2	20	12
South Dakota	9	6	15	6
Texas	85	23	108	167
Utah	6	6	12	7
Virginia	32	23	55	23
Washington	35	13	48	17
Wyoming	9	0	9	3
Total	2,059	3,126	5,185	789

Source: Council of Mutual Savings Institutions.

All Operating Savings and Loan
Associations and Co-Operative Banks

Ratio of Loss Reserves, Surplus and Undivided Profits
to Total Resources at Year-End
1941 -- 1968



Senator ANDERSON. Mr. Mitchell.

STATEMENT OF C. R. MITCHELL, LEGISLATIVE CHAIRMAN, U.S. SAVINGS & LOAN LEAGUE; ACCOMPANIED BY NORMAN STRUNK, EXECUTIVE VICE PRESIDENT; AND STEPHEN SLIPHER, LEGISLATIVE DIRECTOR

Mr. MITCHELL. Mr. Chairman, I have with me this morning Mr. Norman Strunk, executive vice president of the U.S. Savings & Loan League, and Mr. Stephen Slipher, legislative director, U.S. Savings & Loan League.

I am C. R. Mitchell of Kansas City, Mo., chairman of the Legislative Committee of the U.S. Savings & Loan League.

The league's membership includes 5,000 savings and loan associations, both State and federally chartered, cooperative banks, and homestead associations holding over 95 percent of the Nation's total savings and loan assets.

Senator BENNETT. May I ask you a question at this point?

Mr. MITCHELL. Yes.

Senator BENNETT. Does your association include both stock and mutual companies or only mutual associations?

Mr. MITCHELL. Both stock and mutual.

Senator BENNETT. Both stock and mutual.

Mr. MITCHELL. Our principal concern with the pending Tax Reform Act, as well as the Treasury Department proposal for revising savings and loan taxation as presented by Treasury spokesmen to this committee at the outset of these hearings, is that they go far beyond tax reform and the closing of tax loopholes. Both the House bill provisions and the Treasury recommendations for savings and loan taxation relate to a much more fundamental question, namely, that question is the nature of the financial institutions in this country and how homes should be built and financed.

Stated succinctly, we believe that these provisions will ultimately mean the stagnation of the savings and loan business as we know it today. The effect would be to eliminate this assured source of home mortgage credit and eventually require a much larger role for the Federal Government in the financing of homes for the American families.

Here at the outset, let me say that the league approves the two sections of the bill providing for the elimination of the 3-percent mortgage growth alternative provision and the revision in treatment of bond sales by financial institutions. This will increase taxes, significantly for some associations, but they are "loopholes" of the type dealt with "tax reform."

The 3-percent mortgage growth formula is the primary reason why most mutual savings banks and some savings and loan associations have paid only a fraction of the anticipated tax. Thus, this elimination would bring the taxation of thrift institutions back in line with the expectations of the 1962 law.

Going beyond this, as both the House-passed bill and the Treasury proposals do, results in a drastic tax increase for savings and loan associations.

This would impair the mortgage lending ability of the Nation's largest home lenders (savings and loan associations) in two ways.

First, it would reduce our ability to pay a competitive rate for savings in competition with rates paid for savings deposits by the multiservice commercial banks and in competition with the securities markets, including the obligations of the Treasury and the Federal agencies. We need to pay higher rates for savings, but we cannot raise our rates on existing loans. We do not like constantly to raise the rates we charge new home buyers. We recognize there are real limits to how much families can pay for money and afford homeownership. We do not know how we can be competitive in attracting savings if our income tax is virtually doubled.

Secondly, the proposed increase in the income tax would seriously limit our ability to build reserves. The laws of the Federal supervisory authorities require—and wisely so—the accumulation of loss reserves. To set up the needed reserves requires an adequate spread between income and outgo. The growth of our institutions and the amount of our mortgage lending is directly related to the reserve accumulation capacity of these institutions.

A reduction in the mortgage lending ability of our institutions would occur when housing starts are declining at an alarming rate and mortgage interest rates are soaring.

Multipurpose financial institutions—such as life insurance companies and commercial banks—have largely withdrawn from residential lending, particularly single-family home financing. A striking example of this is a recent bulletin from a large life insurance company to its mortgage correspondents advising them that no more funds are available for 1969 residential lending, and that for future lending the minimum prime rate would be 9½ percent "supplemented with some acceptable form of kicker."

Savings and loan associations and savings banks are today virtually the only lenders remaining in the market for traditional type loans on single-family homes and small apartments. For this reason, the Congress today is deeply concerned about the housing problem. The Congress, in fact, has always been concerned about housing and an adequate supply of funds for mortgage lending.

This is the reason the Congress originally established the Federal Home Loan Bank System. This is why the Congress has repeatedly provided special tax provisions for savings and loan associations. This is why Congress has approved and expanded Federal programs relating to urban renewal, public housing, subsidized loans, and the purchase of loans by Fannie May. Leaders in the Federal agencies and in the Congress almost daily express grave concern over present housing market conditions. Yesterday's headline story on the financial page of the Washington Post is indeed timely—"Credit Squeeze Hits Residential Housing Hardest."

Frankly, we cannot reconcile the massive effort to stimulate housing on the one hand and the proposal to substantially increase taxes on the Nation's largest home lenders on the other hand.

I would now like to turn to my second basic point; namely, that these tax proposals would tend to eliminate savings and loan associations as a locked-in source of mortgage money for the average American fam-

ily, where a family seeking credit for the purchase of a home would not get shoved aside in favor of someone bigger or more able to pay a higher rate of interest. The effect of both the House bill and Treasury proposal is to apply equal effective tax rates on banks and savings and loan associations. This may not have been intended by the House, but last minute changes had this effect. The Treasury has made this equality a prominent feature of its tax testimony.

However, the undisputable face is that the two systems have never operated under equal tax provisions. There is no reasonable possibility that they can unless sweeping changes are made to provide savings and loan associations with comparable profit opportunity in terms of operating and investment privileges. Equal operating authority would be demand deposit authority to provide free money and permission to engage in commercial lending.

I am sure that the members of this committee recognize there are very fundamental differences between our institutions and commerical banks. We have no opportunities to change our business or the nature of our lending in order to adjust to differing conditions in the money market. When interest rates rise rapidly, commercial banks are able to adjust very quickly because their loans are short-term loans and an increase in the prime rate almost immediately increases the overall return on most of the bank's assets. Savings and loan associations, on the other hand are stuck with the long-term low-interest rate mortgages already in our portfolio. Thus, at the present time, our loan portfolio earns on the average just a little more than 6 percent. We currently pay our savers an average of almost 5 percent.

This is the central problem of the savings and loan business today. This is the basis for our belief that it is not appropriate to tax alike two such different types of financial businesses.

The history of the Congress shows it wants to keep savings and loan associations as home-lending institutions. The Treasury Department has recommended equal taxation for our institutions and the banks, but we do not believe the Treasury would recommend operating authorities. And further, we think that it is highly unlikely that the Banking and Currency Committees would recommend a change in the longstanding congressional policy that savings and loan associations should remain predominantly a residential lending system.

Mr. Chairman, we believe that the policy of Congress with respect to taxation of thrift institutions should be to continue to encourage homeownership and to avoid the creation of substantial barriers to American families who need to borrow money at reasonable rates in order to buy a home.

Thank you, sir.

Senator ANDERSON. Any qeustions?

Senator MILLER. Mr. Mitchell, you were here earlier this morning, when the Chairman of the Federal Home Loan Bank Board testified?

Mr. MITCHELL. Yes, sir.

Senator MILLER. I take it from your testimony then that the organization you represent is generally pretty much opposed to what he had to say.

Mr. MITCHELL. Yes, to the Treasury formula approach to the taxation of savings and loans.

Senator MILLER. Well, as I understood the Chairman of the Home Loan Bank Board supported the Treasury proposals and, as I understand you, you are opposed to that and you, therefore, are opposed to the statement by the Chairman of the Home Loan Bank Board?

Mr. MITCHELL. Yes, sir.

Senator MILLER. Thank you.

Senator ANDERSON. Thank you very much. We appreciate your statement very much.

(C. R. Mitchell's prepared statement follows:)

STATEMENT OF THE UNITED STATES SAVINGS AND LOAN LEAGUE[1] PRESENTED BY C. R. MITCHELL, LEGISLATIVE CHAIRMAN; ACCOMPANIED BY NORMAN STRUNK, EXECUTIVE VICE PRESIDENT; AND STEPHEN SLIPHER, LEGISLATIVE DIRECTOR

Our principal concern with respect to the provisions of the Tax Reform Act, as approved by the House of Representatives last month, as well as the Treasury Department proposal for revising savings and loan taxation as presented by Treasury spokesmen to this Committee at the outset of these hearings, is that they go far beyond tax reform and the closing of tax loopholes. Both the House bill provisions and the Treasury recommendations for savings and loan taxation relate to a much more fundamental question, and that is the nature of the financial institutions in this country and how homes should be built and financed. Stated succinctly, we believe that the provisions of the House bill and the Treasury proposals for savings and loan taxation will ultimately mean the stagnation of the savings and loan business as we know it today. The effect would be to eliminate this assured source of home mortgage credit and eventually require a much larger role for the Federal Government in the financing of homes for the American families.

This is a bold and sweeping statement. I propose to document it for you in my time before the Committee this morning.

A very brief history should be helpful. Savings and loan associations were developed in this country in the 1800's by the state legislatures in order that families might have a place to go for credit to buy a home where they did not have to compete for credit with all types of other borrowers. Lawmakers recognized from the beginning that a typical family cannot compete on even terms for credit—especially long-term credit of the type needed for home purchases—with commercial enterprises, large corporations, well-to-do families and with Governments, and that a special type of institution had to be created in order that the home ownership ambitions of the American families could be realized.

With the collapse of the financial system in the 1930's, the United States of Federally chartered savings and loan associations, the Federal Home Loan Bank System and the Federal Savings and Loan Insurance Corporation. The Congress took these steps to assure itself that the family seeking credit for the purchase of a home would come before other types of borrowers and where the typical family would not get shoved aside in favor of someone bigger or more able to pay a higher rate of interest.

Since the first Federal income tax law, Congress has provided some tax incentives to savings and loan associations. Originally, these institutions were completely exempt from Federal income tax so long as they confined their business to accepting savings and investing these savings in home loans. This tax exemption was repealed in 1951, but the bad debt allowance provided resulted in only nominal tax payments, until the Revenue Act of 1962. In that Act, Congress carefully provided for a different bad debt allowance than that given commercial banks and rather deliberately structured the law so savings and loans associations would pay Federal taxes at about half the rate of that paid by

[1] The United States Savings and Loan League has a membership of 5,000 savings and loan associations representing over 95% of the assets of the savings and loan business. League membership includes all types of associations—Federal and state chartered, Federally insured, uninsured, stock and mutual. The principal officers are: Tom B. Scott, Jr., President, Jackson, Mississippi; John H. Randolph, Jr., Vice President, Richmond, Virginia; C. R. Mitchell, Legislative Chairman, Kansas City, Missouri; Norman Strunk, Executive Vice President, Chicago, Illinois; and Stephen Slipher, Legislative Director, Washington, D.C. League headquarters is at 221 North LaSalle Street, Chicago, Illinois; and the Washington Office is maintained at 425—13th Street, N.W., Washington, D.C.—Telephone: 638-6334.

commercial banks. In the early 1960's, commercial banks were paying an average rate of tax of about 35 percent of so-called economic income. Beginning in 1963, savings and loan associations paid taxes at an effective rate of about 16 percent. The exact figures follow:

TAX AS PERCENT OF "ECONOMIC INCOME" [1]

Year	Commercial banks	Savings and loan associations
1960	37.8	1.0
1961	35.6	.8
1962	33.3	.9
1963	30.6	16.0
1964	28.2	14.8
1965	23.3	15.2
1966	23.2	16.9

[1] Source: Tax Reform Studies, U.S. Treasury, Feb. 5, 1969.

Most associations pay taxes under the so-called 60–40 formula provided in the 1962 Act. This provides simply that associations may set aside 60 percent of their income after expenses and interest payments to the depositors into reserves and pay taxes on 40 percent of their net income. The 1962 Act also provided a so-called 3 percent of loan growth alternative method of computing allowable additions to the reserve for bad debts.

This 3 percent of loan growth formula has been used by some savings and loan associations and most mutual savings banks. It had the unpredicted results of making it possible for institutions with rapid increases in their mortgage loan portfolio to escape Federal income taxes almost completely. This turned out to be a real loophole in the savings and loan and savings bank section of the 1962 Revenue Act. We have no objection to this loophole being closed. We consider closing it a legitimate part of tax reform.

Neither do we have any objection to the changes proposed in the House bill relating to the tax treatment of capital gains and losses in connection with transactions in Government securities. This change has been discussed in connection with changes in the taxation of commercial banks. It also applies to our institutions, and we have no objection to this method of tax reduction being eliminated, nor do we have objections to other detailed changes proposed in the House bill relating to types of income to be included in computing taxable income. These changes constitute tax reform, and we think they are appropriate in the context of this bill.

However, the heart of our position is our vigorous objection to the radical proposed revision in the 60–40 formula. This provision in the House bill would mean a virtual doubling of savings and loan taxation over a ten year phase-in period. It seems to us this is much more drastic than loophole closing or tax reform.

The alternative Treasury proposal presented September 4 would not lessen the effect of the changes provided in H.R. 13270. Both seem to have about the same practical effect except that the Treasury proposal will get us to the point of double taxation faster. The Treasury proposes a five-year phase-in—the House bill provides for a ten-year phase-in. Both proposals would equalize the effective tax rate for savings and loan associations and for commercial banks. Treasury spokesmen told this Committee that the Treasury's objective is to tax both institutions at an effective rate of approximately 30 percent.

The Congress fortunately has always seen fit to preserve a tax rate differential between those financial institutions whose primary purpose is to assure the American family of a source of home mortgage credit and the multi-purpose, full-service type of financial institutions. This policy of differential was adhered to in the House debate even though last minute changes with respect to commercial banks did, in fact, eliminate the differential according to our statistics.

History has demonstrated that those institutions with a broad range of lending alternatives cannot be expected to be a dependable source of credit for home ownership. Home ownership credit is a specialized credit and there are many periods when lending for home building and home buying is not as profitable as other types of lending or investing. That is why the Congress created a new system of savings and loan associations in the 1930's and that is why they created

a special Federal Savings and Loan Insurance Corporation—independent and separate from the Federal Deposit Insurance Corporation which was created to insure deposits in commercial banks, and that is why Congress created a central banking system—the Federal Home Loan Bank System—separate from and independent from the Federal Reserve System. That is why the Congress put the agencies relating to the savings and loan business under an independent Board responsible separately to the President and the Congress—the Federal Home Loan Bank Board. That is why the Congress has always given savings and loan associations a tax incentive.

The continuous Congressional concern with housing is evidenced in many ways. The Congress has provided and has repeatedly expanded Federal programs relating to Urban Renewal, public housing, subsidized home loans, subsidized rental loans and the purchase of hundreds of millions of dollars by the Federal National Mortgage Association. Without exception, those in the Federal Government and in the Congress with special housing responsibilities have expressed grave concern over the present housing market conditions. Just last week a Senate Subcommittee held hearings on proposals to provide direct Treasury support to the housing market. Legislation has been introduced to provide for $10 billion of direct Federal loans to middle-income families. An almost endless list of actions and statements by public and private officials could be presented with respect to the importance of our national housing programs.

Dr. Irwin Friend of the Wharton School of Finance at the University of Pennsylvania has just completed a three-year study of the savings and loan business, a study that was commissioned by the Congress. Dr. Friend's report, released last week, points out that "savings and loan associations have the most specialized asset structure and the greatest imbalance between the maturity structure of assets (mainly long-term residential mortgages) and liabilities (largely short-term deposits) of any major group of financial intermediaries."

The industry's role in the economy, he noted, has been to accumulate funds from individual savers and make these funds available for financing housing, thus lowering the cost of investment in housing and providing savers with a higher return or lower risk.

"To help the associations carry out these functions—especially the stimulation of investment in housing," Professor Friend said, "they have received several forms of Government assistance, most notably a favorable tax treatment which was intended, at least in part, to compensate them for the lack of investment flexibility resulting from their commitment to the residential mortgage market."

The basic question that Professor Friend raised is whether these present forms of assistance are adequate to insure the viability of the industry in the future, especially during periods of tight money.

Dr. Friend's report pointed up the fact that the savings and loan business is today having great problems in adjusting to the effects of inflation and much higher interest rates. Certainly, this is no time to eliminate or even to phase-out such special protections as the present bad debt allowance which serves in part to alleviate the severe operating problems that tight money has brought to our institutions and to the housing market.

Housing starts currently are in a precipitous decline. Between January and July of this year housing starts have fallen from a seasonal adjusted rate of 1.9 million to 1.3 million—or 28.9%, and projections indicate the decline could continue to a million or less units. It is well recognized that home financing institutions are feeling the burden of tight money more heavily than commercial banks which, by the nature of their operation, are more readily able to adjust to rapid increases in interest rates. It is well recognized that housing and home building are this year—as in 1966—bearing a great and disproportionate share of the cost of the economic effects of tight money. In fact, the home building industry thus far is about the only major industry in the American economy that has been curtailed by the fiscal and monetary restraints that are currently imposed on the economy. This is due in great part to the fact that the growth rate of the savings and loan business has been declining for several years—particularly in 1966 and again this year.

It should be noted that even relatively small differences in the rate of growth in the savings and loan business, whether caused by adverse taxation or economic or competitive conditions, has a tremendous impact on housing. The Federal Home Loan Bank Board has estimated that a billion dollar change in savings affects 21,500 housing starts in the initial year, and 80,000 housing starts over the long run. In a business the size of the savings and loan business—over

$150 billion—it is quite possible to have variations in growth patterns of $5 billion or more in a year. Obviously, the difference in good and bad growth for the savings and loan business translates into hundreds of thousands of housing starts initially, and increases to millions of houses over a period of years.

In its tentative decisions, the Ways and Means Committee indicated that a differential in the effective rate of tax between the savings and loan associations and commercial banks was to be preserved. Committee sources indicated that commercial banks were to be taxed at an effective rate of 36 percent and savings and loan institutions at an effective rate of 30 percent. Our business did not feel that this was enough of a differential in the effective tax rate, but at least there was recognition by the Ways and Means Committee that there should be a differential in the tax rate of the commercial banks and the savings and loan associations, and that there had to be some incentive for our institutions to continue to function as a special service institution for home financing.

Because of a last-minute change in its treatment of tax exempt interest by financial institutions, however, the final tax bill passed by the House would equalize the tax rate between commercial banks and savings and loan associations, which, as the Treasury spokesmen say, is the objective of the Treasury Department. Our data based on the 1968 operations show we would pay, on the average, an effective tax rate of approximately 34 percent compared to 19 percent under the present law. This would be true under both the House bill and the Treasury proposal. Unless the commercial banks change their asset mix considerably, we doubt that their effective tax rate would be that high. Both the Treasury and the FDIC estimate the effective rate for the commercial banks to be 30 percent.

Several fundamental questions present themselves. First, is it proper and sound public policy to tax such different types of financial institutions as banks and savings and loan associations alike? (Remembering that a tax differential has been public policy from the very beginning.) Second, what will be the eventual result of equality of taxation of these institutions?

We are not dealing here with ordinary business enterprises that can do virtually anything their management chooses, that can diversify their operations, drop unprofitable lines, merge, expand to new markets and new cities, etc. We are dealing here with financial institutions chartered either by Federal or state governments able to do only those limited things which the lawmakers, primarily the members of the United States Congress, rigidly prescribe. Savings and loan associations cannot go out and broaden their scope of operation, add profitable new lines, move into new markets in distant cities and compete on equal terms with multi-purpose, full-service commercial banks. The laws prevent this type of competitive equality.

While the advocates of equal taxation give lip service to companion equality among thrift institutions with respect to investment and operating powers, this is totally unrealistic. The modest changes suggested by the savings and loan advocates have never encroached on the fundamental commercial bank prerogatives such as demand deposits, creation of money and general business banking. More importantly, we doubt the Congress would want to see any fundamental change in the nature and structure of savings and loan associations. The history of Congressional action over the last twelve to fifteen years makes it quite clear that the Congress wants to keep the savings and loan business narrowly confined to the business of financing shelter for the American people, primarily single-family home ownership. Congress should recognize that as a quid pro quo for our institutions remaining home financing specialists, there should be a considerable difference in the tax treatment of our institutions and the commercial banks.

Of course, the application of equal taxation will have the effect of driving thrift institutions away from housing in an effort to obtain the profitability which enables commercial banks to prosper irrespective of taxation. Either this will happen or these institutions will lose their competitive capability and cease to be the effective force in home financing that they need to be if our home ownership and home financing system in this country is to be preserved.

The following table shows the importance of savings and loan associations and mutual savings banks in home financing.

TOTAL RESIDENTIAL MORTGAGE LOANS OUTSTANDING

[Dollars in billions]

	December 31				
	1964	1965	1966	1967	1968
Savings and loan associations	$94.2	$102.3	$106.0	$112.9	$120.7
Mutual savings banks	36.5	40.1	42.2	44.6	46.7
Life insurance companies	35.8	38.4	40.6	41.6	42.4
Commercial banks	28.9	32.4	34.9	37.6	41.4
All other holders	35.7	36.9	40.1	43.1	47.3
Total	231.1	250.1	263.8	279.8	298.5
Percent held by savings institutions:					
Savings and loan associations	40.8	40.9	40.2	40.4	40.4
Mutual savings banks	15.8	16.0	16.0	15.9	15.6
Total	56.6	56.9	56.2	56.3	56.0

Sources: Federal Home Loan Bank Board; Federal Reserve Board.

These data relate to total mortgage loans including loans on multi-family properties. So far as the market for credit for one-to-four family homes is concerned, the market is especially dependent on savings and loan associations and savings banks. In recent years, life insurance companies have moved out of financing one-to-four family dwellings to multi-family and commercial real estate. Commercial banks are much less significant in financing residential real estate. Traditionally, and especially so in periods of tight money, the commercial bank's role in mortgage lending is essentially that of a construction lender or one providing the so-called interim financing with the take-out or permanent loan made by life insurance companies, savings banks or savings and loan associations. In times like these, commercial banks are not significant as permanent investors in mortgages or large portfolio lenders and, incidentally, the Treasury proposal will not change this. Commercial banks do not carry the interest rate risk. They don't get stuck with a portfolio of long-term mortgage loans written at interest rates much lower than rates are today. It is the savings and loan associations and the mutual savings banks that carry the risk of rising interest rates and thus have their earnings squeezed and their competitive abilities severely limited in periods like 1966 and 1969.

The following table shows the share of savings and time deposits allocated by various financial institutions to residential mortgage loans.

THE SHARE OF SAVINGS AND TIME DEPOSITS ALLOCATED BY FINANCIAL INSTITUTIONS TO RESIDENTIAL MORTGAGE LOANS

[In percent]

	Savings associations	Mutual savings banks	Commercial banks [1]	Life insurance companies [2]
Dec. 31:				
1964	92.4	74.7	24.8	23.9
1965	92.7	76.5	24.1	24.2
1966	93.0	76.8	23.9	24.3
1967	90.6	74.3	22.4	23.5
1968	91.7	72.5	22.4	22.6

[1] Residential mortgage loans as a percent of total savings and time deposits of individuals, partnerships and corporations.
[2] Residential mortgage loans as a percent of total assets.

Source: Federal Reserve Board.

In recent years, the savings and loan business has secured a decreasing share of total family or household savings. It is well know that the savings and loan business currently is in trouble competitively and the mortgage market has suffered as a result.

The savings and loan business must earn enough to be able to pay enough to be able to attract savings. Associations compete for savings with the commercial banks, with mutual funds and with the securities market, primarily the short-term securities issued by the United States Treasury and the various Federal Agencies. Its competitive edge over the commercial banks is protected by Regulation Q, but this is a very slight edge. The policy people in the Administration constantly suggest that the protection of Regulation Q as to the flows of funds into savings and loan associations and mortgages is not to be expected as a long time proposition. Savings and loan associations need to pay higher rates for savings, but, we cannot raise our rates on existing loans, and there are ceilings on mortgage loan interest rates in many states. We do not like to constantly raise the rates we charge home buyers and there are real limits on how much families can pay for money and afford home ownership.

We have the problem of earning enough to be competitive and we do not know how we can be competitive in attracting savings if our income tax is, over a phase-in period, virtually to double. At the present time, our mortgage portfolio (heavily weighted with previously made low-rate mortgages) earns an average of about 6 percent. We currently pay our savers an average of about 5 percent. This leaves just a one percent spread which must cover all operating expenses, allocations to reserves, and local, state and Federal taxes. This is obviously a far cry from the status of commercial banks. Their prime lending rate is currently 8½ percent, and they pay interest on only about one-half of their total deposits. We cannot offer the broad range of services in competing for savings deposits with full-service commercial banks. We have no new ways of earning more money to pay higher taxes. We cannot go into new making-money ventures as can commercial banks or other lines of business.

Ours is a very specialized business because Congress wants us to do essentially one thing, and we do not think we will be able to continue to do that one thing if the tax picture is radically changed as poposed by the House bill or by the Treasury.

Thus, we have at stake in this legislation not just tax reform and loophole closing, but the fundamental question of whether Congress is to preseve a system of home financing institutions and to protect a source of mortgage money for the average American family—the same family that this tax bill is designed to help.

It should be noted that there are presently two types of organizations engaging to some extent in residential financing who are granted full tax exemption. The first consists of pension and retirement funds which are granted full tax exemption; the second are the mortgage investment trusts which pass through substantially all of their income and by reason thereof are exempt from taxation. Neither of these two establishes or maintains reserves to enable them to survive the impact of a substantial downturn of business. If the time ever comes when a substantial downturn occurs, those two types of businesses will be out of the mortgage market. They will also be out of the mortgage market if other types of investments are more attractive, including mortgage lending on commercial and industrial properties. They are not limited to residential financing.

Savings and loan associations are required by regulatory authority to maintain substantial reserves and to continue to add to those reserves annually. These reserves will permit them to carry on through recessions of all kinds, and to continue in the limited field of residential mortgage lending. Ways must be found for this industry to continue to grow. The job of getting this industry to again grow and expand will be made much more difficult, if not impossible, by adding a greater tax burden at this time.

Public policy in this country from its early years has encouraged the ownership of homes and farms by ordinary families. The veterans of the Civil War were offered 40 acres and a mule. After World War II, a grateful Congress provided the GI loan program. The United States has developed in great part as it has because of the deliberate policy of encouraging the purchase of land and homes by the ordinary family which distinguishes this country from most others of the world. The savings and loan business has been a key part of that program. We believe that the policy of Congress with respect to taxation of thrift institutions should be to continue to encourage home ownership and to avoid the creation of substantial barriers to American families who need to borrow money at reasonable rates in order to buy a home.

STATEMENT OF WILLIAM J. McKEEVER, PRESIDENT, PUBLIC FEDERAL SAVINGS & LOAN ASSOCIATIONS, PHILADELPHIA, PA.; AND PAST PRESIDENT, NATIONAL LEAGUE OF INSURED SAVINGS ASSOCIATIONS; ACCOMPANIED BY WILLIAM McKENNA, GENERAL COUNSEL, AND WILLIAM HALLAHAN, FINANCIAL CONSULTANT

Mr. McKEEVER. Thank you, Mr. Chairman.

My name is William J. McKeever and I am president and executive officer of Public Federal Savings & Loan Association located in Philadelphia, Pa., and I am a former past president of the National League of Insured Savings & Loan Associations and also a former member of the Federal home loan bank board advisory council.

With me at the witness table today are two gentlemen. Our general counsel, William McKenna, and William Hallahan, who is our financial consultant.

Mr. Chairman, I have submitted a full statement along with a summary of the principal points of our testimony, and I would just like to take a few minutes of your time to present orally to this committee what we believe to be some overriding factors of the savings and loan and housing industry, important to your deliberations.

The savings and loan business throughout the Nation has been shocked by the proposed amendments in H.R. 13270 that relate to the taxation of the thrift institutions. These provisions would substantially reduce the bad debt reserve allocation now permitted savings and loan associations under the Revenue Act of 1962, and would have the effect of very nearly doubling our rate of taxation over a 10-year period.

We are shocked in two ways, Mr. Chairman. First of all, the savings and loan business has been paying its fair share of taxes—and we would hope to continue to do so. Even the Treasury Department, in testimony before the House Ways and Means Committee earlier this year, conceded the fact that savings and loan associations' taxes were at an appropriate level. The Treasury, until after mid-year, had no intention of recommending any change in savings and loan taxation.

It was only after the House of Representatives acted on tax reform that the Treasury Department worked up its own proposal for substantially higher taxes for thrift institutions.

The point here is that the tax reform legislation was supposed to have eliminated loopholes and provided greater revenues from those not paying their fair share of taxes, and lower revenues from those paying more than their fair share. The savings and loan business does not fall into either of those two categories, but instead has been paying the amount sought by the Treasury ever since the 1962 revenue act was passed into law.

A second reason for our dismay over the proposed amendments in the House bill is that it will result in even higher costs for housing, while substantially reducing the amount of funds available for that housing. We have a national goal of 26 million new and rehabilitated housing units in the next 10 years. We are now far behind in meeting this goal. By year end we would expect that housing starts would fall

below the million level per year. Interest rates are at the top they have been in 110 years, and money is being diverted to other outlets, other than housing.

Yet when it is suggested that the Congress double the tax rate of savings and loan associations, the one institution that has remained in the home mortgage market throughout this funding drought—the result can only be to deny the housing goal that Congress established just last year.

It seems to us to be inconsistent on the one hand to set up a 10-year housing goal which requires greatly increased funding requirements, and with the other hand, take away funds from the one source that Congress can count on to produce the financing needed to meet that 10-year goal.

Gentlemen, we believe that this is exactly what will result if the proposed amendments relating to the taxation of savings and loan associations remain in this bill.

Let's for the moment examine the rationale contained in the House committee report on this bill, tendered in justification of its proposed amendments.

First, the report states that it recommends cutting in half the bad debt reserve allowance now applicable to our institutions because we "pay a much lower effective rate of tax than the average effective rate for the ordinary business corporation." This bad debt reserve was recommended by the Treasury Department and accepted by Congress in the 1962 revenue legislation.

This statement by the Treasury assumes that savings and loan associations are something like the ordinary business corporation. Such a premise, we believe, is lacking a foundation as a castle built of sand. I am confident that had we had the opportunity to present our views to the House committee on this matter, the amendment would have never been offered.

As an example of the comparison to the average corporation, we would like to ask the question, does the average corporation or any corporation, other than a mutual savings and loan association, pay out 90 percent of its net income as interest to its depositors?

Does the average corporation invest almost up to 100 percent of its savings accounts in mortgages, sometimes considerably more than a hundred percent?

Does the average corporation invest most of its assets in 25-year to 35-year home loans?

Does the average corporation meet account holder wtihdrawable demands as they desire?

Does the average corporation borrow short and lend long?

Does the average corporation assume the unknown risks of a quarter to a third of a century in almost its total loan program?

Does the average corporation finance home loans entirely under any and all stages of economic thrust, recession, depression, or severe vacillations in monetary and fiscal policy? Would you expect any other business, other than insured savings and loan associations of this Nation to so operate regardless of their corporate structure? It would appear that the answer would be no.

We are not an ordinary business corporation. We never have been, and Congress has never expected us to be.

We are a specialized type of institution. We have not changed the investment character of our business in over a century. We have been and are the bedrock provider for many decades of mortgage credit to house our people. We are providing most of the funds for home financing in today's chaotic housing market, just as we always have.

But we will not be able to continue to do so if our ability to accumulate adequate reserves is threatened, as the House bill proposes.

Mr. Chairman, it is this premise on which our testimony is based. We are not the ordinary business corporation, and so we need adequate—and I stress the word "adequate"—bad debt reserves to continue as sound and operating institutions. It is for this reason we must oppose in the strongest of terms the House proposal that would seriously reduce our bad debt reserve allocation. By the same token we must reject the Treasury proposal that would completely eliminate any bad debt research except for actual experience.

This denies the historical concept that has already proved its worth in the United States. In fact, gentlemen, we have exported the savings and loan system to Latin America. It is one of the few things that I think that we are proud of in this regard.

Insured savings and loan associations were called on by the Congress to make America the best-housed nation in the history of the world. To do this we needed—and continue to need—an adequate bad debt reserve allowance, or call it something else, an allowance. The Treasury proposal would do away with this, and to our way of thinking would seriously jeopardize our ability to continue to do the job you have commissioned us to do.

The problem the Treasury cites of wanting to bring savings and loan associations to the same level of taxation as commercial banks is like mixing apples and oranges. It is difficult to contemplate how this can be justified in light of the special, long-term risks inherent in savings and loan operations, and studiously avoided by commercial banks, in the main.

We have a pledge, and the Congress has a pledge, to the American people to rebuild our cities. We are already behind in that work. To increase the taxation of the one type of institution that can be counted on to perform the task of rebuilding is perhaps tantamount to saying that this task will never be accomplished.

Mr. Chairman, I thank you and the committee for your courtesy.

Senator ANDERSON. Any questions?

Senator BENNETT. I have just one question.

Mr. MCKEEVER. Yes, sir.

Senator BENNETT. If you had to choose between the House approach and the Treasury approach which would you choose?

Mr. MCKEEVER. If I had to choose, Senator, you are giving me a difficult choice because I like neither of them.

Senator BENNETT. Well, you have said that in your testimony.

Mr. MCKEEVER. Yes. [Laughter.]

You see, the reason for the Treasury approach, it is contained in about two paragraphs, and this is very difficult to accept as something that is so very unexplained at this time.

Senator BENNETT. Are you saying that you could not understand the Treasury approach?

Mr. McKEEVER. No, sir, I say that it is not spelled out in enough detail.

Senator WILLIAMS. You prefer the House approach, then?

Mr. McKEEVER. I would say no, Senator. We wouldn't prefer to have it, because there are too many unanswered questions in my mind concerning the Treasury approach.

Senator BENNETT. Then you prefer the Treasury approach.

Mr. McKEEVER. No——

Senator BENNETT. I know that you don't like either of them.

Mr. McKEEVER. Right.

Senator BENNETT. But which one would you take as the lesser of two evils?

Mr. McKEEVER. Well, Senator, in order to live under the bill we probably would have to convert to a commercial bank, if we could do that.

Senator BENNETT. Why don't you say to me that you are unable to answer the question?

Mr. McKEEVER. Well, I am unable to answer it at the present time, Senator.

Senator BENNETT. OK. Thank you.

Senator MILLER. What is the difference between your membership and the membership in the U.S. Savings & Loan League?

Mr. McKEEVER. I will give that, Senator to our general counsel.

Mr. McKENNA. Well, their numbers are greater. The U.S. League has many more members than we do. We are limited to federally insured institutions; that is, those insured by FSLIC. We have a much smaller membership, and for that reason we think sometimes we can come to positions a little quicker than our friends in the other league.

Senator MILLER. In other words, the members of your organization could also be members of the U.S. Savings and Loan League but not necessarily the other way around?

Mr. McKENNA. Well, not necessarily, although I think for the most part most institutions are today insured by the Federal Savings and Loan Insurance Corporation and, therefore, there is a great deal of dual membership between the two leagues, Senator.

Senator MILLER. Mr. McKeever, you heard Mr. Mitchell testify that his organization accepts the elimination of the 3-percent rule.

Mr. McKEEVER. Yes, we would agree.

Senator MILLER. Would you agree?

Mr. McKEEVER. Yes, Senator.

Senator MILLER. You also, I presume, heard the testimony of the Chairman of the Federal Home Loan Bank Board earlier this morning?

Mr. McKEEVER. Yes, I did.

Senator MILLER. As I understood him he substantially supported the Treasury approach. Do I understand then you would be very much opposed to the position taken by the Federal Home Loan Bank Board?

Mr. McKEEVER. No, I would not. I would not be substantially opposed.

Senator MILLER. You would not be substantially opposed?

Mr. McKEEVER. That is correct. I would want to see the particular details. I was interested in the novel approach of Dr. Martin to a spe-

cial deduction for inner-city lending. This is one of the big problems that we have in the large cities, because mention is made of insured and guaranteed loans, and the implication is always that they are risk free. This is not so in a big city, particularly where you have to repossess VA real estate. Our biggest losses that we have on our books come from repossessed VA loans that we had to take back in ghetto areas. The VA pays off the 60 percent, gives you back the property, and you can't dispose of it. The city comes in with a list of building violations. To complete curing the violations and have the new equipment stripped out the next day would be foolhardy. So we dispose of these repossessed homes as quickly as we can to somebody who would deal in junky real estate.

Senator MILLER. But it is my understanding that Mr. Martin supported the Treasury's position to do away with your traditional method of computing your reserves. He would sweeten that up with the 5 percent and the 10-percent allowance.

Mr. McKEEVER. Yes; that was my understanding.

Senator MILLER. You are very much opposed to that?

Mr. McKEEVER. I am not opposed to it in toto until I see the whole picture, as to what it is 10 percent of. I have been used to reading the small print and rules and regulations, and I don't like to support one thing with the right hand that the left hand taketh away.

Senator MILLER. Well, it was my understanding the thrust of your testimony was that you were opposed to doing away with the traditional method of computing your reserves, which would increase your tax load, and that the Treasury approach of a 5 percent sweetener will not be an appropriate offset at all.

Mr. McKEEVER. Well, I would say that, yes, sir.

Senator MILLER. So to that extent you are opposed to the Chairman of the Home Loan Bank Board?

Mr. McKEEVER. No, I wanted to examine the Chairman's proposal when he opened up on the special deduction of the 10 percent for moderate- and low-income housing. So to that extent I don't want to foreclose it, Senator.

Senator MILLER. Well, I appreciate that, but I think you ought to recognize that my reaction to your testimony is that you are opposed to this 5 percent approach of the Treasury Department in lieu of the traditional method of computing your bad debt reserve?

Mr. McKEEVER. That is true, Senator.

Senator MILLER. Now, to the extent that there is a 10 percent sweetener that is recommended by the Federal Home Loan Bank Board you want to think about that?

Mr. McKEEVER. Yes, sir, particularly, Senator, for us lending in the inner cities.

Senator MILLER. And to see to what extent that might compensate for the loss or the tax, additional tax load, that the abandonment of the original method of computing your bad debt reserves would result in?

Mr. McKEEVER. I would even, Senator—yes, overall. But I would even buy the special 10 percent as an inducement to lend in the inner cities at the same time retaining what we have now as our bad debt reserve.

Senator MILLER. But that was not Mr. Martin's recommendation, was it?

Mr. McKEEVER. You are right.

Senator MILLER. To that extent you are opposed to him?

Mr. McKEEVER. I am opposed to the 5 percent recommendation, yes, Senator.

Senator MILLER. And opposed to the 10 percent recommendation in lieu of what you now have?

Mr. McKEEVER. Well, now you are trading.

Senator MILLER. Now we are down to the bedrock of your testimony.

Mr. McKEEVER. That is right, and now you separate the men from the boys when you have to make what you consider is the best possible solution to a real hard problem. I would like to think about that some more, Senator.

Senator MILLER. Well, I invite your attention to Mr. Mitchell's testimony that they are opposed to Mr. Martin's position.

Mr. McKEEVER. Well, I can appreciate Mr. Mitchell's testimony. I have known him for a long time. He is extremely knowledgeable.

Senator MILLER. And you are opposed in part and questioning in other part, is that correct?

Mr. McKEEVER. That is correct.

Senator MILLER. Thank you.

Mr. McKEEVER. That is right.

Senator WILLIAMS. Based on your own experience what has been your loss ratio over the last 10 years?

Mr. McKEEVER. It has been very small, Senator.

Senator WILLIAMS. What is very small, what percentage?

Mr. McKEEVER. I don't have the figures for the industry. I could cite my own institution. We probably had about 10 percent of what we put away in our bad debt reserve over those past years as losses.

Senator WILLIAMS. It is about a quarter of a percent?

Mr. McKEEVER. Well, it is very difficult to figure.

Senator WILLIAMS. What is your ratio then, percentagewise, what would it be?

Mr. McKEEVER. Our ratio——

Senator WILLIAMS. Your losses.

Mr. McKEEVER. Our losses I would say are about 15 percent of income without the bad debt deduction which amounts to about—which amounts to 60 percent of income.

Senator WILLIAMS. You mean your loss?

Mr. McKEEVER. I would say that ours is higher because we are lending in a big city——

Senator BENNETT. He is shifting from a base of investment to income, which is a completely unrelated method of stating it.

Mr. McKEEVER. Yes. But you see I don't have the figures, Senator, as a percentage——

Senator BENNETT. What have you been putting into bad debt reserves? What did you put in last year?

Mr. McKEEVER. In dollars?

Senator WILLIAMS. In percentages.

Mr. McKEEVER. We put 60 percent of net income, most of us put that in.

Senator WILLIAMS. 60 percent of net income you set aside for bad debts reserves?

Mr. McKEEVER. That is right.

Senator BENNETT. And his loss is 6 percent, one-tenth.

Mr. McKEEVER. The bad debt reserve is limited to 6 percent of the qualifying reserves for mortgage loans. Once you get up to the 6 percent reserve you no longer can put it in regardless, the 60–40 can no longer go in it.

Senator BENNETT. And those were your actual losses?

Mr. McKEEVER. No, sir. Our actual losses, Senator, I would say were about one-third of what we put in there.

Senator BENNETT. You said a minute ago 10 percent.

Mr. McKEEVER. No, well, let us say, we put 60 percent of net income in there, I say our losses were about one-third of that input.

Senator WILLIAMS. We will leave net income out for a moment. Of your loans, what percentage of your loans would it be?

Mr. McKEEVER. Yes. Yes, Senator, it would be less than 1 percent of the loans.

Senator WILLIAMS. How much are your loans?

Mr. McKEEVER. Our loans are $110 million. Our losses were last year approximately $70,000.

Senator WILLIAMS. Well, that is less than——

Mr. McKEEVER. Seven-tenths of 1 percent. I said less than 1 percent.

Senator WILLIAMS. Yes.

Senator ANDERSON. Thank you very much Mr. McKeever.

(Mr. McKeever's prepared statement follows:)

STATEMENT OF THE NATIONAL LEAGUE OF INSURED SAVINGS ASSOCIATIONS, PRESENTED BY WILLIAM J. MCKEEVER

Mr. Chairman and members of the Committee, my name is William J. McKeever. I am President of Public Federal Savings and Loan Association of Philadelphia, Pennsylvania and Immediate Past President of the National League of Insured Savings Associations. The Natitonal League appreciates the opportunity to present to you its views on H.R. 13270, the Tax Reform Act of 1969.

It was in 1962 that the Congress enacted three alternative bad debt reserve formulas under which the savings and loan industry has operated since that time. In its report on H.R. 13270, the House Committee on Ways and Means acknowledge that "about 90 percent of the savings and loan associations use the 60-percent method and are currently paying taxes in the manner generally anticipated under the tax formula adopted in 1962." (House Report No. 91–413 (Part I), August 2, 1969)

Savings and loan associations are in material part subject to the same provisions and Federal income tax rates as other corporations. The only substantial difference being that in computing taxable income to which the regular tax rates apply, a more favorable bad debt reserve allowance is permitted in recognition of the risks involved in long-term mortgages that constitute most of the investment portfolio of savings and loan associations.

Because as a matter of law and practice, savings and loan associations invest most of their funds in long-term real estate mortgages, they absolutely require a higher bad debt reserve than other corporations. The numerous failures that occurred in the industry in the Great Depression of the early 1930's bear stark witness to the fact that although the homes that served as security for mortgages were sound, the financial inability of mortgagors to make payments on the mortgage when due burdened the savings and loan industry with losses beyond the capability of their then bad debt reserves to meet.

The importance of maintaining adequate bad debt reserves is still paramount despite the introduction of the monthly payment type of mortgage gen-

erally prevalent today. It is not necessary to go outside the District of Columbia to find a recent example of a savings and loan association that found it necessary to merge with another because the merging association's bad debt reserves were inadequate.

Unfortunately, the report of the House Committee on Ways and Means on H.R. 13270 does not give sufficient recognition to this imperative need for bad debt reserves due to the nature of the savings and loan association. That Committee Report cites as the Committee's reason for concluding that present bad debt reserve provisions applicable to mutual thrift institutions are "unduly generous", the fact that they have allowed these institutions "to pay a much lower average effective rate of tax that the average effective rate for all corporations." (House Report No. 91-413 (Part I), page 125) Accordingly, the report continues, H.R. 13270 amends the special bad debt reserve provisions of existing law applicable to those instiutions to provide assurance that significant tax will be paid in most cases on their retained earnings.

We fear that this line of argument in the report fails to recognize the enormous difference that exists between savings and loan associations and other types of corporations, despite the Committee's sincere conclusion that the changes wrought by the bill in such bad debt reserve provisions would still result in reserves consistent with the proper protection of the thrift institution.

The savings and loan association:

1. Pays out about 90 per cent of its net income as interest on deposits to its savers (a pattern that would exempt a real estate investment trust from Federal income tax).
2. Invests almost 100 per cent of its savings account funds in real estate mortgages.
3. Invests most of its assets in mortgages having maturities in the range of 25 to 35 years.
4. From a practical standpoint must be ready to meet widrawal demands as they are made.
5. Borrows short and lends long.
6. Assumes the unknown risks that can arise over a quarter century on nearly all its loan portfolio.
7. Is expected to and does finance residential construction and transfer consistently in good times and in bad.

Savings and loan associations are unique in being corporations that possess all of the foregoing seven attributes. Consequently they need and deserve tax treatment substantially different from that accorded other corporations.

Particularly during the current period of inflationary pressures, savings and loan associations need adequate bad debt reserve funds available. In the field of housing that provides security for nearly all mortgages held by such associations, the inflationary pressures are even more severe than in the rest of the national economy.

Material assembled by E. H. Boeckh and associates demonstrates that compared with a 1957-9 base equaling 100, the construction cost index for residences was 111.6 in 1964 and 143.2 in January 1969, constituting a 28 per cent increase.

Secretary of Housing and Urban Development Romney recently testified to the Subcommittee on Housing of the Senate Committee on Banking and Currency that the cost of housing is rising at the rate of 1 per cent a month or 12 per cent a year.

Practically every cost element entering into the construction of residences from the cost of land through the cost of labor and materials is rising sharply.

The comparative size of loss on a loan in default or a foreclosed property is likewise rising. For not only are the amounts of periodic payments due on the mortgage loan higher but so are the costs of maintaining property taken over by the association due to default under the mortgage during the period when the property is an expense rather than an income producer for the association. Meanwhile the association must continue to pay dividends or interest to the saver on the accounts that produced the funds to make the mortgage loans. Associations must have bad debt reserves on hand and available to take care of these losses in order to continue normal operations. We wish to stress that the reserve funds must be available for use when needed. They must be accumulated in good times for use in bad times. They cannot be built to sufficient levels overnight.

During this period when the degree of inflation in housing surpasses general inflation, it is vitally important that more funds be available in bad debt

reserves. Surely it is not a period in which the ability of associations to build substantial reserves as quickly as feasible should be diminished in the manner proposed in H.R. 13270. Each dollar taken for additional taxes diminishes the amount available for addition to reserves or for investment in home finance.

Nor is the bill's proposal for a 10-year carryback and 5-year carryforward for losses an adequate alternative. First, we question whether this provision would achieve its intended goal since bad debts would be chargeable against the association's reserves and, second, we would doubt whether the provision would produce funds in time to meet current expenses of an association that is suffering losses due to defaulted or foreclosed mortgages.

Under the existing bad debt reserve formulas the savings and loan industry has consistently supplied a major portion of the residential finance in this country. Almost half the homeowners in the nation have reached that status with the aid of mortgage loans from savings and loan associations. The 90th Congress in the Housing and Urban Development Act of 1968 set a housing goal of 26 million units over a 10-year period. Savings and loan associations have combined a dwindling supply of savings funds with proceeds of repayments on outstanding mortgage loans and borrowings from the Federal Home Loan Bank System and other sources to furnish a substantial percentage of the mortgage financing for the housing now being built at the rate of only 1.3 million units per year, which is far below the rate needed to meet Congressional housing goals.

Savings and loan associations by their nature borrow and acquire savings funds on a short-term basis and lend in the real estate mortgage market on a long-term basis. This results in a need for meeting current market costs of money to attract short-term savings while being frozen into fixed-rate yields on long-term mortgage investments. From 1963 through 1967 attracting savings funds has required the payment of dividends thereon in an increasing range of more than 6½ percentage points from 62.6 percent to 69.2 percent of gross operating income. The long-term nature of mortgages held in portfolio reduces the average yield far below current mortgage yield for new loans in a high interest rate period. Real estate mortgage interest income ranged from 84.7 percent to 87.6 percent of gross operating income from 1963 through 1966, decreasing to 86.2 percent in 1967, representing a maximum range of less than 3 percentage points. Net operating income after payment of dividends in the savings and loan industry decreased from 13.7 per cent to 8.9 per cent of gross operating income over the period from 1963 to 1967. Contrary to some apparent opinion, the industry does not lay golden eggs in the form of profits.

In the face of efforts of savings and loan associations to continue to supply mortgage credit to a needy housing market, section 442 of H.R. 13270 would almost double the Federal income tax bill for the savings and loan industry at the end of 10 years. This would result from the provision in section 593(b)(2) of the Internal Revenue Code of 1954 as it would be amended by H.R. 13270 that reduces the 60 per cent maximum for the taxable income formula for computing a bad debt reserve to a 30 per cent maximum over a period of 10 years at the rate of 3 percentage points a year.

We believe the industry can live with the several other changes made by H.R. 13270 in bad debt reserve formulas for savings and loan associations.

In their recent testimony to your Committee Secretary Kennedy and Assistant Secretary Cohen set forth the general outline of some proposal that would provide a special tax deduction for financial institutions, including savings and loan associations. Their statement indicated that details would be provided in a later memorandum to your Committee. Lacking knowledge of those details, particularly those dealing with a phase-in period, it is difficult to appraise the effect of the proposal. However, the testimony disclosed sufficient information to indicate that, if the 60 percent minimum taxable income requirement therein mentioned would become immediately effective, the proposal would result in immediate and substantial increases in Federal income taxes from savings and loan associations as compared with either the present law or the requirements of H.R. 13270 during the next few year. If this be true, the proposal cannot be supported by the National League for the same reasons it cannot support the reduction H.R. 13270 would cause in the 60 percent maximum in the taxable income bad debt reserve formula.

In summary:

(1) The reduction of the 60 percent maximum to 30 percent would absorb in taxes a significant amount of new funds from the home mortgage market.

(2) Long-term mortgages involve a degree of risk demanding adequate bad debt reserves. The increased tax requirements resulting from H.R. 13270 will inhibit the ability of savings and loan associations to build such reserves.

The National League strongly urges this Committee to retain the present provision in section 593(b)(2)' of the Internal Revenue Code of 1954 that fixes at 60 per cent the maximum for the taxable income formula usable in determining a bad debt reserve for savings and loan associations.

We appreciate the opportunity of presenting these views.

Senator ANDERSON. The final witness will be Mr. Harding.

Senator Cranston, we are happy to have you.

Senator CRANSTON. Mr. Chairman and members of the committee, I was particularly anxious to be present today in order to listen and to introduce to you your final witness who will be D. W. Ferguson. Mr. Ferguson is president of the Quaker City Savings & Loan Association of Los Angeles, and is accompanied by Frank Hardinge, executive vice president, California Savings & Loan League.

If I may just say briefly, these are two outstanding representatives of an outstanding industry in California. This is an industry that in the West, particularly in California, faces problems and circumstances that are, unique and quite different from those facing this industry generally in the country. It is a particularly important aspect of our housing industry which, as you know, faces grave problems in California due to our great population growth. Senator Bennett is particularly familiar with this due to his service on the Banking and Currency Committee and I would like to suggest, Senator Bennett, that you direct the same questions to this witness that you directed to the last witness about his preference between the Treasury proposals and the Tax Reform Act as passed by the House.

Thank you very much.

Senator BENNETT. I hope I get a different answer from Mr. Ferguson.

Senator WILLIAMS. If I may, first, figuring up mathematically the answer to the question, previous question, is seven one-hundredths of 1 percent of loss ratio, $70,000 to $110 million of the previous witness instead of seven-tenths.

Senator ANDERSON. Will you give your testimony?

STATEMENT OF D. W. FERGUSON, PRESIDENT, QUAKER CITY FEDERAL SAVINGS & LOAN ASSOCIATION; ACCOMPANIED BY FRANKLIN HARDINGE, JR., EXECUTIVE VICE PRESIDENT, CALIFORNIA SAVINGS & LOAN LEAGUE

Mr. FERGUSON. Thank you, Mr. Chairman.

Gentlemen of the committee, he inadvertently transferred me from Whittier to Los Angeles. Our offices are in Whittier.

Senator CRANSTON. Los Angeles County.

Mr. FERGUSON. Next week I will become president of the California Savings and Loan League.

In the interest of savings your time I will not repeat testimony with which we agree presented by a previous savings and loan witnesses.

We are in agreement with the statement filed by the U.S. Savings and Loan League and the National League of Insured Savings Associations that the present tax system on savings and loans should not be changed and impose an additional burden on already suffering lenders for the housing industry.

If the ultimate proposed tax rates, which are nearly double our present rates, had been in effect since 1962 we estimate that in California 125,000 families would have been denied credit for new or existing housing during the last 6 years.

The Congress in 1962 recognized the need for bad debt reserves for the savings and loan business, and both the House bill and the Treasury proposal recognized the need for reserves, although based on different formulas. Thus the principal issue is how great these reserves should be. The record of loss experience of long-term lenders during the 1930's is in the record books for all to see. Long-term lending entails the taking of risks and inevitably there will be some losses in varying degrees both as to when those losses are taken and by which institutions they will be taken.

With respect to the need for reserves for financial institutions we support the stand taken by Mr. Alexander of the American Bankers Association for the need for bad debt reserves for banks, although we suggest that bad debt reserves for savings and loan associations should be higher because their loans are almost 100 percent long-term while bank loans are predominantly short term.

There is another reason for the need for reserves not mentioned by previous witnesses. It is contended by some that we will never have another serious depresssion. But if we do, the Federal Savings and Loan Insurance Corporation and the Federal Deposit Insurance Corportation are now in existence to pick up losses which might occur. These agencies were not extant in the 1930's. It is significant that both of these insurance corporations insist that their respective member institutions build and maintain their own reserves because these are the reserves which will absorb the primary shock of losses. These government insurance corporations would not be able to cope with serious losses by their members if they had to rely solely on their own reserves.

It therefore seems very clear that the ability of both savings and loans and banks to build reserves out of current income must not be impaired by tax policy.

We note with interest that the Ways and Means Committee of the House of Representatives at the last minute reversed itself so that the House bill now affords favorable tax treatment to the income from municipal bonds. We understand the reason for this decision. It is in the national interest to provide a strong market for the obligations of State and local governments. We suggest that it is also in the national interest to provide similar incentives to encourage the investment in long-term home loans by excluding from taxation a portion of the income resulting from long-term residential lending.

Both the House bill and the Treasury proposal include a provision for phasing in the proposed increase in savings and loan taxation. This really only provides a period during which the total economy must learn to live with a smaller amount of credit available for home loans because neither of the proposals in any manner provide for alternate and additional sources of mortgage credit.

Since both the House bill and the Treasury proposal result in a substantial increase in savings and loan taxation, and changes comparable tax rates from 17 percent to 31 percent for savings and loans and from 23 percent to 27 percent for banks we must oppose both in their present form. If, however, our only alternatives are those two proposals, then we would support the principle of the Treasury proposal but only with higher deductions than those suggested by the Secretary of the Treasury and with other modifications. Of course the Treasury proposal is merely in outline form and we must be given the opportunity of studying the specific technical details of it.

Parenthetically, Mr. Chairman, we would like to correct a typographical error in our statement which was filed. On page 138, the last line of the first paragraph, the correct figure is 60 percent of income, not 50 percent as shown.

In closing, we urge consideration of our porospal to stimulate savings. The basic problem today is our lack of capital to meet demands for housing credit. The American public is saving less of their disposable income than in the past few years. Thus it would be anti-inflationary if the public were given an incentive to save more and spend less.

An additional advantage of tax abatement on interest received by the saver of modest amounts would tend to make this form of savings more attractive without increasing the rate paid on savings. This hopefully would also allow us to pass on such savings to the borrower on home loans. We believe that our proposal is in accordance with the objectives of the Congress in giving tax relief to low- and middle-income people who own the bulk of the savings accounts of our Nation.

Thank you.

Senator WILLIAMS. To the extent that any bad debt reserve is provided for, would you say that it should be also provided that this could not be passed on to stockholders but it must be kept as a bad debt reserve?

Mr. FERGUSON. That is the present situation. I would concur with that, Senator Williams.

Senator BENNETT. In your testimony, you indicate that you would prefer the Treasury proposals to the House, and with Senator Williams' question, I want to repeat it, if you couldn't pay that 5 percent out to shareholders would that change your preference?

Mr. FERGUSON. Senator Bennett, we are mutual institutions, I am talking about our personal situation, we are a pure mutual, so we do not have that privilege anyway.

Senator BENNETT. Isn't the proportion of stock institutions in California higher than the national average?

Mr. FERGUSON. I believe so; yes, sir.

Senator BENNETT. What proportion in California are stock?

Mr. FERGUSON. I will defer to Mr. Hardinge because he has those figures.

Mr. HARDINGE. Senator Bennett, there are about 180 State-chartered associations with about $20 billion in assets. There are about 70 federally chartered associations with about $10 billion in assets in the State of California.

Senator BENNETT. Are you telling me these are the stock companies?

Mr. FERGUSON. The Federals are the $10 billion. Stock companies are the $20 billion, the State chartered, are the stock companies.

Senator BENNETT. Why is it you prefer Treasury proposal?

Mr. FERGUSON. Mr. Hardinge.

Mr. HARDINGE. Senator Bennett, I think we have to start with the premise that both the House and Treasury proposal would substantially increase the effective rate of taxation on savings and loan associations.

We believe, however, that there is a great deal of merit to the type of principle espoused in the Treasury proposal giving incentives to divert as much of our credit to residential lending as possible. We think that if the 5-percent incentive as expressed by the Secretary of the Treasury, were doubled, it would give ample incentive for lenders to put a maximum amount in residential credit as opposed to other types of mortgage credit which would normally bear a higher interest rate.

Senator BENNETT. So it is the Treasury 5 percent or that principle which you hope will be maybe raised numerically which forms the basis of your discussion.

Mr. HARDINGE. Yes sir; our formal statement indicates that we would propose instead of 5 percent, it be 10 percent, and that the ceiling on such deductions be 60 percent instead of 40 percent as under the Treasury proposal.

Senator BENNETT. That is all, Mr. Chairman. Thank you.

Senator ANDERSON. Senator Jordan?

Senator JORDAN. No questions.

Senator ANDERSON. Thank you.

(The statement of the California Savings & Loan League follows:)

POSITION OF THE CALIFORNIA SAVINGS & LOAN LEAGUE ON H.R. 13270, PRESENTED BY D. W. FERGUSON, PRESIDENT, QUAKER CITY FEDERAL SAVINGS & LOAN ASSOCIATION

I appear in opposition to those provisions of the House Bill providing for increased savings and loan association taxation.

The share of national savings going into family shelter has become increasingly inadequate over the past several years. Housing is already at the bottom of the totem pole. The situation is growing more, not less critical. Only last Tuesday, Senator Proxmire told the Banking and Currency Committee that housing starts were down 30% since January, and would continue to decline. Because funds are not available for shelter, many families can neither sell or buy a house at a time when the total housing inventory is grossly inadequate. We believe the House proposals, if enactetd, would accelerate the trend of money out of shelter financing. Further, we believe that the same considerations that make the House Bill grossly unfair to home-financing specialists will be the cause of this acceleration.

Savings and loan associations are required under federal law to make large appropriations to the federal insurance reserve without regard to true net income or income after taxes. Associations, even under the present tax law, have difficulty meeting these present reserving requirements. The House Bill would tax these inaccessible mandatory reserves as income. These additional taxes will place us in the position where any substantial growth, even if possible, will put us in volation of the insurance reserve regulation. If these additional tax burdens are placed upon us it will be very difficult for us to increase our lendable funds. Most importantly, high interest rates on home loans will be frozen into the system because we must make the money meet our reserving requirements and higher taxes.

In 1962 Congress determined to increase taxes greatly from savings and loan associations. In part this action of Congress was in response to the contention

that prior favorable tax treatment channeled too much public savings into housing rather than permitting funds to be allocated by free market forces to the types of credit demand that would pay the most for those savings.

Nevertheless, Congress intended to preserve the concept that more favorable tax treatment should be accorded savings and loans than to optional lenders in order to assure adequate funds for family shelter.

The House Bill would reverse this treatment. The House proposal would increase the tax on savings and loans, as a percentage of taxable income, from 16.9% to 31%, while increasing the bank rate only from 23% to 27.5%, so that for the first time the rate on savings and loans would exceed that on banks. Exhibit A. But by more objective tests savings and loan associations are already excessively taxed. The 1962 tax increase severely hurt savings and loan associations, and has combined with inflation to produce the present grossly unsatisfactory home-financing situation which the new proposals would exacerbate.

In 1963 California savings and loan associations provided 58% of the total funds loaned on real estate of all types, commercial, industrial and residential, by institutional lenders in California. But substantially the entire savings and loan share of real estate loans was for residential financing. In 1968, the percentage of all such real estate loans in California made by savings and loans was only 39.5%. Exhibit B. The lesser savings and loan share of the mortgage market in recent years shows the diversion of funds from long-term, single family home financing to commercial and industrial loans in which other institutional lenders have placed their money. This in turn has produced the present critical shortage of funds for family shelter. The shift in savings since 1963 has gone to commercial banks. Table C demonstrates how the decline of savings growth has impaired the ability of savings and loans to make real estate loans. The table also reveals that banks have been steadily reducing their total real estate lending notwithstanding the fact that their savings growth has been at its greatest during this period.

The adoption of the House proposals would accelerate this diversion of money away from family shelter. While the House proposals would transfer to the Treasury, in the form of taxes, an increased percentage of the total gross income of these institutions, the dollar amounts so realized by the Treasury will eventually be less than if these provisions were not enacted, because of the financial harm these proposals would do to savings and loans and to those who use mortgage credit.

Governments have alternatives, sometimes overlapping, for the provision of money for housing. The alternative which in the United States has provided the most funds for this purpose is sponsorship of a type of institution required by law to place the bulk of its money in the financing of homes regardless of whether other investments are more attractive. This is the savings and loan association. While the savings and loan association must compete in the marketplace for available money against all other forms of investment, it must place that money only in long term loans on homes. To succeed, it must be able to compete in the marketplace for savings against lenders who can pick and choose their investments.

But an additional national policy is that shelter financing be made available to families on a basis which spreads the cost over periods as long as 25 or 30 years with no increase in monthly payments over that period.

As a result savings and loan associations' assets are predominantly long-term home loans. By way of example, at the end of 1968 California savings and loan associations held $25.2 billion in mortgage loans of which $24.2 billion were neither insured nor guaranteed. At the same time these associations held $24.3 billion in savings accounts.

If savings and loan associations are taxed without regard to this dominant factor that most of their funds are invested in long-term home loans, they are unfairly taxed and as a consequence become non-competitive. They cannot meet the marketplace price for money. The money that would otherwise go to them to provide shelter for families instead goes to others to finance corporate acquisitions, or other demands of the economy more rate competitive and flexible than is family shelter.

Exhibit D gives selected average ratios for member commercial banks and for insured savings and loan associations in the United States. These tables show that the bank profit ratio before taxes but after losses (expressed as a percentage of average assets) dropped only from 1.36 to 1.06 from the period 1961 to 1967, even though those banks increased the amount that they were paying for their

money by 145%. In the same period although insured savings and loans could raise their offering price for public savings by only about 25%, their profit ratio before taxes and after losses dropped from .98 to .52. During this period, 90 days notes of commercial banks have been replaced or renewed at interest rates reflecting the market, and therefore inflation. A 30 year loan held by a savings and loan has the same monthly payments and same interest rates now as when it was made.

It is not proper to argue that a fair system of taxation can ignore the operational restrictions placed on savings and loan associations. The House Bill, if it becomes law, will condemn great numbers of families to continued inadequate shelter, and it will have this effect because it is unfair taxation.

The Treasury proposal for taxation of financial institutions is more realistic. The 5% deduction for both banks and savings and loan associations suggested by the Treasury against interest income from residential mortgage loans recognizes the inherent limitations upon long-term home loans as a form of investment. It is designed to cause lenders to voluntarily invest in home loans through appropriate tax treatment.

But the proposed incentive percentage is insufficient. Under its operation there is but slight tax benefit for the lender who has 75% or more of his portfolio in residual loans as contrasted to the lender whose residential loans are 50% or less of his total portfolio. In a low earnings year the 40% ceiling imposed under the Treasury suggestion would eliminate all or a portion of the deduction provided by the incentive percentage, at a time when the deduction may be of critical importance. The appropriate incentive deduction would be 10%, with a 60% ceiling.

As further evidence that there must be an adjustment in both the percentage of deduction from income as well as the ceilings imposed by the Treasury proposal, we point out the comparative effective tax rates between banks and savings and loan associations. With only a 5% incentive deduction and a limit of 40% of net income for such deduction, the minimum effective tax rate on a savings and loan association would be 30% and for the more profitable and efficient association the effective rate could be as much as 42%. On the other hand the Treasury proposal would increase the effective rate now paid by the banks from 23% to 25.5%. The effective tax rates under the House Bill for banks would be 27%.

The Treasury proposal implicitly assumes that the present tax definition of savings and loan associations will be discarded. This industry is unique in that an elaborate schedule of percentages on investments and operations is written into the tax law to serve as a definition of a savings and loan association, overriding in practical effect basic supervisory statutes and regulations, and essential public need. As an illustration, too much investment in low cost, multifamily housing for the poor under the present tax definition would disqualify a savings and loan association.

This is a matter for supervisory statutes and regulations, not for tax law. We suggest that, in lieu of the present elaborate definition, every savings and loan association insured as such by the Federal Savings and Loan Insurance Corporation be considered, for tax purposes, to be a savings and loan association.

The conversion period under the Treasury plan should be extended to the ten years provided by the House Bill. Further, care should be exerted that the deduction allowable from mortgage interest income is clearly adequate to attract optional lenders into the home-financing field.

Regardless of the adequacy of the 5% suggested by the Treasury to attract funds into choice home loans, the 5% suggestion is clearly inadequate to attract funds where they are most needed and the problems greater—low and middle income family shelter. We recommend a higher figure—at least 12%—for income from loans to provide middle and low income family shelter as from time to time defined by Executive Order. These families cannot be deprived of shelter financing because of the cost of lending to them. Shelter financing cannot be totally at the mercy of the marketplace. The base should not be a narrow definition of "interest", but should be income from residential real estate financing.

The modifications, discussed above in the Treasury proposals, are essential to the national interest.

Subject to these critical changes, the California Savings and Loan League endorses the Treasury proposal. The House Bill, on the other hand, would atrophy home-financing funds from savings and loan associations without providing an alternative source of funds for family shelter.

The impact of greater tax on savings and loan associations on home financing is beyond measure. There are no other lenders who would replace the void in home financing left by the inability of savings and loan associations to provide for traditional volume of real estate credit.

Certainly the Treasury proposal has as its objective a tax incentive to encourage lenders to make residential real estate loans. However, the tax proposals would not directly stimulate the availability of funds for residential lending. In a period when interest rates have been rising because the demand for capital is outstripping supply, it would seem desirable that tax incentives to the small saver be made a part of proposals under consideration to encourage more savings. This type of approach would also be anti-inflationary. The most logical implementation of the suggestion would be to provide a tax abatement of all or a portion of the interest received by thrifty citizens of this country from their savings in passbook deposits up to the earnings on accounts of $15,000. In effect, this would be making these savings accounts more attractive without raising interest rates and thus not creating a situation where compensating increases would have to be made in interest rates on residential real estate loans. We believe that to the extent savings is stimulated the loss in revenue from the abatement of taxes on interest earned on savings accounts would be more than offset by taxes on the profits from the application of those savings to home construction.

EXHIBIT A—CALIFORNIA SAVINGS & LOAN LEAGUE—CHANGES IN EFFECTIVE TAX RATES OF BANKS AND SAVINGS & LOAN ASSOCIATIONS (USING 1966 FOR ILLUSTRATIVE PURPOSES)

	Under present law		Proposed law	
	Percentages of economic income	Amount (millions)	Percentages of economic income	Amount (millions)
Banks:				
Total economic income	100.0	$3,643	100.0	$3,643
Tax exempt interest	33.2	1,209	33.2	1,209
Transfer to loan loss reserves and other tax benefits	9.4	342	(1.3)	(48)
Total	42.6	1,551	31.9	1,161
Taxable income	57.4	2,092	68.1	2,482
Tax, at 40.4 percent		845		1,003
Tax as percent of economic income		23		27.5
Savings and loans:				
Total economic income	100.0	579	100.0	579
Tax exemp income	1.2	7	1.2	7
Transfer to loan loss reserves and other tax benefits	56.6	321	23.8	111
Total	57.8	328	25.0	118
Taxable income	42.2	251	75.0	461
Tax, at 39.1 percent		98		180
Tax as percent of economic income		16.9		31

EXHIBIT B.—CALIFORNIA—ESTIMATED GROSS REAL ESTATE LENDING

[Dollar amounts in billions]

	Savings and loans		Banks		Insurance companies		Total, all major institutional lenders	
	Amount	Percent	Amount	Percent	Amount	Percent	Amount	Percent
1963	$7.90	58.4	$3.23	23.9	$2.39	17.7	$13.52	100.0
1964	7.43	53.6	3.64	26.3	2.78	20.1	13.85	100.0
1965	6.10	48.4	3.53	28.0	2.97	23.6	12.60	100.0
1966	3.10	36.6	2.86	33.8	2.51	29.6	9.47	100.0
1967	3.99	42.9	3.09	33.3	2.21	23.8	9.29	100.0
1968	4.06	39.5	3.54	34.4	2.68	26.1	10.28	100.0

EXHIBIT C.--CALIFORNIA AND U.S. NET CHANGE IN RE LOANS VERSUS SAVINGS GAINS

NET INCREASE IN RE LOANS FOR SAVINGS AND LOANS AND BANKS

[In billions of dollars]

Year	Savings and loans: Insured, California	Savings and loans: All operations, United States	Commercial banks: California	Commercial banks: United States
1968	$1.6	$8.9	$0.7	$6.7
1967	1.1	7.8	.2	4.6
1966	.3	3.9	.3	4.7
1965	1.6	8.9	.5	5.7
1964	2.9	10.4	.5	4.6
1963	3.7	12.2	.9	4.8

SAVINGS GAINS FOR SAVINGS AND LOANS AND BANKS

[In billions of dollars]

Year	Savings gains, savings and loans: Insured, California	Savings gains, savings and loans: All operations, United States	Gain in time deposits, commercial banks: California	Gain in time deposits, commercial banks: United States
1968	$0.8	$7.0	$1.9	$20.6
1967	2.3	10.6	1.6	23.7
1966	.2	3.7	1.4	12.1
1965	1.7	8.4	1.7	20.0
1964	2.8	10.6	1.4	15.7
1963	3.2	11.1	1.3	13.4

ASSETS TO RE LOANS—CALIFORNIA AND UNITED STATES

[In billions of dollars]

Year	Savings and loan associations: California: RE loans	Assets	Percent of assets	Savings and loan associations: United States: RE loans	Assets	Percent of assets	Commercial banks: California: RE loans	Assets	Percent of assets	Commercial banks: United States: RE loans	Assets	Percent of assets
1968	$25.2	$29.4	85.6	$130.8	$152.8	85.6	$9.2	$52.1	17.7	$65.3	$500.2	13.1
1967	23.6	27.9	84.4	121.9	143.9	84.9	8.5	46.7	18.2	58.7	450.7	13.0
1966	22.5	26.4	85.1	114.1	134.0	85.1	8.3	42.6	19.4	54.1	402.9	13.4
1965	22.2	25.8	85.8	110.2	129.4	85.1	8.0	39.8	20.0	49.4	375.4	13.2
1964	20.5	23.9	86.1	101.3	119.4	84.9	7.5	30.7	24.5	43.7	276.1	15.8
1963	17.7	20.7	85.5	90.9	107.6	84.6	7.0	28.4	24.7	39.1	253.4	15.4

Source: Federal Deposit Insurance Corporation, "Reports of Call"; FHLBB, "Selected."

EXHIBIT D.—PROFIT SQUEEZE, U.S. BANKS VERSUS SAVINGS AND LOANS

[In percent]

Items in numerator	Member commercial banks					Member savings and loans				
	Ratio to average assets			Change in basis points		Ratio to average assets			Change in basis points	
	1961	1967	1968	1961-67	1961-68	1961	1967	1968	1961-67	1961-86
Gross income	4.42	5.39	5.63	+97	+121	5.60	5.83	6.02	+23	+42
Loan income	2.75	3.55	3.73	+80	+98	4.70	5.02	5.13	+32	+43
Total money cost [1]	.86	1.88	2.06	+102	+120	3.43	4.23	4.24	+80	+81
Spread between gross income and money cost	3.56	3.51	3.57	−5	+1	2.17	1.60	1.78	−57	−39
Operating cost [2]	2.11	2.20	2.20	+9	+9	1.20	1.06	1.08	−14	−12
Profit before taxes but after nonoperating gains and losses	1.36	1.06	1.04	−30	−32	.98	.52	.72	−46	−26

[1] Includes interest paid on time deposits in commercial banks plus interest paid on borrowed funds. Includes dividends paid on withdrawable shares for saving and loans plus interest paid on borrowed funds, plus stock dividends paid by State-chartered saving and loans.

[2] Excludes interest paid for borrowed funds for both banks and saving and loans and interest paid on time deposits at banks.

Source: Federal Home Loan Bank Board: Combined Financial Statements, Board of Governors, Federal Reserve System, Federal Reserve Bulletin.

Senator ANDERSON. We will recess until 10 o'clock tomorrow morning.

(Whereupon, at 1 p.m. the committee recessed to reconvene at 10 a.m., Tuesday, September 16, 1969.)

TAX REFORM ACT OF 1969

TUESDAY, SEPTEMBER 16, 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 Russell B. Long (chairman) presiding.

Present: Senators Long (presiding), Anderson, Gore, Talmadge, Byrd, Jr. of Virginia, Williams of Delaware, Bennett, Curtis, Miller, Jordan of Idaho, and Fannin.

The CHAIRMAN. The hearing will come to order.

This morning the committee will take testimony on the general subject of the taxation of capital gains. The House bill makes a series of changes in this area of the law. The most important of these changes would be to extend the holding period from 6 months to 12 months and to repeal the maximum 25-percent tax rate on long-term capital gains.

The Treasury Department has expressed opposition to these features of the House bill. They take the position that these changes impose too great a burden on capital investment.

Our first witness this morning is Mr. Robert W. Haack, president of the New York Stock Exchange.

Before Mr. Haack proceeds, I want to state for the benefit of the television and radio, particularly the television and motion picture cameras, that committee members have complained about these lights and while we are happy to accommodate them and the witnesses insofar as we can, we do not want these lights kept on members of the committee or for that matter the witnesses, unless they are at that point engaged in televising them. So, I would like to have it agreed that the lights will be kept off unless the cameraman wants to take a picture. At that point he may turn his lights on.

Now, will you proceed, Mr. Haack.

STATEMENT OF ROBERT W. HAACK, PRESIDENT OF THE NEW YORK STOCK EXCHANGE; ACCOMPANIED BY BERNARD J. LASKER, CHAIRMAN OF THE BOARD OF GOVERNORS OF THE STOCK EXCHANGE; AND DONALD L. CALVIN, A VICE PRESIDENT OF THE STOCK EXCHANGE

Mr. HAACK. Thank you, Mr. Chairman. Gentlemen, my name is Robert W. Haack. I am president of the New York Stock Exchange. With me today on my left are Bernard J. Lasker, chairman of the board of governors of the exchange, and Donald L. Calvin, a vice president of the exchange.

My statement this morning is the summary of a comprehensive 18-page statement analyzing the impact of the capital gains tax provisions of the tax reform bill now before this committee. Copies of the full statement, including my summary, have been submitted to the committee.

The CHAIRMAN. They will be printed.

Mr. HAACK. In the 10 minutes allotted to me this morning, I will summarize the principal points and conclusions of that statement.

As passed by the House of Representatives, the specific capital gains tax provisions of the tax reform bill constitute a sharp increase in the capital gains tax. The exchange believes that three major adverse results may be anticipated if these provisions are enacted in their present form:

First, risk-taking incentives and the supply of essential venture capital would be seriously curtailed.

Second, investments in modern plant and equipment and in new technologies would diminish.

And third, the mobility of capital assets—which is crucial to maintaining a dynamic and fluid economy—would be impeded.

To my knowledge, there is no controversy about the need for maintaining an adequate level of investment to promote long-run economic prosperity. Recognition of this need is implicit in a recent statement by Secretary David M. Kennedy, who pointed out that the bill passed by the House is—quote—"weighted in favor of consumption, to the potential detriment of the Nation's productive investment." Secretary Kennedy concluded that the present version—and again I quote—"could impede economic growth in the years ahead by curtailing the incentive to make productive investments."

The exchange's own analysis of the probable economic impact of the proposals under consideration suggests that their hasty enactment could cause irreparable harm to the Nation's long-term capacity for growth.

Let us look briefly at each of the major proposed revisions in capital gains treatment:

The holding period—I do not think anyone would quarrel with the proposition that smooth functioning of capital markets is largely dependent upon liquidity—that is, the ease with which investors can move in and out of investments.

The holding period required to distinguish between an investment transaction—which qualifies for capital gains tax treatment—and a noninvestment transaction—which does not—automatically decreases the liquidity of the national investment pool.

In determining the most suitable length of the holding period, there is necessarily a trade-off between the opposing goals of making the necessary distinction between types of transactions and of stimulating market liquidity. To achieve one goal completely would be to sacrifice the other.

All available data indicate that the existing 6-month holding period is more than ample to filter out the majority of noninvestment transactions.

The proposal to extend the holding period to 12 months simplistically assumes that most investors will refrain from altering their investment behavior and that the net result will be a revenue gain. I

submit that it is far more realistic to assume that investors will tend to follow their individual self-interest; that they will lock themselves into existing investments for the longer period in order to qualify for capital gains treatment. In that case, the net result could well be a revenue loss.

The logical tendency of an investor with a sizable gain would be to speculate against the holding period if there were any reasonable chance of preserving enough of the gain to make waiting worthwhile. To the extent that this incentive would be operative, it would tend to lock large amounts of capital into current investment positions—with an inevitable, and significant, loss in both capital mobility and market liquidity.

The House Ways and Means Committee report suggests that upper-income taxpayers are the principal beneficiaries of the shorter holding period. But an examination of the available data refutes this. The most recent Treasury Department statistics show that only 4 percent of all long term gains realized by taxpayers with incomes of $100,000 or more were from assets held between 6 and 12 months. By contrast, the ratios were 10 percent for those with incomes under $10,000 and 9 percent for those in the $10–50,000 bracket.

Stated somewhat differently, the top-income group acounted for only 17 percent of all gains realized between 6 and 12 months after purchase, while taxpayers with incomes under $10,000 accounted for 16 percent of all gains realized during the 6 to 12-month period—and those in the $10–50,000 bracket accounted for 50 percent.

Thus, it is clear that the major portion of the additional tax burden that would be imposed by lengthening the holding period would fall not on the wealthiest taxpayers—but on those who can least afford to bear it.

The alternative rate—the most direct impact on the flow of risk capital would result from the proposed elimination of the alternative tax rate.

This, pure and simple, an increase in the tax rate on long-term capital gains. And as such, it would lower the incentive for investors to out money at risk—by reducing the after-tax rewards. Moreover, it would discourage the transfer of capital from matured investments to more venturesome opportunities by raising the tax cost of such transfers. Ultimately, the cost of capital would rise as entrepreneurs would be forced to compete for a portion of the smaller pool of available risk capital.

Relatively few individuals qualify for use of the alternative rate. However, it is this group that is the prime source of venture capital. These investors provide the cutting edge of economic growth. In effect, eliminating the alternative tax would penalize the group from which the largest proportionate share of the national investment pool is expected to be accumulated.

Common sense dictates that the lower the after-tax value of an existing investment, the more likely the investor is to hold on to it. This is, of course, another aspect of the "lock-in" phenomenon. The proposal to eliminate the alternative tax optimistically—we might even say, naively—minimizes the probable lock-in reaction of those who would be affected. The available data tabulated in the text of our statement clearly demonstrate that the higher the income, the greater

the tendency to wait before realizing accrued capital gains. Elimination of the alternative tax would strongly accentuate this tendency.

Treatment of capital losses—Investment risk would also be affected marginally by the proposal to restrict the long-term capital loss deduction from ordinary income to 50 percent of the loss. It is no secret that investors weight prospective gains or losses in terms of total dollars, and make their investment decisions accordingly.

The capital loss proposal assumes that many taxpayers can manage their investments so as to realize gains and losses in different years. Not only is this assumption not valid, but the proposed change would most seriously affect lower-income taxpayers who are least able to time realizations to achieve a tax advantage, and who have the least prospect of offsetting accumulated losses against future gains.

In effect, a majority of taxpayers who may sustain investment losses—which, in the lower- and middle-income brackets can often amount to a sizable portion of annual income—would be subject to further penalties. The rationale for this seems to be that it is justifiable in the interests of restricting a relatively small number of higher bracket individuals who, however, would still be in a position to use the loss provision to best advantage.

Contrary to the avowed intent of this measure's proponents, the disparity of loss treatment would continue to exist between taxpayers who can manage their investments so as to realize gains and losses in different years—and the great majority who can not.

Conclusions—the bill under consideration contains several additional proposals which would tend to dampen investment incentives. Two of these are discussed briefly in the full statement we have submitted to the committee. We plan to submit a more detailed analysis of these provisions for the record at a future date.

The proposals to lengthen the holding period, to eliminate the alternative tax, and to restrict capital loss deductions would—if enacted—have a serious adverse effect on investment incentives, capital mobility and stock market liquidity.

We agree with the Secretary of the Treasury that they carry the potential for impeding economic growth in the years ahead, and we respectfully urge this committee to reject all three provisions.

For the future, we would urge that any new proposals to revise the existing capital gains tax structure be preceded—or at the very least accompanied—by a detailed study of all aspects of capital gains taxation. We would hope that such a study would provide more definitive data—both on the effectiveness of the existing structure and on the probable impact of any proposed changes—than were available to the House Ways and Means Committee when the present bill was drafted.

The CHAIRMAN. Thank you, sir. I think I fully understand your statement, so I am not going to interrogate you about that. As a matter of fact, I was aware of your position and in large measure I agreed with you before you ever came here to testify.

Mr. HAACK. Thank you.

The CHAIRMAN. Now, I do want to ask you about another thing, though, that I have not discussed with you before. Let me do it while you are here because you people ought to be experts on this subject. I have here a list of price-earnings ratios and yields on stocks trading on the New York Stock Exchange of which you are president. Now,

here is where it states that Standard Oil of New Jersey, price earnings ratio, 11.7, yields, 5.24. Texaco, price earnings, 10.7, yields 4.89. Standard of California, price earnings, 10.8, yields 4.67. You understand what I am talking about?

Mr. HAACK. Yes., I do.

The CHAIRMAN. Other blue chip stocks, General Motors, price earnings, 12.3, yields, 5.9. United States Steel, price earnings, 8.2, yields 6.3. General Electric, price earnings, 19.5, yields, 3. Here are your glamor stocks, some of the best ones. IBM, price earnings, 40, yields 1.16. Xerox, price earnings, 48, yields, 0.62. Control Data, price earnings ratio, 36, yields, zero.

Now what that says to me is that in the blue chip stocks, the price earnings ratio is higher than it is in the oil stocks. In the glamour stocks it is far higher than it is in the oil company stocks. I would like to ask you why that would be the case.

Mr. HAACK. Well, a couple of things come to mind off the top of my head. First of all, in the three industrials that you mentioned, General Electric, United States Steel and General Motors, in United States Steel and General Motors you have highly cyclical industries, large investments in capital, and I think that in view of the fact that market prices generally reflect the hopes and expectations of the marketplace, the price earnings level gives an indication as to what the market projects as far as future potential is concerned.

The CHAIRMAN. Well, now, United States Steel, 8.2, that probably has to do with the fact that imports are giving them a lot of trouble, does it not?

Mr. HAACK. I am sure that imports are one of the problems. The matter of cost, the raising of prices, the very cyclical nature of the steel industry itself which is subject to vast fluctuations. General Electric yielding approximately 3 percent, I think, represents a combination of a highly regarded industrial operation but which also has potential for growth by reason of the exotic areas of their operation. The companies in the office equipment industry, Xerox, the Control Data, and——

The CHAIRMAN. IBM.

Mr. HAACK. IBM, I think all recognize what the market regards as the extreme growth potential in this segment of the industry. IBM, as you know, has been an exceptional example and the public in recognition of the fact that it expects this growth to continue is continuing to pay a high premium for those earnings and is willing to sacrifice current income in the form of dividends and would rather have the company reinvest it and in turn earn more.

The oil securities, I think, are generally selling on what you would almost call a yield basis. The range that I think was approximately 4.6 to 5.25. This, I think, indicates that the public views the oil industry as having growth but it also, I think, recognizes that it would not put too high a premium probably on the basis of some of the problems facing the oil industry. There have, incidentally, been some minor fluctuations in these price earnings of oil companies since the opening of bids on the north slope of Alaska. Some of them have had some substantial runups depending on the markets evaluation of the leases that were allotted. But I think here you have the full spectrum of a highly cyclical industry yielding fairly liberally, the

oil industry rather in between position, and the so-called growth glamour stocks yielding almost nothing.

The CHAIRMAN. All right. Now, would not a ratio with regard to the oil stocks indicate that there is no excess incentive to invest money in them?

Mr. HAACK. Rather than give a top-of-my-head opinion on that, sir, could I respond to that in writing and give you a more considered judgment? (See below.)

The CHAIRMAN. Fine. Obviously, you and I have not discussed this matter but I thought I ought to ask about it.

Thanks very much.

Senator Anderson?

Senator ANDERSON. Are you on record that growth is the most important factor in the stock market now, is it not?

Mr. HAACK. No question about it. Yes.

Senator BENNETT. No questions, Mr. Chairman.

Senator TALMADGE. No questions.

The CHAIRMAN. Senator Byrd?

Senator BYRD. No questions, Mr. Chairman.

The CHAIRMAN. Thank you very much.

(Mr. Haack's response to the chairman's question and his prepared statement follow:)

NEW YORK STOCK EXCHANGE,
New York, N.Y., September 25, 1969.

Hon. RUSSELL B. LONG,
U.S. Senate, Committee on Finance,
New Senate Office Building, Washington, D.C.

DEAR SENATOR LONG: This is in reply to the question you raised on the price-earnings ratios of petroleum stocks during my September 16 appearance before the Finance Committee.

As I observed at that time, stock prices essentially are the representation of the hopes and expectations of individuals. More formally put, securities valuations consist of ". . . capitalizing the expected future earnings and/or dividends at an appropriate rate of return," according to one standard work in the field, Benjamin Graham's and David L. Dodd's book, "Security Analysis, Principles and Techniques." "The capitalization rate, or multiplier, applied to earnings and dividends, will vary with the quality of the enterprise and will thereby give recognition to the longer-term profit possibilities which cannot be established with precision."

Accordingly, two analysts using the same basic analytical techniques may arrive at different conclusions because their expectations of "longer-term profit possibilities" differ. Of course, the assessment of profit possibilities is a distillation of separate judgments on any number of factors. For the petroleum industry, for example, the analyst has to weigh such factors as market outlook for each of the various petroleum products, oil reserves and potential addition o reserves, location of reserves, Federal and state tax policy as well as policy on imports and state production quotas, labor and transportation costs, capital investment plans, exploration activity, and a host of other factors. The importance of each of the myriad of factors differs for each company.

Further, complexities in evaluating current price performance arise from the role investor psychology plays in the market. Is a particular bull or bear market a reflection of basic economic trends or a response to some stimulus that has unduly influenced the imagination of investors? Similarly, fads for specific industries come and go. How much of the current interest in the Alaskan oils, for example, is grounded on basic analyses of profit potential and how much is based on the unwarranted euphoria often associated with new discoveries and the opening up of new frontiers?

It is no wonder that trained analysts differ in their assessment of prospects for the petroleum industry. To illustrate this, I have enclosed a compendium of comments on current trends in, and prospects for, the petroleum industry drawn from

several recent research reports issued by New York Stock Exchange member firms.

I have also enclosed Merrill Lynch's most recent compilation of yields and price-earnings ratios by industry groups, based on closing prices of September 5. As you will see, there appears to be little relationship between the price-earnings ratios and the dividend yields. That is, of course, because the current dividend yield is but one of the many factors considered in setting the price. Incidentally, the price-earnings ratio for the petroleum industry group (13.4) is a trifle above the average for the Dow-Jones Industrials (13.3), although the industry's dividend yield (3.4%) is considerably below the average for the Dow-Jones Industrials (4.2%).

To sum up, there are few objective judgments about the proper price level for any stock or group of stocks—only subjective ones. In essence, the only objective measure of the worth of a stock is the price the market sets.

I appreciate your giving me the opportunity to reflect on the answer to your basic, but complex, question.

Sincerely,

ROBERT W. HAACK.

Enclosure.

"SAMPLING OF RECENT OPINION ON PETROLEUM INDUSTRY STOCKS

"The House in August passed and sent to the Senate a bill to cut the [depletion] allowance from 27½% to 20%. The impact of any such reduction obviously would be fairly appreciable. On the other hand, given pricing flexibility, changes in the tax laws, if effected, could probably be absorbed without too serious an impact on earnings of most companies.

"On this basis, shares of major petroleum companies deserve to perform better, particularly when the upsetting influence of legislative proposals is spent. The earnings dips reported by several majors for the first six months of 1969 reflected special circumstances in most cases, such as write-offs, plant startups, weak product prices in some areas, or strikes. In view of the industry's flexibility, better earnings comparisons are possible in the second half of 1969 and in 1970. Growth in demand should continue unabated, and the longer-range prospects of the industry are bright." (August 14, 1969)

* * * * * * *

"The proposal of the House Ways and Means Committee to reduce the tax depletion allowance granted to oil and gas producers from the previous level of 27½% to 20% has produced a marked decline in the prices of oil shares. Coming as it did when the over-all market was in a decline, the market reaction to the tax proposal has tended to be magnified, in our opinion. Our studies indicate that the proposed reduction in the depletion allowance would not have severe consequences, for most companies. In fact, we believe that most companies are capable of adjusting accounting procedures and operating levels to minimize the effect on per-share results. Nevertheless, the reduction in the depletion allowance would be a blow to the industry and, to some extent, would create difficulties about financing exploration over the long run.

"Our conclusion is that the petroleum industry is still in a growth trend, but that the growth rate could be reduced briefly if the tax laws are changed as proposed. In the most general terms, the proposed tax change would reduce earnings by 2.5-to-11%. We also conclude that prices for all shares have reacted to a point at which they are attractive investments for capital appreciation and long-term growth." (September 1969.)

"Higher costs limited the growth of petroleum industry earnings during the first half of 1969, despite substantially higher product sales."

"Results varied widely among individual companies, and there was no clear-cut trend indicating greater profitability in the period for domestic companies compared with the internationals, or vice versa. Overall, twenty-five of the firms reported profit increases. Eight had declines."

"This growth [in demand] combined with increased prices for domestic crude and gasoline was not reflected in higher earnings as much as might have been expected because of higher costs for wages and materials, and to a lesser degree because of higher interest payments on long-term debt and higher taxes."

"Profits during the second half should be bouyed by a continuing strong growth in demand and increased domestic crude production. The industry may end the year with record high earnings, but incremental growth in profits is not expected to be as great as in the immediate past. Some companies with

disappointing, first six months earnings are expected to do impressively better during the second half.

"The industry and investors for the rest of the year are likely to be preoccupied with the extent and ownership of crude reserves on Alaska's North Slope, possible import policy changes, and possible revisions in the 27½% depletion allowance and other key tax provisions, all of which could have a far-reaching impact." (September 3, 1969.)

* * * * * * *

"In our opinion the 27½% oil depletion allowance will definitely be cut, because it has been established in the mind of the public as a symbol of oil industry tax preference. Various other changes will also be made to bring the total tax cost for the industry to the $500 million, or higher, range. We believe that the industry will make every effort to offset this tax increase with higher refined product prices, particularly gasoline prices. If any such effort is successful, the net effect on industry profits will likely be very small." (August 11, 1969.)

"The effect on earnings [of a cut in the depletion allowance] would vary from company to company depending largely on operating costs of producing fields. It is estimated, for example, that at a 20% depletion rate, Gulf Oil's earnings would drop approximately 10¢ per share, Standard Oil of New Jersey would drop approximately 15¢ per share, Standard Oil of Indiana approximately 30¢ per share, Continental Oil about 15¢ per share, Royal Dutch about 10¢ per share and Atlantic Richfield 30¢ per share.

"The effect among other Master List stocks would be even less noticeable. There would be very little if any effect on Clark Oil's earnings at present, as it produces very little oil and gas. Buttes Gas & Oil similarly would be affected very little by such a change in the depletion allowance. Concededly, however, the aforementioned estimates of the effect of a 20% depletion allowance on earnings don't take into account possible offsets such as higher product prices. We regard such price increases as a real possibility if the allowance is reduced."

"In summary, it is evident that while this remaining proposal [depletion allowance cut] would not be helpful to the major oil companies, the scope of the proposed cut's actual effect on earnings would be quite small as shown here. We believe, accordingly, that the proposal does not constitute a basis for changing our highly constructive attitude toward the group in general, and the Master List oil stocks in particular." (July 31, 1969)

* * * * * * *

"There is always the danger of putting your money in the wrong [oil] stock. And there is also the risk of paying too high a price; many [oil] stock prices are moving up a lot faster than companies can justify them with new discoveries.

"The recent major decline in the stock market did bring the prices of many oils—speculative and blue chip—a lot closer to reality. What interests most investors now, however, is finding the stocks that will be the biggest movers in tomorrow's market. Our opinion is that the type of leadership being sought will be found most readily among the oil and oil drilling companies with stakes in the emerging areas of discovery.

"We are bullish on this group to a large extent because of the old, established investor enthusiasm for natural resources that can be kindled at the drop of a rumor. We also feel that once the Alaskan North Slope land sales are concluded on September 11th, there may be a number of announcements about who has discovered what and the size and potential value of those discoveries. Apparently the oil fields involved in the Alaskan and Indonesian discoveries are in the multi-billion-dollar category. We can imagine how this will spark investors' imaginations. As high as the stakes may be, the potential rewards are even higher. And we know that more and more people are coming to realize that in today's inflationary economy, oil in the ground can be a lot better than money in the bank.

"Another major factor is the simple law of supply and demand. More crude oil is being consumed than ever before in history. Many oil companies that we visited during our recent trip to the West Coast showed us studies indicating a four-fold increase in world demand over the next decade. In the United States we have been able to meet our needs domestically, but the rate of consumption is now outdistancing the rate at which we replace our oil reserves." (August 22, 1969)

MERRILL LYNCH, PIERCE,
FENNER & SMITH, INC.,
SECURITIES RESEARCH DIVISION,
September 12, 1969.

AVERAGE YIELDS AND PRICE-EARNINGS RATIOS

Following are average yields and price-earnings multiples for the industry groups that make up the Merrill Lynch stock price index. These industry averages are based on current dividend rates, estimated 1969 earnings, and closing prices of September 5. Comparable figures for the Dow-Jones Industrial Average are shown at the bottom of page 2.

Industry group	Yield (percent)	P/E ratio
540 stock composite	3.5	13.6
Aerospace Manufacturing	4.4	11.8
Agricultural machinery	5.5	11.6
Air conditioning	1.5	23.1
Airlines	1.6	19.4
Aluminum	3.2	11.7
Apparel manufacturing	2.8	14.0
Appliances, housewares	3.1	13.9
Auto equipment	4.6	11.1
Auto finance	4.9	11.5
Automobiles	4.2	10.2
Banks:		
New York City	4.0	11.6
Outside N.Y.C	3.7	10.6
Beer	2.6	19.6
Beet sugar	5.7	N.A.
Biscuits	3.8	18.1
Bread baking	4.4	9.5
Canning	2.6	13.9
Cement	4.0	15.1
Chemicals	4.3	13.1
Cigarettes	5.7	10.0
Coal	0.9	18.6
Construction machinery	4.9	10.9
Consumer electronics	2.6	14.3
Containers—glass	1.9	14.6
Containers, metal	2.3	13.6
Containers, paper	2.6	10.5
Copper	5.3	6.9
Cosmetics	1.4	23.0
Dairy products	3.6	15.2
Department stores	2.8	15.7
Discount chains	1.0	14.0
Drugs	2.0	24.6
Electrical equipment	2.7	16.9
Electronics	.8	25.1
Food chains	3.1	13.4
Gold	1.5	24.4
Home furnishing	2.1	15.8
Industrial; composite	3.2	14.3
Insurance, fire and casualty	4.3	15.2
Insurance, life	2.2	12.5
Lead and zinc	5.5	15.8
Liquor	3.0	16.6
Machine tools	4.3	9.9
Machinery, heavy	4.8	9.9
Meat packing	2.9	15.8
Metal fabricating	6.6	12.3
Movie producers	2.6	26.2
Office equipment	1.1	30.4
Oil field equipment	3.0	14.5
Packaged foods	3.2	16.6
Paint	4.8	13.0
Paper, composite	3.5	13.0
Paper, diversified producers	3.9	13.7
Paper makers	3.4	15.0
Petroleum	3.4	13.4
Plumbing and heating	3.3	13.7
Printing and publishing	2.8	16.1
Railroad car leasing companys	4.4	13.4
Railroads, composite	5.2	9.2
Railroads, coal	6.6	9.5
Railroads, Eastern	5.8	11.1
Railroads, Southern	5.2	9.0
Railroads, Western	4.7	9.0
Recreation	2.2	14.9
Roofing and wallboard	3.0	17.4
Rubber	4.1	10.3
Shoe chains	2.9	13.9
Shoe manufacturing	4.3	10.2
Small loans	4.1	12.2
Snuff	5.3	10.2
Soap detergents, toiletries	2.1	20.7
Soft drinks	2.1	25.8
Steel	5.3	8.1
Textiles	5.4	12.9
Utilities:		
Composite	5.4	12.3
Electric	5.4	12.5
Gas Distributors	6.1	11.6
Holding company	5.0	13.8
Integrated gas companies	6.3	10.7
Natural gas pipelines	5.1	11.2
Communications	4.9	14.4
Variety chains	3.8	12.0
Vending	1.8	15.7
Dow-Jones Industrials	4.2	13.3

STATEMENT OF ROBERT W. HAACK, PRESIDENT, NEW YORK STOCK EXCHANGE

SUMMARY

My name is Robert W. Haack. I am President of the New York Stock Exchange. With me today are Bernard J. Lasker, Chairman of the Board of Governors of the Exchange, and Donald L. Calvin, a Vice President of the Exchange.

My statement this morning is the summary of a comprehensive 18-page statement analyzing the impact of the capital gains tax provisions of the tax reform bill now before this Committee. Copies of the full statement, including my summary, have been submitted to the Committee.

In the ten minutes allotted to me this morning, I will summarize the principal points and conclusions of that statement.

* * * * * * *

As passed by the House of Representatives, the specific capital gains tax provisions of the tax reform bill constitute a sharp increase in the capital gains tax. The Exchange believes that three major adverse results may be anticipated if these provisions are enacted in their present form:

First, risk-taking incentives and the supply of essential venture capital would be seriously curtailed.

Second, investments in modern plant and equipment and in new technologies would diminish.

And third, the mobility of capital assets—which is crucial to maintaining a dynamic and fluid economy—would be impeded.

To my knowledge, there is no controversy about the need for maintaining an adequate level of investment to promote long-run economic prosperity. Recognition of this need is implicit in a recent statement by Secretary David M. Kennedy, who pointed out that the bill passed by the House is (quote) "weighted in favor of consumption, to the potential detriment of the nation's productive investment." Secretary Kennedy concluded that the present version (and again I quote) "could impede economic growth in the years ahead by curtailing the incentive to make productive investments." (End of quote).

The Exchange's own analysis of the probable economic impact of the proposals under consideration suggests that their hasty enactment would cause irreparable harm to the nation's long-term capacity for growth.

Let us look briefly at each of the major proposed revisions in capital gains treatment:

The holding period

I don't think anyone would quarrel with the proposition that smooth functioning of capital markets is largely dependent upon liquidity—that is, the ease with which investors can move in and out of investments.

The holding period required to distinguish between an investment transaction—which qualifies for capital gains tax treatment—and a non-investment transaction—which does not—automatically decreases the liquidity of the national investment pool.

In determining the most suitable length of the holding period, there is necessarily a trade-off between the opposing goals of making the necessary distinction between types of transactions and of stimulating market liquidity. To achieve one goal completely would be to sacrifice the other.

All available data indicate that the existing six-month holding period is more than ample to filter out the majority of non-investment transactions.

The proposal to extend the holding period to 12 months simplistically assumes that most investors will refrain from altering their investment behavior and that the net result will be a revenue gain. I submit that it is far more realistic to assume that investors will tend to follow their individual self-interest; that they will lock themselves into existing investments for the longer period in order to qualify for capital gains treatment. In that case, the net results could well be a revenue *loss*.

The logical tendency of an investor with a sizeable gain would be to speculate against the holding period if there were any reasonable chance of preserving enough of the gain to make waiting worthwhile. To the extent that this incentive would be operative, it would tend to lock large amounts of capital into current investment positions—with an inevitable, and significant, loss in both capital mobility and market liquidity.

The House Ways and Means Committee Report suggests that upper-income taxpayers are the principal beneficiaries of the shorter holding period. But an examination of the available data refutes this. The most recent Treasury Department statistics show that only 4 percent of all long-term gains realized by taxpayers with incomes of $100,000 or more were from assets held between six and 12 months. By contrast, the ratios were 10 percent for those with incomes under $10,000 and 9 percent for those in the $10–50,000 bracket.

Stated somewhat differently, the top-income group accounted for only 17 percent of all gains realized between six and 12 months after purchase, while taxpayers with incomes under $10,000 accounted for 16 percent of all gains realized during the six-to-12 month period—and those in the $10–50,000 bracket accounted for 50 percent.

Thus, it is clear that the major portion of the additional tax burden that would be imposed by lengthening the holding period would fall not on the wealthiest taxpayers—but on those who can least afford to bear it.

The alternative rate

The most direct impact on the flow of risk capital would result from the proposed elimination of the alternative tax rate.

This is, pure and simple, an increase in the tax rate on long-term capital gains. And as such, it would lower the incentive for investors to put money at risk—by reducing the after-tax rewards. Moreover, it would discourage the transfer of capital from matured investments to more venturesome opportunities by raising the tax cost of such transfers. Ultimately, the cost of capital would rise as entrepreneurs would be forced to compete for a portion of the smaller pool of available risk capital.

Relatively few individuals qualify for use of the alternative rate. However, it is this group that is the prime source of venture capital. These investors provide the cutting edge of economic growth. In effect, eliminating the alternative tax would penalize the group from which the largest proportionate share of the national investment pool is expected to be accumulated.

Common sense dictates that the lower the after-tax value of an existing investment, the more likely the investor is to hold onto it. This is, of course, another aspect of the "lock-in" phenomenon. The proposal to eliminate the alternative tax optimistically—we might even say, naively—minimize the probable lock-in reaction of those who would be affected. The available data tabulated in the text of our statement clearly demonstrate that the higher the income, the greater the tendency to wait before realizing accrued capial gains. Elimination of the alternative tax would strongly accentuate this tendency.

Treatment of capital losses

Investment risk would also be affected marginally by the proposal to restrict the long-term capital loss deduction from ordinary income to 50 percent of the loss. It is no secret that investors weigh prospective gains or losses in terms of *total* dollars, and make their investment decisions accordingly.

The capital loss proposal assumes that many taxpayers can manage their investments so as to realize gains and losses in different years. Not only is this assumption not valid, but the proposed change would most seriously affect lower-income taxpayers who are least able to time realizations to achieve a tax advantage, and who have the least prospect of offsetting accumulated losses against future gains.

In effect, a majority of taxpayers who may sustain investment losses—which, in the lower and middle-income brackets can often amount to a sizeable portion of annual income—would be subject to further penalties. The rationale for this seems to be that it is justifiable in the interests of restricting a relatively small number of higher-bracket individuals who, however, would *still* be in a position to use the loss provision to best advantage.

Contrary to the avowed intent of this measure's proponents, the disparity in loss treatment would continue to exist between taxpayers who can manage their investments so as to realize gains and losses in different years—and the great majority who can not.

Conclusions

The bill under consideration contains several additional proposals which would tend to dampen investment incentives. Two of these are discussed briefly in the full statement we have submitted to the Committee. We plan to submit a more detailed analysis of these provisions for the record at a future date.

The proposals to lengthen the holding period, to eliminate the alternative tax, and to restrict capital loss deductions would—if enacted—have a serious adverse effect on investment incentives, capital mobility and stock market liquidity.

We agree with the Secretary of the Treasury that they carry the potential for impeding economic growth in the years ahead, and we respectfully urge this Committee to reject all three provisions.

For the future, we would urge that any new proposals to revise the existing capital gains tax structure be preceded—or at the very least accompanied—by a detailed study of all aspects of capital gains taxation. We would hope that such a study would provide more definitive data—both on the effectiveness of the existing structure and on the probable impact of any proposed changes—than were available to the House Ways and Means Committee when the present bill was drafted.

ANALYSIS OF ECONOMIC ASPECTS OF THE CAPITAL GAINS TAX PROVISIONS OF H.R. 13270

Any examination of the specific capital gains tax provisions of the tax reform bill must consider the broad economic consequences which may flow from enactment of the bill in its present form. As passed by the House, these provisions constitute an effective increase in the capital gains tax. The Exchange believes that three major adverse results may be anticipated if these provisions are enacted in their present form:

(1) Risk-taking incentives and the supply of essential venture funds would be seriously curtailed.

(2) Investments in modern plant and equipment and new technologies would diminish.

(3) The mobility of capital assets, which is crucial in maintaining a dynamic and fluid economy, would be impeded.

These effects, as discussed in greater detail below, would retard long-term economic growth and enterprise and would, ultimately, limit the rise in our nation's real standard of living. The New York Stock Exchange shares the view that policies which may inhibit the incentive to invest, to innovate, and to take risks should not be enacted in haste and without careful study. The mobility of capital assets is vital to the entire concept of private enterprise. Beyond these broader economic considerations, we believe that the House proposals on capital gains will fail in their avowed purpose of redistributing tax burdens in a more equitable fashion. Therefore, the current proposals should be made to bear a heavy burden of proof before they are accepted by the Congress.

Capital gains and risk

Congress has long acknowledged that there are distinct differences between ordinary income and gains realized on true capital assets, in that it is to the national economic advantage to encourage people to invest in productive enterprises. Accordingly, capital gains should be—and, since 1921, have been—subjected to a lower tax rate than ordinary income. Long-term investments play a crucial role in promoting economic growth. The House appears to have ignored the fact that the expectation of capital gains induces not only saving, but investing, and an optimum allocation of resources—all of which are indispensable to a rising per capita income.

Capital must be encouraged to flow into new ventures if society is to benefit from new technological trends and discoveries. And the individual's willingness to assume unusual capital risks depends to a considerable extent upon the prospect he sees for suitable returns. Obviously, then, higher taxes on the gains from high-risk situations would discourage investors from assuming such risks. Accordingly, if the tax provisions dealing with capital gains are altered to provide less favorable treatment, a reduced flow of equity capital to newer, more risky, business ventures and a diminution of aggregate investment will result.

Impact on the level of investment

There is no controversy about the need for an adequate level of investment to promote long-run economic prosperity. Government has available various fiscal and monetary tools by which it can attempt to influence aggregate investment, Since the acquisition of physical assets, such as plant and equipment, typically requires the issuance of securities of one type or another, tax policies towards buyers of securities directly affect the ease and cost of financing expansion. Realistic tax treatment of capital gains can effectively induce the saver-investor to offer funds in greater quantity and at lower cost to enterprises undertaking the expansion or modernization of their physical facilities. A number of industrial nations—including Canada, West Germany and Japan—have indicated their awareness of this by exempting capital gains from any form of taxation.

Administration officials have voiced concern on several occasions with regard to this bill's detrimental impact on the level of real economic investment. In a recent speech to the Tax Section of the American Bar Association, Assistant Secretary of the Treasury for Tax Policy Edwin S. Cohen stated that economic analysis indicated that the Bill "involves too great an allocation of benefits to consumption and not enough to investment in productive equipment and capacity." Secretary of the Treasury David M. Kennedy reiterated the view that the House bill was "weighted in favor of consumption, to the potential detriment of the nation's productive investment." He concluded that the House version "could impede economic growth in the years ahead by curtailing the incentive to make productive investments."

Capital mobility

Increases in capital gains taxation will adversely affect both the level of investment and the allocation of investment funds.

Economists in general agree that the mobility of capital should be encouraged in order to achieve optimum allocation of economic resources. Tax measures which hamper investment liquidity and impair capital mobility are clearly undesirable. Increases in capital gains taxation offers a classic example of such measures. If funds are to be allocated among competing investment projects with maximum efficiency, it is essential for investors to have access to a liquid and orderly market when a sale is to be consumated. Liquidity in securities markets facilitates the purchase and sale of securities, and thereby frees capital to flow to whatever industries or companies offer the highest prospective returns. Individuals should not be deterred from making desirable shifts in the composition of their assets as their needs and expectations change. Inevitably, higher capital gains taxes, by discouraging investors from switching to other alternatives, will interfere with the optimal allocation of resources, to the ultimate detriment of economic growth.

The level of savings and inflation

It would, in any case, be difficult to imagine a more inopportune time for setting forth the proposed changes in capital gains taxation. The major economic issue confronting the American economy today is excessive demand and inadequate savings. Inflationary pressures are intense and to some extent, are likely to remain with us into the 1970's. Tax policy at this time should *encourage* savings as a means of combatting the pressures of excessive demand. Instead, we find tax policy changes proposed which would increase the tax burden on capital gains. Studies indicate that individuals view capital gains in a different light than ordinary sources of income. Regarded as unusual and unpredictable receipts, capital gains are not typically consumed but are returned to the flow of savings. It follows that an increase in capital gains taxation may well stimulate consumption at the expense of savings, and decrease the over-all pool of funds available for investment. Such recommendations are inconsistent with other recent counter-inflationary policies, such as the income tax surcharge which represents a compulsory form of personal savings. To the extent that business capital investment is financed through savings rather than through the expansion of the money supply, price pressures are relieved and the task of the Federal Reserve is made easier.

Higher aggregate savings can also lessen inflationary pressures that arise from the "cost-push" side. Greater availability of aggregate savings serves to promote investment in more productive techniques.

By making the most efficient equipment available to employees, industry improves the productivity of the labor force. Larger gains in output per man-hour serve to narrow the gap between wage increases and improvements in productivity and thereby limit the inflationary push coming from the cost side. Thus, it seems clear that in the current economic environment, any tax policy which discourages savings compounds the problem of achieving non-inflationary economic growth.

The current economic climate underscores the importance of continuing existing capital gains tax policies without significant change. From the short-run point of view as well as the longer-run goals of our economy, it would be wise to refrain from altering the tax treatment of capital gains in a manner that would reduce savings, impair the mobility of capital, and seriously interfere with the flow of capital to newer, more dynamic, and more risky ventures. We believe that the recommendations made in the House bill have been conceived in haste and are based on inadequate data. Our analysis of the economic impact of the proposals under consideration suggests that their hasty enactment can cause irreparable harm to the nation's long-term capacity for growth.

In the following pages, each of the major capital gains tax proposals is discussed in some detail, with reference to available data which we believe strongly accentuate the dangers inherent in proceeding at this time with the changes recommended by the House.

THE HOLDING PERIOD

Tax incentives for capital investment, however, are not the only determinant of capital market efficiency. Smooth functioning of a nation's capital markets is dependent upon liquidity—the ability to move readily in and out of investments. The less liquid an investment, the less attractive it is to investors. Rates

of return reflect, in part, the degree of liquidity. The strength of the NYSE—and the U.S. securities markets in general—stems from the large numbers of orders that continually flow to it. Any diminution in the flow tends to impair market quality.

The NYSE agrees with the assertion in the House Ways and Means Committee's Report that "The holding period is an arbitrary and imperfect procedure that may be inaccurate in some specific situations, but it provides an approach under which there are significantly fewer administrative and compliance difficulties than would arise under a less objective standard." In setting this admittedly imperfect cut-off point, two considerations should be paramount. First, the barrier must be raised high enough to separate ordinary business transactions and speculation from investment; and, second, it must not be raised so high as to seriously impair market liquidity. In other words, there is a trade-off between the two objectives. To achieve one completely is to sacrifice the other.

The current six-month holding period filters out the vast majority of transactions by those who earn their livelihood by buying and selling securities. It has the same effect with regard to investors who buy and sell securities with the objective of making short-term gains. The Ways and Means Committee estimates that the revenue gain from an extension of the holding period to 12 months will ultimately total $150 million annually. Underlying this estimate is the assumption that the proposed changes in the tax treatment of capital gains will have relatively little impact on investment behavior. It is realistic to assume, however, that investors would tend to significantly alter their pattern of realizations to conform to the lengthened holding period requirement. Some investors would be discouraged from purchasing equities altogether. It is, of course, impossible to determine precisely, in advance, the revenue effect of a changed holding pattern. It is clear, however, that, at best, postponement of realizations would tend to minimize the revenue gain associated with a holding period extension and might very well lead to a revenue loss.

The problem is to weigh the uncertain promise of a small revenue gain against the economic disadvantages which would stem from a holding period extension.

Effectiveness of the six-month holding period

All available data indicate that the six-month holding period is more than ample to filter out the majority of "non-investment" transactions. Transactions data from the 1962 Internal Revenue study of capital gains, for example, demonstrates where long-term investment apparently is not the motivating factor, there is a strong tendency to go for quick gains.

TABLE I.—*Gains transactions in corporate stock by length of holding period, 1962*

	Number of transactions
Short term, total	1,124,449
Under 1 month	408,114
1 under 3 months	316,687
3 under 6 months	200,411
Not available	189,237
Long term, total	2,621,942
6 to 12 months	432,214
1 under 2 years	472,202
2 under 3 years	300,343
3 under 4 years	223,332
4 under 5 years	151,044
5 under 10 years	411,212
10 under 15 years	153,808
15 under 20 years	71,304
20 years and more	78,422
Not available	328,061
Total, all periods	3,746,391

Source: "Statistics of Income—1962, Supplemental Report, Sales of Capital Assets Reported on Individual Income Tax Returns," U.S. Treasury Department, table 12, p. 112.

As can be seen from Table I, 2.6 times as many *transactions* occurred in stock held under six months than in stock held from six months to a year. Especially significant is the fact that the number of gain transactions that occurred in stock held under one month (408,000) was almost as great as the total for the entire six to twelve-month period (482,000). The number of gain transactions that occurred within three months of purchase is, in fact, so great—approximately three-fourths of all short-term gain transactions—as to suggest that six months may be a longer period than necessary to catch most non-investment transactions.

Corroboration of this view is apparent in the findings of studies of public transactions on the NYSE over the years. Results of the most recent studies are presented below.

TABLE II.—VALUE OF SHARES SOLD BY INDIVIDUALS BY HOLDING PERIODS

[In percent]

NYSE public transaction studies	Holding periods: 1 month or less	Over 1 to 6 months	Over 6 months
1960	[1] 17	[1] 22	[1] 61
1961	10	32	58
1963	24	[2] 29	[3] 47
1965	12	28	60
1966	23	23	54

[1] Percentages are based on total excluding "don't know" category.
[2] Over 1 to 3 months of holding accounted for 16 percent of total sales and over 3 to 6 months accounted for 13 percent.
[3] Over 6 to 12 months of holding accounted for 18 percent of sales.

Source: New York Stock Exchange.

As can be seen in the summary of the five studies in Table II, from two-fifths to over half of the *value* of sales occurred before the end of the six-month holding period, with disproportionately large dollar volume of sales taking place within the first month after purchase. A more detailed analysis of holding periods is available only for the 1963 study.

In that study, not only did most sales (53%) not qualify for long-term gains under the six-month test, but also the amount of sales within the first six months of holding were nearly three times greater than the amount in the six-to-12 month period.

There was a greater tendency to sell within three to six months after purchase than in six to twelve months. Putting the 1963 sales data on a monthly average basis, to allow for the difference in length of period, the ratio of all sales made in the three-to-six-month holding period (4.2%) was higher than the ratio for sales in the later period (3.0%).

In 1966, the American Stock Exchange undertook a similar study, the results of which confirm the findings of the 1963 NYSE study. As can be seen, 66% of the value of sales did not qualify for capital gains treatment, and only 13% of the sales total was attributable to holdings in the six-to-12 month category. Furthermore, the highest income group accounted for a disproportionately low share of sales in the six-to-12 month holding period.

TABLE III.—VALUE OF SHARES SOLD BY HOLDING PERIODS, AMERICAN STOCK EXCHANGE, MAY 25, 1966

[In percent]

Income class	Short sales	Under 1 month	1 to 3 months	3 to 6 months	6 to 12 months	12-plus months	Unknown
Under $10,000	5	29	23	11	15	9	8
$10,000 to $25,000	9	25	15	13	13	18	8
$25,000 plus	10	27	14	10	9	25	5
Unknown		24	12	27	13	12	12
Total	7	28	20	11	13	14	7

The transactions data collected by the New York and American exchanges do not specifically isolate the trading proclivities of short-term traders, who are the prime target of the holding period. We believe, however, that the typical short-term trader is interested in rapid turnover of funds with relatively

small profits on each transaction, rather than with achieving long-term capital gains treatment.

Evidence on this point is provided by a study made in July 1961 among NYSE floor members who traded for their own account. There is little reason to doubt that the 1961 findings remain valid today. The study found that only 3% of both number and value of shares sold during a one week period was held longer than six months. By contrast, 86% of the shares sold and 90% of their value were held one month or less.

The foregoing analysis of transactions strongly suggests that the six-month holding period is more than doing the job it was intended for. While it "may be inaccurate in some specific situations," it is clear that the six-month holding period excludes from long-term capital gains treatment the vast majority of transactions which are not consistent with the basic concept of what should and what should not qualify for preferential treatment.

Shortcomings of Ways and Means Committee analysis

Underlying the NYSE analysis is the concept that the most accurate measure of the holding period's effectiveness is the number and value of transactions disqualified from capital gains treatment. The Ways and Means Committee's conclusion that the current holding period is not adequate for the job of distinguishing between investment and non-investment transactions stems from a limited perspective of the problem. Rather than measuring transactions directly, the Committee looked at capital gains realizations. Standing alone, gains realizations give little indication of trading patterns. One should also ask, how much trading do the gains represent?

For example, the Ways and Means Committee supports its contention that ". . . assets held between 6 months and 1 year tend to be speculative" by showing "that almost 90% of all capital gains on corporate stock in 1962 arose from sales occurring after 1 year of possession." But this offers no true indication of the efficacy of the six-month holding period. As indicated in the table on transactions above (Table I), taken from the same IRS study used in the Ways and Means Committee analysis, more capital gains transactions in stock (472,000) occurred between the first and second years of holding than in the 6 to 12-month period. By contrast, 1,124,000 transactions took place before the expiration of the holding period. If the six-month holding period did not adequately cope with the question of speculative and normal business transactions, we would expect the opposite results—that is, a jump in gain transactions from the first to the second half of the year after purchase and a decline in the number of transactions in the second year after purchase.

The pattern of transactions provides a more reasonable basis for judging the holding period than the statistic that almost 90% of gain occurs from sales occurring after one year of possession. This compares growth over a single year with the total of gains which have accrued over many years. Obviously, in a growing economy with a secularly rising stock market, the dollar value of appreciated stocks held over a period of years will be substantial.

The Ways and Means Committee Report offers as evidence of the inadequacy of the current holding period, the "sharp increase in sales between the sixth and seventh months the stock was held." The fact is that there will always be a tendency for realizations to bulge at the expiration of a holding period of any duration.

In appraising both the preceding and the Ways and Means Committee's discussion of trading patterns during the first year, it must be noted that 1962, the only year for which detailed IRS data on gains realizations are available, was undoubtedly an atypical year. A sharp market break in the spring of that year prompted early realization of both profits and losses in order to preserve the former and minimize the latter. The high ratio of realized losses to gains emphasizes this point. In 1962, short-term losses reported to IRS ($768,000,000) were 2.2 times greater than short-term gains. Similarly, the value of losses realized after six to 12 months of holding ($804,000,000) was double the value of six-to-12-month gains.

The 1962 pattern of realization emphasizes the need for preserving flexibility for the investor. No matter what his initial intentions, he is exposed to the fluctuations of the market after making his original purchase. An intended "long-term investment" may become a short-term gain, or even a loss as market conditions shift. The greater uncertainties of a longer holding period are bound to discourage investors. It would impede the mobility of capital and thereby lessen market liquidity. New ventures, particularly, would find financing more

difficult as the longer holding period added to the basic risk associated with venture capital.

From the Treasury's point of view, a longer holding period, particularly in a year like 1962, would reduce revenue collections. This would ocur because the investor is often well-advised to wait for the end of the holding period, *even if substantial erosion in his gain takes place.* With capital gains taxed at half the regular rate, the investor in the 50% tax bracket waiting for the holding period expiration could accept a one-third erosion in his gain and still come out with the same after-tax profit. At the top 70% marginal rate, the break-even point is a 60% erosion in profits, assuming a 25% alternative capital gains tax rate.

TABLE IV.—EROSION IN GROSS GAIN AT WHICH CAPITAL GAINS AND REGULAR TAX RATES RESULT IN EQUIVALENT AFTER-TAX YIELDS

	Marginal tax rate	Erosion factor		Marginal tax rate	Erosion factor
Percent	14	8	Percent	50	33
Do	20	11	Do	60	[1] 47
Do	30	18	Do	70	[1] 60
Do	40	25			

[1] Assumes 25 percent alternative capital gains tax rate.

Who uses the 6–12 month holding period?

The Ways and Means Committee report asserts that the inadequacy of the six-month holding period is demonstrated by the pattern of realizations in the first year of holding by the $100,000-and-over group. The report demonstrates that the top income group realizes a far greater portion of its first-year gain in the six-to-12 month period than in the 0-six month period. As shown in the preceding table (Table IV), that is to be expected, since higher income groups take a smaller risk (in after-tax profits) in delaying realizations than do lower income groups. This pattern would hold no matter what the holding period.

Furthermore, the Committee report does not point out that the higher income groups tend to hold assets longer than the lower income groups. In fact, when the data for all long-term realizations are examined—rather than just those for the first year—we find that in terms of total long-term capital gains, realizations in the six-to-12 month period are far more important for the lower income groups than the higher income groups.

For example, as indicated on Table VI, in 1962, only 4% of all realized long-term gains on returns with incomes of $100,000 or more were from assets held 6 to 12 months. By contrast, the respective ratios were 10% and 9% for those with incomes of under $10,000 and from $10,000 to under $50,000.

Put another way, the $100,000 and over group, while accounting for 33% of all reported long-term gains in 1962, accounted for only 17% of all gains realized in the six-to-12 month period; while taxpayers with incomes under $10,000 accounted for 16% of all gains realized in the six-to-12 month period—and those in the $10–50,000 bracket accounted for 50% (Table V).

Similar results were obtained in the American Stock Exchange study. The AMEX study indicated that 74% of all sales in the six-to-12 month period were made by persons in the under $10,000 group, compared with only 14% for the over $25,000 group. By contrast, their portion of sales of stock held longer than one year were 44% and 40%, respectively.

TABLE V.—DISTRIBUTION OF CORPORATE STOCK CAPITAL GAINS BY HOLDING PERIOD AND INCOME CLASS, 1962

[In percent]

Holding periods	Taxable returns			
	Under $10,000	$10,000 under $50,000	$50,000 under $100,000	$100,000 and over
6 to 12 months	16	50	16	17
1 under 2 years	16	50	17	18
2 under 3 years	15	47	16	22
3 under 4 years	14	47	16	22
4 under 5 years	15	45	17	23
5 under 10 years	13	39	16	32
10 under 15 years	7	39	16	39
15 under 20 years	5	31	16	48
20 years and over	8	21	12	59
Total, all periods	11	40	16	33

Source: "Statistics of Income—1962, supplemental report, Sales of Capital Assets Reported on Individual Income Tax Returns," U.S. Treasury Department, table 12, p. 112.

Available data give strong indication that lengthening the holding period would not exclude very many additional non-investment transactions for long-term capital gains treatment. Its principal effect would be to realign investment holding patterns, hinder market liquidity and capital mobility and increase the risk to venture capital.

ALTERNATIVE RATE

Among the proposed revisions in capital gains treatment, the most direct impact on the flow of risk capital would stem from elimination of the alternative tax rate. First, it would lower the incentive to put money at risk by reducing the after-tax reward. Second, it would discourage the movement of capital from mature, less risky investments to new and unproved but potentially rewarding opportunities by raising the tax cost of transferring investments. Ultimately, the cost of capital would rise as entrepreneurs vie for shares of the smaller pool of venture capital.

Relatively few individuals qualify for use of the alternative rate on long-term capital gains; however, it is this group that is the prime source of venture capital. These investors provide the cutting edge of economic growth.

In the landmark study, *Effects of Taxation, Investments by Individuals*, it was concluded that ". . . business must look mainly to a very small percentage of the population—individuals with large incomes or substantial holdings of wealth or both—to find any widespread willingness to assume the risks of business ownership, especially of unseasoned enterprises." The authors also found that there is ". . . very strong evidence for the validity of the major finding of this section, namely, that the investment decisions of the upper income and wealth groups are of overwhelming importance in governing the flow of equity capital from private investors to business enterprise."*

While any blunting of investment incentive serves as an impediment to the generation and free flow of investment capital—as the NYSE has pointed out many times—its effects are magnified as the degree of risk increases. It is a fact of economic life that the relative handful of large savers are in the best position to supply risk capital. The problem is to maintain an investment environment which would stimulate the large savers to frequently turn over their matured investments and seek out new risk situations. The tax penalty for turning over an investment is clearly a major factor in the decision.

A dollar in an existing investment paying a reasonable return at minimum risk, often proves more attractive than 75¢ (after the alternative capital gains tax) in a high-risk investment that holds out the possibility of sizeable returns. The existing investment dollar looks even more attractive to top-bracket taxpayers when its after-tax value drops 18%, from 75¢ to 65¢. The lower the after-tax value of an existing investment, the more likely the investor is to hold on to it—or "lock" himself in. This "lock-in" effect is generally acknowledged.

*J. Keith Butters, Lawrence E. Thompson, and Lynn L. Bollinger, *Effects of Taxation, Investments by Individuals* (Cambridge, Mass.: The Riverside Press, 1958), p. 27.

The 1965 capital gains study conducted for the NYSE by Louis Harris and Associates, Inc. was designed to measure investors' reactions to 20% and 50% *reduction* in tax rates. In examining the *long-run* implications of a 20% cut in the maximum capital gains tax rate, Harris estimated that Treasury revenues would rise by slightly more than one-quarter. If the maximum rate were halved, to 12½%, estimated revenues would climb nearly three-quarters. The implications of these findings in the context of a tax rate *increase* are clearly disturbing.

This study of the lock-in effect of the capital gains tax suggests that an increase in the rate would have a substantial impact on capital mobility. As a consequence of the decline in gains realizations, the revenues increment would not rise in proportion to the increase in the effective capital gains tax rate.

Current holding patterns

Available data clearly demonstrate that the higher the income, the greater the tendency to wait before realizing accrued capital gains. This shows up in the following table.

TABLE VI.—DISTRIBUTION OF REALIZED LONG-TERM CAPITAL GAINS ON CORPORATE STOCK, BY HOLDING PERIODS AND INCOME SIZE CLASS, 1962

[In percent]

Holding period	Taxable returns			
	Under $10,000	$10,000 under $50,000	$50,000 under $100,000	$100,000 and over
6 to 12 months	10	9	7	4
1 under 2 years	13	12	10	5
2 under 3 years	11	10	9	5
3 under 4 years	9	9	8	6
4 under 5 years	8	7	7	4
5 under 10 years	28	25	25	24
10 under 15 years	8	14	15	17
15 under 20 years	4	7	9	13
20 years and over	9	7	10	22
Total	100	100	100	100

Source: "Statistics of Income, 1962, Supplemental Report, Sales of Capital Assets Reported on Individual Income Tax Returns," U.S. Treasury Department, table 12, p. 112.

In the lowest (under $10,000) income group, 51% of total long-term capital gains were realized on assets held five years or less. While this ratio is only modestly higher than those for the $10,000-to-under $50,000 and $50,000-to-under $100,000 income groups, it is more than double the 24% ratio for the over $100,000 income group. By contrast, 22% of gains realizations by the top income group were accounted for by sales of holdings of 20 years or more, compared with only 7% to 10% for the three lower income groups.

We do not mean to imply that differences in the timing of realizations are all attributable to the lock-in effect. We do suggest, however, that securities markets (and other investors) would be better served if the holding pattern of the top income earners more closely resembled that of the less affluent groups (i.e., more frequent asset turnover). Elimination of the alternative tax on long-term capital gains wound have the opposite effect. It would further widen the disparity in length of holding.

From the point of view of capital mobility, inclusion of capital gains in income averaging is not a substitute for the alternative tax. While the latter helps to ease the lock-in problem somewhat, income averaging would tend to aggravate it by providing an incentive to postpone the realization of gains so as to qualify for the advantages of averaging.

The blunting of tax incentives to the prime source of venture capital will mean more competition for the pool of available risk money. Returns to risk capital will have to rise if new ventures are to attract equity financing. In turn, desirable, but less promising, new ventures may fall by the wayside in the tougher competition for risk capital.

In an environment of strong competition for funds, it is especially imperative that incentives for risk capital be preserved if the business sector is to make a maximum contribution to national economic growth and well-being. The proposal

to eliminate the alternative tax—which is essentially a technique for increasing the tax rate for the most substantial investors—offers a virtually foolproof means of *reducing* such incentives.

TREATMENT OF CAPITAL LOSSES

Investment risk would also be affected marginally by the proposal to restrict the long-term capital loss deduction from ordinary income to 50% of the loss. Investors weigh prospective gains or losses in terms of *total* dollars and make their judgments accordingly.

The proposal is largely predicated on the assumption that many taxpayers are in a position to manage their investments in such a way as to realize gains and losses in different years. Not only is the assumption not valid, but the proposed change would have the greatest impact on the lower-income groups, which are in the least advantageous position to arrange the timing of realizations to qualify for beneficial tax treatment. In effect, the great bulk of taxpayers already hurt by investment losses—often amounting to a sizeable portion of annual income—would be further penalized in order to restrict a relatively small number of taxpayers who are in a position to use the loss provision to best advantage.

Not only does that rationale lead to inequities, but it still does not deal directly with the problem. Taxpayers in a position to properly time gain and loss realizations would still do so.

It should be emphasized that most capital losses (74% in 1962) result from stock sales. Stockholdings are subject to market fluctuations. For the most part, losses may be realized either because of the need for cash or to prevent possible erosion of the value of holdings. In either case, the sale cannot be postponed for very long. Similarly, for most investors, the possibility of erosion of the gain during the period when realization is postponed generally outweighs the advantage of the minor tax saving attributable to proper timing.

From the individual's point of view, a loss is a loss no matter how it comes. A dollar lost through a decline in an investment hurts just as must financially as one lost through negligence or theft.

Impact of the proposed treatment of losses

The limitation on deduction of loss hits hardest at the lower income groups. In point of fact, lower-income taxpayers with losses have far less of a possibility of offsetting losses against future gains or future income than do upper-income taxpayers. As a group, lower-income taxpayers sustain very high losses in relation to income.

TABLE VII.—LONG-TERM CAPITAL LOSS CARRYOVER ON TAXABLE RETURNS SHOWING NET CAPITAL LOSS, 1966

Adjusted gross income classes	Average adjusted gross income	Average carryover	Average carryover as percent of average income
Under $3,000	1,432	3,589	254
$3,000 to under $4,000	3,491	2,974	85
$4,000 to under $5,000	4,500	6,744	151
$5,000 to under $6,000	5,005	13,628	248
$6,000 to under $8,000	6,985	8,838	127
$8,000 to under $10,000	8,941	4,308	48
$10,000 to under $15,000	11,937	4,142	35
$15,000 to under $20,000	16,976	5,428	32
$20,000 to under $50,000	28,240	5,458	19
$50,000 to under $100,000	65,847	7,183	11
$100,000 to under $200,000	131,729	10,574	8
$200,000 to under $500,000	280,453	16,202	6
$500,000 to under $1,000,000	670,661	14,077	2
$1,000,000 and over	2,161,328	15,125	1

Source: Adapted from "Statistics of Income—1966 Individual Income Tax Returns," U.S. Treasury Department, table 19, p. 41.

For returns with under $8,000 of adjusted gross income, the average capital loss carryover generally runs well in excess of income. The ratio of loss carryover to income dwindles as income rises above $8,000, falling to only 1% for the top income earners.

That the tax burden of proposed capital loss limitations (including revised treatment of losses of married couples) will fall upon the lower and middle-income groups is corroborated by the Ways and Means Committee's revenue estimates. Of the $65 million of additional revenue attributable to the change in treatment of losses, 57% would be paid by the under $15,000 income group and 34% by the under $10,000 group.

In summary, net capital losses in practice have been virtually non-deductible. The proposed changes in treatment of losses will further penalize investors whose financial positions have already been impaired. They would hit hardest at individuals in the low and middle-income groups, who have the least prospect of offsetting accumulated losses against future gains.

OTHER PROVISIONS AFFECTING INVESTORS

In adition to the three proposed revisions in capital gains treatment already discussed, the Bill contains several other proposals which would tend to dampen investment incentives. The NYSE will submit a detailed statement on these to the Committee on Finance at a future date. Here, we will comment only briefly on two of these proposals.

Disallowance of non-business deductions

Non-corporate taxpayers would be required to allocate non-business deductions such as interest, state and local taxes, charitable contributions, casualty losses and medical expenses—between taxable income and tax preference items. The latter include one-half of long-term capital gains, presumably on the theory that one-half of long-term capital gains is being excluded from income.

In simplest terms, the proposal amounts to an increase in the effective rate of the capital gains tax. It does by indirection and through administrative complexity what could be more easily done by a simple increase in the tax rate, if that were thought desirable. The burden of the change in treatment of deductions would fall primarily on those individuals who are the major source of venture capital. Their response to the proposed change would be essentially the same as it would be to an increase in the alternative tax (discussed above).

In addition, the provision does not differentiate between capital gains realized in connection with a trade or business as contrasted with ordinary investments.

Furthermore, the rationale for the allocation of deductions between income included and excluded from taxable income does not, in actual practice, apply to the vast majority of realized capital gains. In the words of the report of the Committee on Ways and Means, "The bill essentially requires allocation of any itemized deduction where it is *reasonable to assume* that a portion of the pertinent expense is met out of nontaxable income." The fact is that most individuals who would be affected—those with relatively large capital gains—would tend to reinvest their realized funds rather than use them for living expenses—the assumption on which the proposal is based.

Overlooked completely by the proposal is its effect on the relationship between state income taxes and the Federal tax. Escalation of state tax rates at the upper end of the income scale is predicated on the theory that the taxpayer would recoup a large part of the additional tax through the state tax deduction. In addition, since many states tie their tax base to the Federal base, effective state income taxes in many instances would also rise. Combined, the two would have a substantial effect on total tax costs (state and Federal) of large investors which the report of the Ways and Means Committee evidently did not foresee.

Limitation on deduction of investment interest

Limiting the interest deduction on loans used to finance investment property to $25,000 over and above investment income also penalizes those individuals who exhibit the greatest willingness to take investment risks. It seems anomalous to permit unlimited interest deductions for consumption purposes, while limiting interest deductions on funds put into productive investment. Furthermore, where does one draw the line between legitimate risk-taking through leveraging investments and tax considerations? Even where tax considerations are a factor, the end result is still an increase in investment.

This provision was apparently prompted by the widely-publicized 150 or so high-income returns for 1966 in which excess investment interest allegedly was used to insulate from taxation other types of income received by the taxpayers. The simple way of handing this situation would have been to include investment

interest within the "limit on tax preferences" structure. Instead, the Bill offers an extremely complex provision which is shot through with possibilities for inequities.

To the extent that interest must be offset against long-term capital gains, with an effective 50% disallowance, the real tax on such gains is substantially increased.

If the investment on which the interest is being paid results in a capital loss, both the loss and the interest in excess of the minimum are disallowed—a disturbing new form of double tax jeopardy. When a taxpayer repays investment borrowings from non-investment income, he can deduct practically no capital losses and, under this Bill, only limited amounts of investment interest.

The argument that the $25,000 annual limitation means that only substantial investors are confronted with such a choice of alternatives hardly alters the intrinsic unfairness of the provision. It underscores, however, the fact that the impact of the Bill falls most heavily upon those investors who necessarily must be depended upon to supply a major share of risk capital.

CONCLUSION

The whole question of investment incentives, including capital gains taxation, is fraught with uncertainty. That incentives for investment are essential for sustained economic growth in a free enterprise economy is not in dispute. What constitutes a proper level of incentives is a question on which reasonable men can differ. The existing treatment of capital gains has been essentially unchanged for over a quarter of a century. Over that period, the U.S. has compiled an enviable record of economic growth.

In the years immediately ahead, the rate of generation of new capital must be stepped up if our economy is to meet the demands put upon it by an increasingly sophisticated and expensive industrial plant and a population demanding an attack on the backlog of social and environmental problems. In the face of these needs, the structure of incentives which has proved out over the years should not be casually or hastily dismantled.

Unfortunately, there is little hard current data on the capital gains tax and other incentives. Based on the fragmentary data that do exist, the NYSE believes that the various capital gains provisions are essentially doing the job for which they were designed.

Heavy reliance by proponents as well as opponents of capital gains tax revision has been put on a single study done in 1962—a year in which stock market performance, and probably gains realizations, was distinctly not typical.

As we have demonstrated, the existing data offer no persuasive rationale for altering the existing capital gains tax structure at this time; and, in fact, there is every indication that the provisions now in effect are accomplishing the job for which they were designed.

If, at some future time, it should be deemed desirable to alter the present tax treatment of capital gains, it would certainly seem necessary to base any proposals for far-reaching changes on a detailed study of capital gains. Such a study would aim to provide timely and definitive new data on all aspects of the capital gains tax provisions of the Internal Revenue Code.

The CHAIRMAN. Our next witness will be Mr. Donald T. Regan, president of Merrill Lynch, Pierce, Fenner & Smith, Inc.

STATEMENT OF DONALD T. REGAN, PRESIDENT OF MERRILL, LYNCH, PIERCE, FENNER & SMITH, INC.; ACCOMPANIED BY HENRY W. MEERS, CHAIRMAN OF THE ASSOCIATION OF STOCK EXCHANGE FIRMS AND SENIOR PARTNER OF WHITE WELD & CO.; DR. LEON T. KENDALL, PRESIDENT OF THE ASSOCIATION; AND JAMES R. ROWEN, TAX PARTNER, SHERMAN & STERLING OF NEW YORK CITY

Mr. REGAN. Mr. Chairman, members of the committee, I am Donald T. Regan, president of Merrill, Lynch, Pierce, Fenner & Smith. I am honored to be here and have the opportunity to testify on behalf

of the Association of Stock Exchange firms. Accompanying me on my left, Mr. Henry W. Meers, chairman of the association, and senior partner of White Weld & Co.; on my right, Dr. Leon T. Kendall, the association's president and James R. Rowen, tax partner in the firm of Sherman & Sterling of New York, N.Y. These gentlement will try to help me answer questions you may have. I filed a more complete statement, so I will only summarize our position in the next few minutes.

The Association of Stock Exchange represents 520 New York Stock Exchange member firms doing 85 percent of the securities business of the Nation. These firms are concerned with the investments of more than 26 million Americans who own securities outright and 100 million more who own them indirectly through their participation in pension and profit-sharing trusts and other institutional investments.

As president of Merrill Lynch, Pierce, Fenner & Smith, I have the responsibility for the management of 209 brokerage offices throughout the world, employing some 3,700 securities brokers to serve our 1.5 million customers. I am, therefore, both in my capacity as spokesman for the association and in my professional capacity, particularly concerned with those sections of the House bill directed at capital gains. I believe that these sections, if enacted in their present form, would have substantial material consequences directly affecting millions of Americans and the Nation's economy.

I refer to section 511, repealing the alternative tax on long term capital gains.

Section 512, reducing the deductibility of capital losses and section 514, extending the holding periods on capital assets. Principally because of these sections, we concur in Secretary of the Treasury David M. Kennedy's view that the bill is "weighted in favor of consumption to the possible detriment of the Nation's productive investment".

On the alternative tax we approve the Treasury's proposal to revise the tax, but oppose its elimination. The 25 percent ceiling is a critical investment inducement to individuals capable of taking risks and the Nation greatly needs risk capital, as I shall endeavor to show.

Capital is an essental ingredient in a flourishing economy. Before there is a return, before there is income, there must be an expenditure of capital, of labor, of entrepreneurial energies.

At present $25,000 in capital stands behind each job in manufacuring in this country; this is one of the principal reasons why we have the highest standard of living in the world. For every new job we create, another $25,000 of capital will be required. In this respect capital equals jobs.

Today we spend $25 billion annually for research and development and in the last fiscal year, $87 billion of new capital was invested in new issues of stocks, bonds, and investment company shares. Many of the issuing companies are engaged in vital work, such as the control of air and water pollution, oceanography, education, and medicine. Their success means new jobs and perhaps whole new industries.

I ask you, as you consider tax legislation, to bear in mind the importance of capital in meeting our future economic needs. Please remember that it will take $28 billion in new capital each year just to provide new workers with jobs, to say nothing of housing and an increasing standard of living.

Passage of the provisions to extend the holding period of 12 months would have a serious impact on the Nation's ability to meet its capital needs. Testimony of the New York Exchange before this body provides what I regard as a landmark analysis of the holding period. We endorse it fully.

In fact, I can go further. My experience as a sales manager, underwriter, and managing executive of a securities firm convinces me the longer the time period over which an investment decision must be made, the greater the uncertainty in the mind of the investor.

As uncertainty grows, decisionmaking slows.

A 12-month holding period would impair the liquidity of the marketplace and the free flow of capital to its best use and would also cost the Treasury tax revenues. This is not a conjecture but a real and immediate prospect. It is documented in a recent independent survey of a cross-section of Merrill, Lynch customers conducted by Guideline Research Corp. of New York City, a respected marketing research organization. A summary of the survey results is appended to my statement and the full report of the survey is available.

Using charts I want to review briefly what the survey showed.

ATTITUDE TOWARD PASSAGE OF CAPITAL GAINS PROVISIONS OF H.R. 13270

Although our customers accept the theory of capital gains taxation, nearly three out of four (73 percent) are against passage of the three capital gains provisions. Only one in five (20 percent) favors them. The balance has no opinion. Note that the opposition is almost the same in all three brackets polled.

[In percent]

	Total	$10,000 to $19,999	$20,000 to $49,999	$50,000 or over
For passage	20	22	20	16
Against passage	73	70	72	76

ATTITUDE TOWARD LENGTH OF HOLDING PERIOD

The present 6-month holding period meets the approval of more than two-thirds (68 percent) of our investors.

Furthermore, another 14 percent feel the period should be decreased rather than increased. Only 12 percent favor longer holding periods. Again, the response is about the same regardless of income.

[In percent]

	Total	$10,000 to $19,999	$20,000 to $49,999	$50,000 or over
Holding period should be:				
Increased	12	12	14	11
Decreased	14	15	13	15
Kept the same	68	68	68	[illegible]7

EFFECT OF PASSAGE OF ALL THREE PROVISIONS OF INVESTMENT BEHAVIOR

We asked our customers what they would do with their investments if these were enacted. One out of three (34 percent) say they would decrease investments next year. Note that the proportion giving this response rises as income increases, reaching 39 percent in the $50,000 and over category. Only 6 percent said that they would increase their investment.

[In percent]

Passage of all 3 provisions	Total	$10,000 to $19,999	$20,000 to $49,999	$50,000 or over
Increase investments	6	7	7	3
Decrease investments	34	26	35	39
Keep about same	53	60	50	50

Investors were also asked what their investment decisions would be in the event of passage of each one of the proposals. Time will not permit me to display the charts covering the responses to these questions, but they are available for your examination. In each instance a significant number of investors say they would decrease their stock purchases in the year ahead.

Now is not the time to create further doubt about the future of the economy. The fall-out from inflation is all around us, and the adjustment we have been patiently waiting for is still more of a promise than a reality.

In the meantime, paper losses in the values of securities have climbed to $125 billion since May, and that itself is quite a tax on capital. Bear markets feed on doubt and indecision. There is a large measure of both hanging over the securities markets today. Investors are seriously questioning whether shifting social and political tides can be channeled into the right course, or whether the legitimate cry for tax reform will lead to some uneconomic decisions. The final form this bill takes will be a key indicator that millions wiill be watching.

Thank you, Mr. Chairman.

The CHAIRMAN. Looking at the chart you have there, it indicates that an average of more than 30 percent, roughly 33 or 34 percent of investors, would actually reduce their investments in the event that this bill passed in its present form. Is that what you are saying here?

Mr. REGAN. Yes, sir.

The CHAIRMAN. And only about 6 percent of investors would increase their investments under those circumstances.

Mr. REGAN. Yes, sir.

The CHAIRMAN. Now, I am somewhat aware of that problem because a businessman told me some time ago that in Canada there is no tax on capital gains. Is that not correct?

Mr. REGAN. That is correct, Mr. Chairman.

The CHAIRMAN. No capital gains tax in Canada. Now, man's attitude was that he was willing to pay a fair and reasonble amount of taxes, but he thought the five different things in this bill attacking capital gains are outrageous and if that was going to be done to him, the kind of investments he had could be made just as well in Canada as here and he was just going to move his money to Canada. Is that not a possibility if this bill passes in its present form?

Mr. REGAN. That is a possibility. We note that 78 percent of our customers said they actually were in favor of a capital gains tax but they did not like the provisions the House suggested be made.

The CHAIRMAN. In other words, most investors would not argue that we ought to have the Canadian system rather than ours. They simply say under our system the tax ought to be fair and should not be punitive or unreasonable.

Mr. REGAN. That is correct, Mr. Chairman.

The CHAIRMAN. Now, are you aware of the tax situation where in real terms—in terms of purchasing power—the person made no profit at all even though he was taxed for a profit?

Mr. REGAN. Inflation, yes, sir.

The CHAIRMAN. For example, a man buys property for $100,000. It could be stocks or it could be real estate. He holds that for, let us say, 30 years. Now, by the time he cashes it in, it might well be that the purchasing power of his dollar is only about a third of what it was originally. Well, then, he is taxed at a 25-percent rate on the difference where actually there was no gain in real terms. He is in effect being made to pay a tax and is penalized because the Government has failed to maintain the purchasing power of a dollar. Now, you are aware of that problem, are you not?

Mr. REGAN. Yes, sir. This is one of the reasons we oppose any change in the capital gains tax because in many cases unless the increase in value of the particular asset, be it real estate or stock or what have you, each year is greater than that of inflation, when the tax is paid it is really a tax on inflation.

The CHAIRMAN. I find it very interesting that your customers do feel that there should be a capital gains tax, because it is against their interests to feel that way. But that would indicate that most of them feel that anybody making money ought to be paying something, no matter how he is making it.

Mr. REGAN. That is what they seem to feel.

The CHAIRMAN. Senator Anderson?

Senator Bennett?

Senator BENNETT. Mr. Chairman—Mr. Regan, I understand one part of the survey had to do with the age of investors. Do you have a chart here showing that part of the survey?

Mr. REGAN. Unfortunately, I do not have a chart.

Senator BENNETT. But you do have the figures?

Mr. REGAN. I have some figures, Mr. Chairman, that I could give you. Mr. Bennett, each Senator, I believe, was furnished with a copy of these. It is a profile of Merrill Lynch customers. What we did, Mr. Chairman, was to try to find out who are the new customers of Wall Street. Who are the people that are now becoming stockholders? And we found to our great surprise that in our new customers, 29 percent of them are between the ages of 20 and 29; 21 percent are between the ages of 30 and 39. In other words, 50 percent of all new customers in Wall Street as far as Merrill Lynch is concerned, are below the age of 40, which we think is a very healthy sign as far as the future of our Nation is concerned. As far as their income is concerned, 53 percent are below the $15,000 tax bracket. As far as occupations are concerned, 28 percent came from such professions as sales, industrial craftsmen,

secretarial, clerical, housewife, Armed Forces, and students. We think it is very helpful.

The CHAIRMAN. Senator Curtis?

Senator CURTIS. No questions.

The CHAIRMAN. Mr. Jordan?

Senator JORDAN. No questions.

(Donald T. Reagan's prepared statement follows:)

STATEMENT OF DONALD T. REAGAN, PRESIDENT, MERRILL LYNCH, PIERCE, FENNER & SMITH, INC.

Mr. Chairman and Members of the Committee, I am Donald T. Regan, President of Merrill Lynch, Pierce, Fenner & Smith. I am honored to be here and have the opportunity to testify on behalf of the Association of Stock Exchange Firms. Accompanying me are Mr. Henry W. Mears, Chairman of the Association and a senior partner of White Weld & Company; Dr. Leon T. Kendall, the Association's President, and James R. Rowen, tax partner in the firm of Shearman & Sterling of New York, N.Y. These gentlemen will help me try to answer any questions you may have.

I have filed a more complete statement, so I will only summarize our position in the next few minutes.

The Association of Stock Exchange Firms represents 520 New York Stock Exchange member firms doing about 85 percent of all the securities business of the nation. These firms are concerned with the investments of the 26 million Americans who own securities outright and 100 million more who own them indirectly through their participation in pension and profit-sharing trusts and other institutional investments.

As President of Merrill Lynch, I have responsibility for the management of 209 brokerage offices throughout the world, employing some 3,700 securities brokers to serve our one and one-half million customers.

I am, therefore, both in my capacity as spokesman for the Association and in my professional capacity, particularly concerned with those sections of the House bill directed at capital gains. I believe that these sections, if enacted in their present form, would have substantial, material consequences directly affecting millions of Americans and the nation's economy.

I refer to:

—Section 511 repealing the alternative tax on long-term capital gains,

—Section 512 reducing the deductibility of capital losses, and

—Section 514 extending the holding period on capital assets.

Principally because of these sections, we concur in Secretary of the Treasury David M. Kennedy's view that the bill is "weighted in favor of consumption to the possible detriment of the nation's productive investment." "Such overweighting," he went on to say, ". . . could impede economic growth in the years ahead by curtailing the incentive to make productive investments."

On the alternative tax, we approve of the Treasury's proposal to revise the tax, but oppose its elimination. The 25-percent ceiling is a critical investment inducement to individuals capable of taking risks, and the nation greatly needs risk capital, as I shall endeavor to show.

There is concern today among us. We wonder whether the burden of taxation is equitably apportioned. We question whether some economic concentrations may be immune to fair taxation. This questioning is necessary, and the answer is clear. There is a genuine need for tax reform. But we must be careful that the zeal to reform does not, by inadvertence, impede our economic growth.

Capital is an essential ingredient in a flourishing economy. Before there is a return, before there is income, there must be an expenditure of capital, of labor, of entrepreneurial energies.

At present $25,000 in capital stands behind each job in manufacturing in this country; this is one of the principal reasons why we have the highest standard of living in the world. For every new job we create, another $25,000 of capital will be required. In this respect, capital equals jobs.

Economic progress is the result of a skillful blending of four basic factors—resources, labor, capital, and management. The importance of having all four elements is apparent when we observe the economic condition of other nations that are lacking in one or more of these elements.

Today we spend $25 billion annually for research and development, and in the last fiscal year, $87 billion of new capital was invested in new issues of stocks, bonds, and investment company shares. Many of the issuing companies are engaged in vital work, such as the control of air and water pollution, oceanography, education and medicine. Their success will mean new jobs—and perhaps whole new industries.

In the decade ahead, new families will be formed at the rate of more than a million a year, and 1.4 million additional workers will seek to enter the labor force annually. These projections have very human implications. More people mean more jobs, more housing, more transportation and health services, more of everything—unless rising aspirations are to be frustrated.

I ask you, as you consider tax legislation, to bear in mind the importance of capital in meeting our future economic needs. Please remember that it will take at least $28 billion in new capital each year just to provide new workers with jobs—to say nothing of housing and an increasing standard of living.

The traditional source for significant quantities of this capital has been—and will continue to be—our securities markets. It is, therefore, the public interest that is at stake in enacting legislation that would affect these markets.

Passage of the provision to extend the holding period to 12 months would have a serious impact on the nation's ability to meet its capital needs. Testimony of the New York Stock Exchange before this body provides what I regard as a landmark analysis of the holding period. We endorse it fully.

In fact, I can go further. My experience as a sales manager, underwriter and managing executive of a securities firm convinces me that the longer the time period over which an investment decision must be made, the greater the uncertainty in the mind of the investor.

As uncertainty grows, decision-making slows.

A 12-month holding period would impair the liquidity of the marketplace and the free flow of capital to its best use—and it would also cost the Treasury tax revenues. This is not conjecture but a real and immediate prospect. It is documented in a recent independent survey of a cross-section of Merrill Lynch customers conducted by Guideline Research Corporation of New York City, a respected marketing research organization. A summary of the survey results is appended to my statement, and the full report of the survey is available.

Using charts, I want to review briefly what the survey showed.

ATTITUDE TOWARD PASSAGE OF CAPITAL GAINS PROVISIONS OF H.R. 13270

Although our customers accept the theory of capital gains taxation, nearly three out of four (73 percent) are against passage of the three capital gains provisions. Only one in five (20 percent) favors them. The balance has no opinion. Note that the opposition is almost the same in all three income brackets polled.

[In percent]

	Total	$10,000 to $19,999	$20,000 to $49,999	$50,000 or over
For passage	20	22	20	16
Against passage	73	70	72	76

ATTITUDE TOWARD LENGTH OF HOLDING PERIOD

The present six-month holding period meets the approval of more than two-thirds (68 percent) of our investors. Furthermore, another 14% feel the period should be decreased rather than increased. Only 12% favor a longer holding period. Again, the response is about the same regardless of income.

[In percent]

Holding period should be—	Total	$10,000 to $19,999	$20,000 to $49,999	$50,000 or over
Increased	12	12	14	11
Decreased	14	15	13	15
Kept the same	68	68	68	67

EFFECT OF PASSAGE OF ALL THREE PROVISIONS ON INVESTMENT BEHAVIOR

We asked our customers what they would do with their investments if these were enacted. One out of three (34 percent) say they would decrease investments next year. Note that the proportion giving this response rises as income increases, reaching 39 percent in the $50,000-and-over category. Only six percent say they would increase investments.

[In percent]

Passage of all 3 provisions	Total	$10,000 to $19,999	$20,000 to $49,999	$50,000 or over
Increase investments	6	7	7	3
Decrease investments	34	26	35	39
Keep about same	53	60	50	50

Investors were also asked what their investment decisions would be in the event of passage of each one of the proposals. Time will not permit me to display the charts covering the responses to these questions, but they are available for your examination. In each instance a significant number of investors say they would decrease their stock purchases in the year ahead.

To sum up, our principal concern is that three sections of the House bill—Sections 511, 512 and 514—would tend to freeze capital assets and to reduce incentives to invest. As a result, the liquidity of otherwise marketable securities would diminish, and this condition would be detrimental to economic growth. As Assistant Secretary of the Treasury Edwin S. Cohen testified, "Present capital investments would tend to be frozen and the economy as a whole would suffer."

Now is not the time to create further doubt about the future of the economy. The fallout from inflation is all around us, and the adjustment we have been patiently waiting for is still more of a promise than a reality.

In the meantime, paper losses in the value of securities have climbed to $125 billion since May, and that itself is quite a tax on capital. Bear markets feed on doubt and indecision. There is a large measure of both hanging over the securities markets today. Investors are seriously questioning whether shifting social and political tides can be channeled into the right course, or whether the legitimate cry for tax reform will lead to some uneconomic decisions. The final form this bill takes will be a key indicator that millions will be watching.

Thank you Mr. Chairman.

Senator BYRD. No questions.

Senator FANNIN. No questions.

The CHAIRMAN. Thank you very much.

Mr. REGAN. Thank you, sir.

The CHAIRMAN. We will now hear from Mr. Roland M. Bixler, chairman of the board of directors, the tax council.

STATEMENT OF ROLAND M. BIXLER, CHAIRMAN, BOARD OF DIRECTORS, THE TAX COUNCIL

Mr. BIXLER. Mr. Chairman, unlike my distinguished predecessors, I am here alone but I hope our case will speak for itself.

My name is Roland M. Bixler. I am founder and president of J–B–T Instruments, Inc., a manufacturer of electrical instruments and electronic components located in New Haven, Conn.

I appear here on behalf of the tax council of which I am chairman of the board of directors. The council is a membership organization supported by business concerns, some large, some medium sized, and some small like our own firm. Broadly, the council's purpose is to work toward a body of tax law in harmony with the economics of progress. We like to think of ourselves as a center for fresh and innovative

thinking on tax issues of major importance to capital formation, economic growth and the creation of new and better jobs.

Consistent with its purpose, the tax council has developed two fundamental programs of tax reform, one in the capital gains area and the other on income tax rates.

The capital gains program implements a single idea, namely, that being transfers of capital the long-term capital gains of individuals do not belong in the income tax base.

Our program for reduction and reform of income tax rates also implements a single idea, namely, that taxpayers should have first but not irreversible claim to at least one-half of the increase in revenue which comes from economic growth.

My complete testimony has been supplied. I will just proceed on to a summary of it and then try to hit a few of the highlights.

We urge that H.R. 13270 be amended to incorporate the council program on capital gains, and to make modest changes consistent with the program on income tax rates. The major policy points which we propose for implementation in the pending legislation are summarized as follows:

SUMMARY OF RECOMMENDATIONS

1. With respect to capital gains, we recommend that:

(*a*) A new system be created for the separate taxation of long-term capital gains of individuals, with more moderate rates of tax than at present.

(*b*) A credit against estate taxes of long-term gains of individuals be provided under the new system.

(*c*) A reasonable rule be enacted for allocation of interest deductions between income under the income tax system and long-term capital gains under the new system.

(*d*) Tax be eliminated on gains from sale of owner-occupied homes.

2. With respect to individual income tax rates, we have these recommendations:

(*a*) In H.R. 13270 rate deductions through the middle brackets be adjusted towards the goal of flattening, and I emphasize the word flattening, the curve of graduation.

(*b*) The 50 percent maximum rate on earned income be enacted (section 802 of H.R. 13270).

3. With respect to the corporation income tax, we recommend reduction in the top rate of 45 percent to take effect in the near future.

The basic program proposed on capital gains is explained in detail in my full statement. We have talked in terms of a new system which recognizes that capital gains are a transfer of capital assets. Capital assets are something which all the rest of the world seems to have recognized better than we, very important for future economic growth, for more and better jobs. We feel there should be a holding period. We have not taken an exact position as to the time of it. We feel that long-term losses to individuals on the sale of assets should be allowed only as an offset against long-term gains but with an unlimited carryover of the excess losses.

Then another new proposal is a credit against estate taxes of the taxes paid on long-term gains by individuals. The tax on gains would

be cumulatively recorded in a special box in the annual tax return filed during the taxpayer's life and then the total would be offset against any estate tax he otherwise should pay at death. We also think in terms of mixed transactions, that there would be no departure from the present practice in taxing the gains from mixed transactions.

On literary works we feel that the creators of literary, music, and artistic compositions should be accorded the same tax treatment as is the work of inventors, by creation of an additional class of special statutory gains.

And finally, on the matter of the sale of homes, with the inflation that has occurred there, we feel the tax should be eliminated on the gains from sales of owner-occupied homes and other properties which are not subject to loss offsets.

This program was adopted by the council some months ago. We later have added the matter of interest deductions and we feel what is given in the testimony under interest deductions would be particularly advantageous because it would recognize that interest often is a cost in long-term capital gains.

Our purpose would be to have less tax restraint on mobility and to promote the venturesome use of capital from which economic growth comes.

Now, referring to the tables presented, the first indicates a suggested rate schedule for long-term capital gains of single individuals and you will see it goes from 4 to 22 percent. The second table covers capital gains for joint returns, again using the same rates. In comparing the rates to those that are paid under the income tax system, the most important point to keep in mind is that under this proposal the tax paid on capital gains tax would be paid without regard to a taxpayer's income. This would be a particular break for taxpayers whose gains are small in relation to income.

We often hear the argument that all capital gains should be taxed as income because some people live off their gains. There may be some people who do this, but the fact is that if we taxed all gains as income, we would compound the discrimination against the working people who now pay the tax on their gains off the top of their income. So, the proposed system would end the present discrimination by bringing the tax on gains paid by those who earn income down to the same tax paid by those who do not work for a living. This is shown in table No. 3, where in the first column we indicate what would happen with taxable incomes of zero to $40,000 but, if there were long-term capital gains of $50,000 in this example, the same tax of $4,840 would be paid by each of these taxpayers regardless of whether his taxable income was zero or $5,000 or $40,000.

We, however, in table 3 also compare this with what was proposed in the Kennedy-Johnson administration in 1963 when there was a proposal to substantially reduce long-term capital gains and this table indicates that in taxing long-term gains we would again, as I pointed out, eliminate discrimination against persons who earn their income. So, a man who earns $40,000 income now pays about $6,000 more on $50,000 gains than a man who earns no income whatsoever. Our proposal would correct that.

Table 4 then indicates what would happen to long-term gains of a person with $20,000 of taxable income but with varying amounts of

long-term capital gains and you will see that our proposal there would be lower up through $50,000—would be substantially lower up through $50,000 of long-term capital gains but would escalate to a point somewhere higher than the 1963 administration proposal but lower than the present top tax of 25 percent.

Now, on the matter of the unrealized gains at death, there gets to be a real question of equity here because one person has sold and paid tax and another person has stayed frozen in his assets to avoid tax? We feel that by giving credit to the individual who has paid capital gains during his lifetime, at the time estate taxes are figured, we could ameliorate this problem. On the matter of deductions for interest, we have indicated here that we favor substitution for section 221 of H.R. 13270, so that interest payments in excess of, say, $5,000 annually, would be allocated as follows:

First, the deduction under the income tax system of the amounts of dividends, interest and 10 percent of other income included in the adjusted gross income.

Second, we would then have a deduction under the separate capital gains system we proposed.

And third, he could deduct the remainder under the income tax system.

Now, as to the income tax rates, we would like to emphasize that we considered several benchmarks. The first is, it is neither fair nor good economics to impose a sharply ascending scale of tax rates on the more ambitious, energetic and successful members of any generation. Whoever works longer, harder and more effective than the average deserves extra compensation. That is a principle we generally accept but when we get to the income tax rates we do not seem to recognize that.

Then further, that the greater amount of capital which is available to any society, the greater will be its economic development, the higher its living standards and the better its ability to take care of the disadvantaged.

Finally, the excessive rates of tax and the burden of tax at the Federal level inevitably create taxpayer resistance to State and local levels and in many cases we know where this is happening in our home communities.

And finally, if we did not have excessive rates of tax, then in the case of a real major national emergency we have some place to go.

Our proposal for the individual income tax is shown in tables 5 and 6. I might just say for the record, that the first column in table 5 should say in thousands. Those are not dollars as indicated. But I think it can all be told in one picture in the chart which follows, and our objective again is to flatten out the curve rather than have this strange geometric form we have under the present form.

And in table 6 we then give illustrations of how we can make a start with the House bill. We strongly do favor the 50 percent maximum rate on earned income and support the House and Administration positions that this might well reduce the incentive for other kinds of proposals to relieve the income producer.

Finally, on the corporate income tax, our proposal is instead of a reduction of one percentage point in 1971, and again in 1972, that this be increased to 1½ percentage point each year to get down to 45 as the top percentage after the surcharge is repealed.

Mr. Chairman, that is the bulk of our testimony.

The CHAIRMAN. Thank you very much.

Questions?

Senator ANDERSON. Item 4, on page 2.

Mr. BIXLER. Now, Senator, you are referring to this or the printed one?

The CHAIRMAN. Page 4 on this statement right here.

Mr. BIXLER. All right. Page 4. Item——

Senator ANDERSON. Credit at death.

Mr. BIXLER. Credit at death. This essentially would say that when we are taxing transfer of capital we record that during the life of the individual. Each time he pays a capital gains he keeps a cumulative box on his tax return and at death that is then applied against his estate taxes so we are not dissipating that capital twice. Now, there is substantially more discussion about that further in the paper, over on page 10. It goes into pages 10 and 11. We go into that in considerably more detail.

Senator ANDERSON. Has not there been quite a discussion about capital gains at death and people who escape them?

Mr. BIXLER. There are proposals, of course, for two kinds of taxation at death. One is to charge for the unrealized capital gains under the income tax system before the estate tax is applied. The other would be to tax the unrealized gains in the estate tax returns. In either case this seems to us to mean a double simultaneous imposition on the transfer of capital.

Senator ANDERSON. Do you think it is wrong?

Mr. BIXLER. I do, sir.

Senator ANDERSON. Would you rather have the other system of trading off charges——

Mr. BIXLER. It seems to me that if we charge a more reasonable capital gains, long-term capital gains tax during life, we increase the mobility of capital which is highly desirable, but that the estate tax should not dissipate the capital to the extent of the tax during life. Now, I am seeing some of this as an individual as the principal of a closely held business which we hope to perpetuate. But it is a much broader matter than that.

The CHAIRMAN. Senator Bennett.

Senator BENNETT. I have just one question. I am looking at your chart on page 69 which is the one that shows the difference in the rate of increase in the rates. Have you made or has anyone made any kind of an appraisal as to the revenue effects of this flattening of the curve?

Mr. BIXLER. Yes. We have. To do the complete job would cost in the neighborhood of $25 billion. This should be figured out more concisely by the staff, but the cuts that we proposed in table 6, however, would be about a fifth of that, or the revenue effect might be on the order of $5 billion annually, including the cuts already in the House bill.

Senator BENNETT. That is all, thank you.

The CHAIRMAN. In all of these revenue estimates you are not really giving much weight, are you, to the fact that if people were not paying a rather prohibitive rate of taxes they might invest their money more freely and start more new enterprises.

Mr. BIXLER. This seems to us very likely. Also, if there were greater mobility of capital it might well increase the revenue for the time being. That has not been taken into account at all because those would be assumptions.

Senator JORDAN. Just one question. Have you calculated what the revenue loss would be by the implementation of your graduated capital gains tax for personal income?

Mr. BIXLER. We have made some very preliminary estimates and it would be modest, but frankly, we did not have all the data available, so I would rather not say specifically. But the cost would be surprisingly low, especially if we were to recognize that, for example, some locked in capital gains, potential capital gains, actually occur and were subject to capital gains taxation.

Senator JORDAN. When you finish your study write us a letter of your report.

Mr. BIXLER. I would be very happy to, Senator.

Senator JORDAN. Thank you, Mr. Chairman.

Senator FANNIN. I agree with your idea of giving incentive to develop investment capital, especially for small businesses. We realize how difficult it is now and that is why we have the SBA, and other agencies to assist small business.

Now, when you say eliminate one-half of the increase in revenue that comes about by economic growth, you are not adjusting that for inflation or would you recommend that some adjustment be made?

Mr. BIXLER. Hopefully, we are going to get hold of inflation to a greater extent, but it might well be taken into account because there is real—when our system is functioning properly, there is real economic growth which is on the order of $12 to $15 billion a year, but if half were taken without the inflationary factor it would still be, I think, a very strong incentive.

Senator FANNIN. But, at the present time, you just have the one-half of the increased revenue that would be involved; it would not do very much more than cover the inflationary amounts that have been brought about through what has happened in the last few years.

Mr. BIXLER. That is true, that in the last few years where we have had a greater amount of inflation. However, I did not take the time to say this, but it seems to us very important in terms of capital gains to think in terms of heavier investment because heavier investments are really the only way that we can compete against foreign competition and the only way that we can hope to bring prices into stability and still continue higher wage rates.

Senator FANNIN. I certainly agree and we know from what has been said this morning and through other sources that Canada and Great Britain and other countries certainly have utilized greater incentives for the production of additional capital, whereas we have gone the opposite direction. When you talk about adjustment for those with greater earned income, I imagine you have in mind that those that do have earned income probably are going to be more likely to invest it in businesses and would be more active than those who have earned income from municipal bonds and similar sources. Is that the thought you have behind that? That is the recommendation?

Mr. BIXLER. Yes, Senator. That is one of the important factors, that the venture capital we think would much more often come from a

person who had earned and saved it than from someone else, but there is a little more to it than that. The earner, with the 50-percent income tax ceiling, if he is a professional or a businessman or whatever his source of income, he will work harder at what he knows best to produce more income instead of spending his time trying to find all the ways to get around the tax system and in the end this will be to our national advantage.

Senator FANNIN. Thank you.

The CHAIRMAN. If the witness will suspend. I do not know what that cameraman has in mind taking pictures in the audience, but I would suggest that unless there is some good reason why it should be done, that it be terminated. If there is someone in the audience who wants his picture taken, he can step outside and have his picture taken and that is perfectly all right with me.

Any further questions?

Thank you very much, sir.

Mr. BIXLER. Thank you.

(Roland M. Bixler's prepared statement follows:)

STATEMENT OF ROLAND M. BIXLER, CHAIRMAN, BOARD OF DIRECTORS, THE TAX COUNCIL

My name is Roland M. Bixler. I am founder and President of J-B-T Instruments, Inc., a manufacturer of electrical instruments and electronic components located in New Haven, Connecticut.

I appear here on behalf of The Tax Council of which I am Chairman of the Board of Directors. The Council is a membership organization supported by business concerns, some large, some medium sized, and some small like my own. Broadly, the Council's purpose is to work towards a body of tax law in harmony with the economics of progress. We like to think of ourselves as a center for fresh and innovative thinking on tax issues of major importance to capital formation, economic growth and the creation of new and better jobs.

Consistent with its purpose, The Tax Council has developed two fundamental programs of tax reform, one in the capital gains area and the other on income tax rates.

The capital gains program implements a single idea, namely that being transfers of capital the long-term capital gains of individuals do not belong in the income tax base.

Our program for reduction and reform of income tax rates also implements a single idea, namely, that taxpayers should have first but not irreversible claim to at least one-half of the increase in revenue which comes from economic growth.

We urge that H.R. 13270 be amended to incorporate the Council program on capital gains, and to make modest changes consistent with the program on income tax rates. The major policy points which we propose for implementation in the pending legislation are summarized below:

SUMMARY OF RECOMMENDATIONS

1. With respect to capital gains, we recommend that:
   a. A new system be created for the separate taxation of long-term capital gains of individuals, with more moderate rates of tax than at present.
   b. A credit against estate taxes of long-term gains of individuals be provided under the new system.
   c. A reasonable rule be enacted for allocation of interest deductions between income under the income tax system and long-term capital gains under the new system.
   d. Tax be eliminated on gains from sale of owner-occupied homes.
2. With respect to individual income tax rates, we recommend that:
   a. In H.R. 13270 rate reductions through the middle brackets be adjusted towards the goal of flattening the curve of graduation.
   b. The 50 percent maximum rate on earned income be enacted (Section 802 of H.R. 13270).

3. With respect to the *corporation income tax*, we recommend reduction in the top rate to 45 percent to take effect in the near future.

DISCUSSION AND COMPLETE RECOMMENDATIONS

A. Capital gains

All capital gains have been taxed within the income tax system since its inception in 1913, but with special treatment (lower rates than on income) dating from 1922. For twenty-five years, the top rate (alternative tax) has been 25 percent. After studying capital gains for over a year, the Council last summer released a program for reform based on the belief that much of the controversy and unsettled atmosphere which pervades the field is due to its linkage with income taxation. H.R. 13270 confirms this belief by eliminating the alternative tax and by including gains in other provisions designed to increase the tax on high incomes.

Our original program contains seven major recommendations, as follows:

1. *The new system.*—Creation of a new system for taxing long-term capital gains of individuals derived from transactions having all the characteristics of a transfer in capital assets. Rates of tax would be more moderate than at present, and there would be an appropriate form for reporting and paying this tax.

2. *Holding period.*—Use of a holding-period test for separating gains to be taxed as transfers of capital under the new system, and ordinary income under the income tax system.

3. *Long-term losses.*—That long-term losses of individuals on sale of assets under the new system be allowed only as an offset against long-term gains with unlimited carryover of excess losses.

4. *Credit at death.*—Credit against estate taxes of the taxes paid on long-term gains by individuals. Under the new system, the taxed gains would be cumulatively recorded in a special box in each annual return filed during a taxpayer's life. The total would be offset against any estate taxes otherwise payable at death.

5. *Mixed transactions.*—No departure from present practice in taxing gains from mixed transactions, that is, the special treatment now accorded capital gains under the income tax system having characteristics partially related to transfer of capital assets and partially related to realization of income, including but not limited to those which are now generally known as "special statutory" gains.

6. *Literary works, etc.*—That the works of creators of literary, music and artistic compositions be accorded the same tax treatment as the works of inventors, by creation of a new class of "special statutory" gains.

7. *Sale of homes.*—That tax be eliminated on gains from sales of owner-occupied homes and of other properties not subject to loss offsets; moreover that short-term gains on sale of homes and other properties involved be relieved from tax unless loss offsets are provided.

Interest deductions.—In addition to its original recommendations, the Council now recommends enactment of a reasonable rule for allocation of interest deductions between income under the income tax system and capital gains under the new system.

Major points in support of the separate system are:

Enactment of the separate system would make clear that these long-term gains are really a part of capital and not of the income stream.

Tax law would be cleansed of the taint so often associated with present treatment of gains by one branch of tax theory.

It would no longer be possible to becloud the problem of tax burdens on high incomes by lumping together income and long-term gains.

The economic implications of both the income tax, and the capital gain tax, could be more objectively observed, studied and evaluated.

Revision in rates of tax on long-term capital gains would be related to factors peculiar to capital use and not to factors peculiar to receipt and use of income as at present.

Because the tax would be a levy on the transfer of capital during life which would be transferred again at death, the case of offsetting the earlier tax against the later one would be evident. Thus, the problems of locked-in investments and fairness would be solved by minimizing instead of maximizing tax.

The situation of gains with income characteristics receiving special treatment under the income tax system would be more clearly seen and appreciated.

There would be less tax restraint on mobility and venturesome use of capital.

Suggested rate scales.—The rate scales we suggest for long-term gains of individuals under the new system are set forth in Tables I and II for single and married taxpayers, respectively.

TABLE I.—*Suggested rate scale for taxable long-term capital gains of Individuals—(single returns)*

Taxable gains:	Tax:
Not over $5,000	4 percent
$5,000 to $10,000	$200 plus 7 percent of excess over $5,000
$10,000 to $15,000	$550 plus 10 percent of excess over $10,000
$15,000 to $20,000	$1,050 plus 13 percent of excess over $15,000
$20,000 to $30,000	$1,700 plus 16 percent of excess over $20,000
$30,000 to $40,000	$3,300 plus 19 percent of excess over $30,000
$40,000 and over	$5,200 plus 22 percent of excess over $40,000

Table II.—Suggested rate scale for taxable long-term capital gains of individuals (joint returns)

Taxable gains:	*Tax*
Not over $10,000	4 percent
$10,000 to $20,000	$400 plus 7 percent of excess over $10,000
$20,000 to $30,000	$1,100 plus 10 percent of excess over $20,000
$30,000 to $40,000	$2,100 plus 13 percent of excess over $30,000
$40,000 to $60,000	$3,400 plus 16 percent of excess over $40,000
$60,000 to $80,000	$6,600 plus 19 percent of excess over $60,000
$80,000 and over	$10,400 plus 22 percent of excess over $80,000

In comparing these rates to those paid under the income tax system, the most important point to keep in mind is that they would be paid without regard to a taxpayer's income. This fact is of much less importance to people whose gains are taxed at the alternative rate of 25 percent at present than it is to those who have not yet built up substantial investment capital. Taxpayers whose gains are small in relation to income would benefit the most from breaking the link with income taxation. For example, a married taxpayer under the present system with a gain of $8,000 would pay an effective rate of 12.5 percent on the gains if his taxable income is $12,000 but 18 percent if it is $24,000. Under the proposed system, the same tax would be paid on any given amount of gains regardless of the amount of taxable income.

In addition to taxing small amounts of gains at up to the highest rates applying to capital gains, the present system taxes trivial amounts of gains if the taxpayer has taxable income. We suggest an exemption of $500 to avoid tax on trivial amounts of gains under the proposed system.

A reason sometimes given for advocating that all capital gains be taxed as income is that there are people who "live off their gains." Granting that there may be some such people, the fact is that taxing all gains as income would compound the discrimination against the working people who now pay tax on their gains "off the top of their income." The proposed system would end the present discrimination by bringing the tax on gains paid by those who earn income down to the same tax paid by those who do not work for a living.

It is of more than passing interest to recall in these proceedings that the program which the Kennedy-Johnson Administration submitted to Congress in 1963 would have substantially reduced the taxes on long-term gains.

Table III below shows the tax on $50,000 of long-term gains in relation to varying amounts of taxable income under four different tax methods.

TABLE III.—COMPARISON OF TAX ON LONG-TERM GAINS OF $50,000 ACCORDING TO AMOUNT OF TAXABLE EARNED INCOME (MARRIED, JOINT RETURNS)[1]

	Taxable income	Tax on $50,000 of long-term gains: Present system and rates (1)	Proposals: Tax council (2)	Proposals: 1963 administration (3)	If taxed in full as ordinary income under present rates (4)
1	0	$6,020	$4,840	$3,010	$17,060
2	$5,000	7,070	4,840	3,570	18,840
3	10,000	8,100	4,840	4,200	20,480
4	20,000	10,180	4,840	5,540	23,340
5	30,000	11,770	4,840	6,680	25,660
6	40,000	12,500	4,840	7,510	27,040

[1] The temporary surcharge is disregarded in all figures.

Table III reveals a number of things, but especially illustrates how the Council program in taxing long-term gains would eliminate the discrimination against persons who earn income which exists under the present system and would have been continued under the 1963 proposals. If gains were taxed fully as income, the discrimination would be compounded. As shown by the table, a man earning $40,000 in income now pays about $6,000 more on $50,000 in gains than a man earning no income, but if gains were taxed at present income tax rates he would pay $10,000 more.

The next table relates tax-wise varying amounts of long-term gains to a stable amount of taxable income, $20,000.

TABLE IV.—COMPARATIVE TAX ON GAINS OF MARRIED TAXPAYERS WITH $20,000 TAXABLE INCOME AND VARYING AMOUNTS OF LONG-TERM GAINS[1]

	Taxable income[2]	Long-term gains	Tax on gains under—: Present system (1)	Proposals: Tax council[3] (2)	Proposals: 1963 administration (3)
1	$20,000	$2,000	$320	$40	$192
2	20,000	5,000	800	160	480
3	20,000	10,000	1,640	360	960
4	20,000	15,000	2,540	680	1,460
5	20,000	20,000	3,500	1,030	2,000
6	20,000	50,000	10,180	4,840	5,540
7	20,000	100,000	23,340	15,580	13,280
8	20,000	400,000	104,380	79,580	66,000
9	20,000	1,000,000	250,000	212,580	190,600

[1] The temporary surcharge is disregarded in all figures.
[2] Tax on income alone, joint return, $4,380.
[3] Tax after 2 exemptions of $500.

It will be noted that a middle-bracket income taxpayer with capital gains in the range of very modest up to something in excess of his taxable income would benefit the most under the Council program. This would be true as compared with the system now in effect as well as with the 1963 Administration program. At higher levels of taxable gains, benefits under the Council program would taper off percentage-wise but would still be quite significant as compared with the system now in effect. In the highest levels illustrated, however, the benefits under the 1963 Administration program would have been greater than the Council now proposes.

Unrealized Gains at Death.—Under present law, gains not realized before death of a taxpayer are not taxed. This has led to a view held by a number of tax authorities that such gains should be taxed as part of the decendent's last income tax return, with remaining capital then being subject to estate taxation. Others have proposed that the unrealized gains be taxed twice within the estate tax system. Whichever way it might be done, the taxation of unrealized gains at death would mean a double simultaneous impost on a transfer of capital.

We cannot avoid, however, the fact that there is a problem of equity between the parties affected when gains are—or are not—realized before death. We also must recognize the effect on mobility of capital when gains are not realized in order to pass them untaxed to heirs. The question of policy is whether it is better to resolve such problems by increasing or decreasing the overall burden of taxes. Our view is that all possibilities for solution through decreasing taxes should be considered before contemplating an increase in taxes.

From this approach, there would be no reason to consider an increase in taxes to resolve the problems caused by unrealized gains at death. Even with long-term capital gains linked to the income tax system, it would be possible to work out an arrangement by which taxes on gains during life were cumulatively recorded and then credited against estate taxes at death. But the complete logic of the matter here, as with other aspects of taxing long-term gains, would be more evident if the link with income taxation were broken, and such gains taxed in the first instance under a separate system as transfers of capital.

Allocation of Deductions for Interest.—When we prepared our capital gains program we had not contemplated any deductions against long-term gains of individuals except those now allowed as costs added to the basis for separate assets, plus the $500 exemption. This past winter we recognized that interest incurred in realizing capital gains is a cost which should be deductible against the gains and we amended the program accordingly. Specifically, in substitution for the provisions limiting the deduction of interest in Section 221 of H.R. 13270, we recommend for a taxpayer with long-term capital gains, and interest payments in excess of some figure such as $5,000 annually, the amount in excess of that figure be allocated as follows:

First, deduction under the income tax system up to the amounts of dividends, interest and 10 percent of other income included in adjusted gross income.

Second, deduction under the separate capital gains system up to the amount of otherwise taxable gains.

Third, deduction of any remainder under the income tax system.

B. Income tax rates

Basic program.—This program would inaugurate regular, repetitive steps in reform and reduction of personal and corporate income tax rates when inflation has been contained. Its major elements are:

a. Pre-emption of at least one-half of the revenue growth, now estimated at $12 to $15 billion annually;

b. Substantial cuts in personal tax rates in all brackets with the greatest cuts through the middle brackets to flatten the curve of graduation;

c. Reduction of the top rate of corporate tax to 38 percent; and

d. Provision for temporary arresting of scheduled reductions by Congress if and when the public interest requires.

In preparing this program, we have been guided by five basic benchmarks as follows:

1. *It is neither fair nor good economics to impose a sharply ascending scale of tax rates on the more ambitious, energetic and successful members of any given generation.*—This is the pattern of existing rates, and it is unfair because it is contrary to the accepted norm for compensation, namely, that whoever works longer, harder, and more effectively than the average deserves extra compensation. Graduation of rates penalizes those who are rewarded for extra effort by both private and public employers. The result is poor economics, we believe, because it arbitrarily reduces the amount of new capital in the most dynamic hands.

2. *The greater the amount of capital available to any society, the greater will be its economic development and the higher its living standards.*—It is this factor more than any other which tends to be overlooked when tax policy is viewed from the short term. Taking a broader and longer view, whatever limits capital limits economic growth and the creation of new and better jobs. Looking abroad, we always recognize the insatiable need for capital, but there is a tendency to overlook the application of this statement at home. It is not suggested here that tax policy should favor capital formation over current consumption, but there certainly is a case for getting much closer to neutrality as between the two than would be indicated by much of the economic literature of recent decades. This is the course which would lead to more growth with less inflation, to ever better jobs as well as more jobs, and especially to the best opportunities for those Americans who to the present have been counted among the disadvantaged.

3. *The excessive rates and burden of taxes at the federal level inevitably create taxpayer resistance to state and local levies.*—It is evident that the fundamental corrective is moderation of both the rates and the burden at the federal level.

4. *The same excessive tax rates, and the same excessive burden of taxation overall, inevitably would make it most difficult for the Federal government to meet a really major new national emergency.*—A significantly lower base of both rates and overall burden would put the national government in the position of being fiscally prepared to meet whatever emergencies may come hereafter.

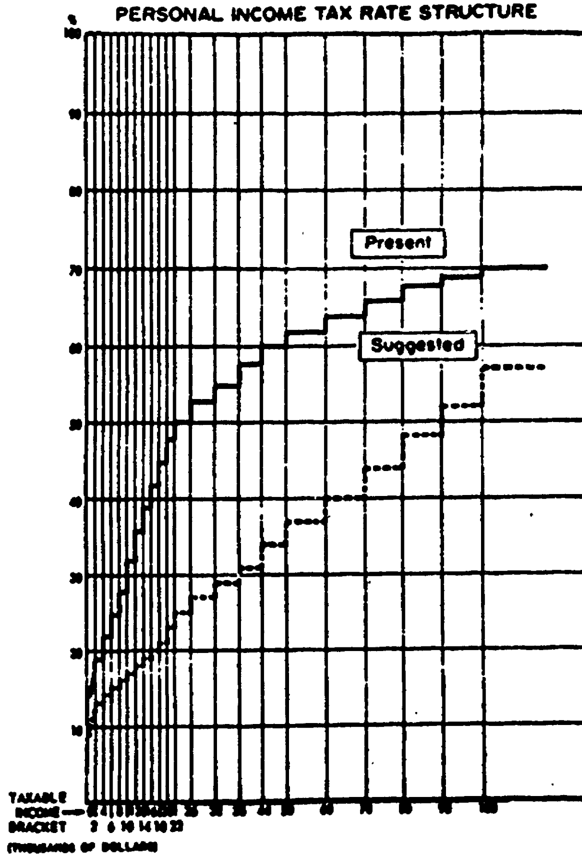
5. *In planning ahead, the government can maintain flexibility as regards that part of the revenue growth which is earmarked for tax reduction, but will lose flexibility as regards the part earmarked for spending.*—This is because a program of scheduled tax reductions may readily provide for arresting or even temporarily reversing any given reduction, but spending programs do not lend themselves to this kind of procedure. It is true this procedure could exert a discipline on increased spending for domestic purposes by identifying the cost in terms of tax reduction dollars immediately foregone, but this would seem an attractive addition to budget-making procedures.

The reform of personal tax rates recommended by the Council is shown in Table V and illustrated in the chart which follows:

TABLE V.—PERSONAL INCOME TAX RATE STRUCTURE (DISREGARDING TEMPORARY SURCHARGE)

Taxable income bracket (sinlge returns)[1]	Present	Suggested	Percent rate reduction
0 to $0.5	14	9	36
$0.5 to $1	15	10	33
$1 to $1.5	16	11	31
$1.5 to $2	17	12	29
$2 to $4	19	13	32
$4 to $6	22	14	36
$6 to $8	25	15	40
$8 to $10	28	16	43
$10 to $12	32	17	47
$12 to $14	36	18	50
$14 to $16	39	19	51
$16 to $18	42	20	52
$18 to $20	45	21	53
$20 to $22	48	23	52
$22 to $26	50	25	50
$26 to $32	53	27	49
$32 to $38	55	29	47
$38 to $44	58	31	47
$44 to $50	60	34	43
$50 to $60	62	37	40
$60 to $70	64	40	38
$70 to $80	66	44	33
$80 to $90	68	48	29
$90 to $100	69	52	25
$100 and over	70	57	19

[1] Brackets are double the given range for joint returns.



We estimate that effectuation of the personal rate cuts over a five-year period would result in tax reductions of something over $5 billion annually based on current income levels.

Adjustment in Middle Bracket Rates of H.R. 13270.—Despite the benefits which would result therefrom, we realize it is too much to ask enactment of the Council's complete program at this time. *However, we do urge the Committee on Finance to endorse the objective of flattening the curve of graduation through the middle brackets.* As applied to the rate reductions in H.R. 13270, this principle would require adjustments in only a dozen brackets. These are shown in Table VI below:

TABLE IV.—PERSONAL INCOME TAX RATE REFORM (DISREGARDING TEMPORARY SURCHARGE)

[Rates in percent]

Taxable income bracket (single returns)[1]	Present	H.R. 13270	Recommended adjustments
0 to $500	14	13	
$500 to $1,000	15	14	
$1,000 to $1,500	16	15	
$1,500 to $2,000	17	16	
$2,000 to $4,000	19	18	
$4,000 to $6,000	22	21	20
$6,000 to $8,000	25	23	
$8,000 to $10,000	28	27	26
$10,000 to $12,000	32	30	29
$12,000 to $14,000	36	34	32
$14,000 to $16,000	39	37	35
$16,000 to $18,000	42	40	38
$18,000 to $20,000	45	42	40
$20,000 to $22,000	48	44	43
$22,000 to $26,000	50	47	45
$26,000 to $32,000	53	49	48
$32,000 to $38,000	55	50	
$38,000 to $44,000	58	52	
$44,000 to $50,000	60	54	
$50,000 to $60,000	62	58	57
$60,000 to $70,000	64	60	59
$70,000 to $80,000	66	60	
$80,000 to $90,000	68	61	
$90,000 to $100,000	69	61	
$100,000 to $120,000	70	62	
$120,000 to $150,000	70	63	
$150,000 to $200,000	70	64	
$200,000 and over	70	65	

[1] Brackets are double the given range for joint returns.

The reduction in rates with the adjustments we recommend would average about 10 percent through the middle brackets, or one-fifth of the full cuts contemplated in our complete program.

50% Maximum Rate on Earned Income.—As a matter of principle, we believe that the top rate of tax on all income should be no higher than 50 percent. The maximum tax of 50 percent on earned income provided in Section 802 of the House bill is a long step in this direction. We agree with the Ways and Means Committee that this will diminish the pressures to avoid drawing down income as earnings. We also recognize that it would not be feasible in one step at this time to reduce the top rate on all income to this level. Accordingly, we endorse the provision as included in the House bill, and strongly recommend that it be retained in the final legislation.

C. Corporat eincome tax

As businessmen, we are acutely aware that the pace of business investment in the contemporary period is thought to be a major factor in the continued inflation. This spending, however, is the first line of defense against inflation over any period of time enabling as it does the production of more goods at lower unit costs. Such spending also is necessary to keep us competitive in international trade. It is noteworthy, moreover, that there is little or no evidence today that industry is building excess capacity, or putting new machinery in place which it cannot use effectively. The question then is what is industry doing wrong?

The answer is that too much current activity is being financed by borrowing and too little from savings out of current income. From this standpoint, the pending legislation is not going to help things. The drain of present taxes on retained earnings of corporations is a primary cause of dependence on bank financing for expansion. It is a disturbing matter therefore that H.R. 13270 as passed by the House of Representtives would increase the overall tax burden on corporations by almost $5 billion.

As much as we want to get the current inflation under control, we don't want a new era of deflation with lagging growth and employment such as existed a decade ago. We are especially mindful that deflation would decrease the employment opportunities for marginal workers.

We therefore were most pleased to note the Administration's proposal for including in H.R. 13270 a one-percentage point cut in the corporate rate in 1871 and again in 1972. We do, however, recommend that the total cut be increased to three percentage points, or one and a half in each year.

CONCLUSION

In conclusion, may I note that, if long-term capital gains of individuals were broken out of the income tax system, many aspects of capital gains taxation which have proven troublesome through the years would fall into a rational pattern. Overall, an unsettled and controversial field of tax policy—a sort of breeding ground for reform proposals inimical to taxpayers—would become one with a firm philosophic base consistent with the nature of capital and transactions in capital assets.

In the field of income tax rates, moreover, H.R. 13270 offers the opportunity to make a beginning towards full-scale reform over the years.

We appreciate the opportunity to present the thinking of the Tax Council in these hearings, and we hope our thoughts and suggestions prove helpful to you in your deliberations on improving the tax law.

The CHAIRMAN. Mr. David Ehlers, president, Gibraltar Growth Fund.

STATEMENT OF DAVID EHLERS, PRESIDENT, GIBRALTAR GROWTH FUND, INC.

Mr. EHLERS. Mr. Chairman, gentlemen of the committe, my name is David Ehlers. I am engaged in the brokerage business in Fort Lauderdale, Fla., where we serve customers who invest substantial sums in equity securities. I am also president of the Gibraltar Growth Fund, Inc., an open end mutual fund with over 21,000 stockholders and investments in equity securities in excess of $75 million. I greatly appreciate the opportunity to appear before you today as a concerned citizen to testify against adoption of capital gains amendments contained in the Tax Reform Act of 1969 passed by the House of Representatives last month.

My statement is on file and I will limit my remarks to a summary of those contained in that statement.

I firmly believe that the changes in the capital gains tax structure as outlined in the bill will create a further shortage of investment capital, thereby compounding our inflationary problems, contributing to higher interest rates, further depress securities markets and ultimately the possibility of unemployment.

The act as by the House, fails to recognize and distinguish what I believe is a very significant difference between capital and income. The possessor of capital is not the captive of our system as is the recipient of income. The capital possessor has a number of alternatives to the taking of capital gains or to the utilization of his capital for risk taking purposes. To the extent that he invisions or sees our economic atmosphere as increasingly hostile to capital he will do something else with his funds.

There are many alternatives to risk taking. I believe that any step which tends to inhibit capital creative opportunities is decidedly not in the best long-term interests of the economy.

The needs of our economy are now well known, including, for example, answers to the problems of low-cost housing and the effective utilization of the economically underprivileged. The private sector cannot achieve these aims without the motivation to do so. That motive

in our economy is the profit motive. If we eliminate it or retard its potential, we also eliminate or retard the motive for its creation.

I believe that the practical effect of the amendment will be to discourage needed capital investment just at a time when such investment should be most encouraged. I believe that our domestic equity markets as a result would become less attractive, thereby inviting an outflow of investment moneys to foreign or other markets. To the extent that investable capital is eroded by the imposition of taxes and inflationary expansion of credit results, this problem as it exists today might be aggravated by the present proposal.

I further believe that the 12-month holding proposal will reduce to a dangerous extent the liquidity in our securities markets and that the long-term effect would be to reduce, not increase, revenues to the Federal Government. Should our markets become less liquid and less attractive, foreign investors would most likely find our markets also less attractive.

In 1968, foreign institutions and individuals purchased some $2.3 billion of our securities and greatly contributed to our balance-of-payments situation. If additional revenues from taxation of capital are imperative, I believe they might be raised through a kind of withholding tax on foreign investments.

Now, I am aware that we have certain tax treaties to stand by but nonetheless, wealthy foreigners, both institutions and private individuals, deal extensively in our markets, take advantage of our economic system, yet make no tax contribution to its maintenance. This is the equivalent of their using our schools and our highways and yet paying no taxes.

I believe that an imaginative capital gains tax policy could generate substantial amounts of new capital for our economy. For instance, a graduated capital gains structure with a downward hook at the end of the curve might be very beneficial for the economy. A progressive scale of taxation might reach a maximum rate at, say, $300,000 per year and thereafter incremental gains would be taxed at a regressive rate.

Another provision which would provide more risk capital for the economy would be one which would permit capital to be moved from one place to another without any taxation, say within a 6-month period, and incur no tax as is a similar provision for housing.

In summary, I feel that the capital gains provisions of the Tax Reform Act of 1969 are not in the best interests of the economy since they would discourage risk-taking, particularly at a time when such risk-taking should be encouraged, and moreover, would render our capital markets less liquid and less attractive, thereby inviting an outflow of both domestic and foreign capital. If anything, I would urge a program designed to render the movement of capital more flexible by less, not more taxation.

These steps, I believe, would best contribute to real economic growth, a goal we all seek.

Senator GORE. Thank you very much.

Questions?

Thank you, sir.

(David Ehler's prepared statement follows:)

STATEMENT OF DAVID EHLERS, PRESIDENT, GIBRALTAR GROWTH FUND, INCORPORATED

Mr. Chairman and Gentlemen of the Committee, my name is David O. Ehlers; I am engaged in the brokerage business in Fort Lauderdale, Florida, serving customers who invest very substantial sums in equity securities. I am also President of The Gibraltar Growth Fund, Inc., an open-end mutual fund with over 21,000 stockholders and investments in equity securities in excess of $75 million. I appreciate the opportunity to appear before you today as a concerned citizen to testify against adoption of capital gains amendments contained in the Tax Reform Act of 1969 passed by the House of Representatives last month.

Industrial, financial and governmental leaders have recognized and agreed for the past several years that a world-wide shortage of capital exists. The problem has not been corrected and all indications point to a worsening of the situation. This is true not only in the undeveloped nations of the world where it is so painfully obvious but in the industrialized countries as well, including our own United States, the most industrialized nation of all.

A clear indication of the shortage of capital in the United States is the present inflationary climate, including sharply rising interest rates, depressed securities markets, and increasing unemployment.

In the face of a serious shortage of capital and the accompanying alarming symptoms present in the economy today, the U.S. House of Representatives has included in the Tax Reform Act of 1969 amendments to the existing capital gains tax structure which can only have the effect of worsening the situation.

My purpose in appearing before you today is to make three basic points:

First, that the capital gains amendments adopted by the House do not make allowances for the significant difference between capital and income;

Second, that the amendments will discourage needed capital investment at a time when such investment should be encouraged; and

Third, that as a result of the proposed legislation, our domestic equity markets will become less attractive and less liquid, thereby inviting domestic capital to consider domestic or foreign alternatives and foreign capital to cease its recent flow toward the U.S., thereby aggravating our already serious balance of payments problems.

There is a direct relation between capital and progress. A dramatic example of this relationship within the memory of many living in this country today is the depression of the 1930's. During that period investment capital disappeared. Our economy was stagnant. Savings were not being channeled into development of new industry or enterprises.

Since World War II, there has been generally a greater recognition that a high rate of savings or investment is necessary to support a high rate of consumption; that the existence of one does not deny the other. Savings and consumption will both falter, of course, if there is not a steady expansion of credit and the supply of money. Credit and the money supply are expanded in our capitalist economy by savings being distributed through the nation's debt and equity markets. To the extent that investable capital is eroded by the imposition of taxes, an inflationary expansion of credit results.

The importance of capital investment to American industry can be suggested from Department of Commerce statistics published last month. During 1968 total expenditures for new plant and equipment were slightly more than $64 billion, while the total labor force on payrolls increased by about 2 million persons. This means that for each additional job created in 1968, industry had to spend about $31,000 in plant and equipment alone. Comparable figures for the more capital intensive manufacturing sector or our economy during the same period indicate an investment of about $79,000 for each new job. This high cost of creating new jobs emphasizes the large amount of capital necessary to sustain expansion of our industry and to employ our growing population.

The $64 billion needed to buy plant and equipment in 1968 came of course from a variety of sources, including bank loans and retained earnings as well as sale of securities. The Department of Commerce reports that in 1968 American corporations raised approximately $16 billion of this amount from the sale of securities or 25% of the plant and equipment expenditures. The figures also show that on a percentage basis, total sales of equity securities (common and preferred stocks) about doubled in 1968 over 1967, while sales of debt securities (bonds) declined 20%. Because of a number of complex factors, industry appears to be relying more and more on equity financing and less on debt securities. It seems obvious that any policy that will negatively affect the sale of

securities will jeopardize future plant and equipment expansion and the creation of new and better jobs for our increasing labor force.

It should be noted that the repeal of the investment credit contained in the Tax Refort Act will make less funds available internally to industry from profits. Thus, industry will become even more dependent on outside sources of capital. If outside sources are made less available, as I believe they will be because of the capital gains tax amendment, industry will have to curtail investment and will find whatever capital is available to be costly.

I heartily agree with a statement contained in the Wall Street Journal's September 8th "Review and Outlook" column:

"Thus Treasury Secretary Kennedy is quite right in telling the Senate Finance Committee that the House measure contains a bias against investment in favor of consumption. 'Such overweighting, embodied in the proposed treatment of capital gains as well as corporate tax increases, could impede economic growth in the years ahead by curtailing the incentive to make productive investments.'

"It is important, we think, to stress the long-term aspect here. If the economy is to maintain a much larger future population in conditions of reasonable well-being, a high degree of capital formation is absolutely essential. And intentionally or not, capital formation is one of the principal targets of the House bill."

Contrary to what apparently is assumed by many members of our national community, capital is not easy to create or to replace. It takes time, care and confidence to develop and nurture its increase. An increase in capital is very different from ordinary income earned from labor or sale of goods. True, it superficially looks the same. One may save by capital increase or save out of ordinary income. However, the increase in capital or gain "realized" when one asset is transferred for another really is not income at all. One "whole" has been exchanged for another "whole." When a person spends the increase in value he is really disposing of a part of his asset, not income. In short, there is nothing about a capital "gain" to distinguish it from the rest of the capital; the entire capital is equally as spendable or disposable.

This quality of capital gains distinguishes it from income. Since the inception of federal taxation of capital gains this distinction has been recognized by Congress as one justification for extending different tax treatment in this area than imposed in the area of ordinary income. The amendments now enacted by the House largely ignore this important distinction, seeking to tax the increase in value of an asset as if it were ordinary income. Not only does the House disregard this basic difference between capital gains and income, but also it has, in an effort to reform the tax structure, chosen to ignore another basic reason for offering so-called "special treatment" for capital gains that has been recognized by past Congresses, namely the necessity of encouraging capital investment.

I firmly believe that the amendments enacted by the House, in particular the repeal of the alternative capital gains tax and the lengthening of the holding period, will result in investors curtailing investments so that expansion of the economy through creation of new or expanded facilities will be sharply reduced. The effect of repealing the alternative tax rate and increasing the holding period for capital gains on exchange of property will be most damaging to our equity markets and, in my opinion, the federal government is bound to *lose*, not increase, revenue as a result of the inevitable decline in the attractiveness of U.S. security investments. I am sure it is not the intention of this Congress to kill the goose that lays the golden egg.

The expansion of the holding period from six months to one year will lessen the attractiveness of an investment in the first instance, and will further serve to postpone sale of securities that otherwise would be sold, reducing liquidity of the securities markets. The damage to be suffered in the securities markets from loss of liquidity will be much greater than any revenue benefits that the House apparently feels will arise from denying long-term capital gains treatment to assets sold in the period seven to twelve months after acquisition.

Wealthy investors account for a major portion of the capital provided in our economy. The present alternative capital gains tax—a maximum of 25% on net long-term capital gains as opposed to the imposition of a regular tax on 50% of net long-term capital gains—does benefit the wealthier members of our community; but more important it is the encouraging factor that spurs the wealthy investor on to make his capital available. If the repeal of the alternative tax as provided in the Act is retained, there is no doubt that transactions will be curtailed and that the capital of the wealthy will be less readily available.

Increasing the corporate maximum rate to 30% from 25% will have a similar adverse effect.

Other undesirable results can be expected from increasing taxes on capital gains. Possessors of large amounts of capital may be expected to shy away from common stocks, venture capital and other capital gains situations in favor of either taking capital abroad (perhaps even changing the domicile of the possessor) or deferring the realization of capital gains. It seems apparent that at the very least possessors of capital will, upon consideration of the burdensome taxes imposed, begin to look elsewhere than the organized domestic stock markets for investing their capital. I believe that investment funds in our free enterprise enconomy should be permitted to flow to the point where return is maximized, and should not be impeded by artificial tax considerations which will further aggravate capital shortages.

The Nation's already serious balance of payments problem may be worsened by passage of laws non-beneficial to holders of capital. In 1968, our balance of payments was greatly aided by an estimated $2.8 billion of U.S. securities purchased by foreigners.* After a number of years of decline, foreign confidence in U.S. common stocks is on the increase because of, for among other reasons, the substantial levels of foreign sales of American mutual funds. To the extent that our equity markets deteriorate in liquidity or atractiveness, foreign investors will look to other forms of and areas for investment. Thus, the significant inflow of foreign capital may well be expected to decline, thereby compounding the already unfortunate balance of payments problem.

CONCLUSION

I feel that the amendments to the existing capital gains tax structure adopted by the House in the Tax Reform Act ignore the difference between increase in value of capital and income, the need to encourage rather than discourage capital savings or investment, and the dangers to the economy and securities markets. While I have directed most of my remarks to the effect on securities markets of but two of many proposed amendments, it is my opinion that the amendments, as a whole, by increasing the tax burden on holders of capital or reducing their freedom of action will have serious negative consequences for all capital markets in this country.

Therefore, I respectfully urge the rejection of the capital gains amendments contained in the Tax Reform Act of 1969, and suggest instead that consideration be given to setting up a separate structure for taxation of increase or "gain" of capital, part from the income tax. This would give clear recognition to the distinction between capital increase and ordinary income, and would permit incentives needed to attract capital required to benefit the long range needs of our economy. Further, it would increase revenues to be colletced by the Federal Government, not only through sums realized by a capital gains tax but also through the tax revenue from the general increase in business activity that would result.

This might best be accomplished by progressive tax on capital gains at a rate lower than that applicable to ordinary income. At some point, say $300,000 of capital gains for the year, incremental gains would be taxed at a declining rate. While the decline might appear to be somewhat novel, I believe that it would permit possessors of substantial capital freedom and flexibility not now possible to channel great amounts of capital to points where new capital might otherwise not be available, so that new industries and jobs could be created for our growing population.

A further innovation might include taxation at the source of foreign investors' capital gains. Capital gains of foreigners currently are not taxed. By placing their capital in our economy, foreign investors are, in essence, utilizing the advantages of the most highly developed nation in the world without contributing to its support. In this respect, these foreign investors enjoy a free participation in the American economy not accorded our own citizens. In all fairness, foreign capital should be willing to bear a fair share of our tax on capital gains.

Thank you.

*Fortune Magazine, August 1969.

STATEMENT OF DR. HARLEY H. HINRICHS, ASSOCIATE PROFESSOR OF ECONOMICS, U.S. NAVAL ACADEMY AND LECTURER IN ECONOMICS, UNIVERSITY OF MARYLAND GRADUATE SCHOOL

Mr. HINRICHS. Mr. Chairman, I am Harley H. Hinrichs, Associate Professor of Economics at the U.S. Naval Academy and lecturer in economics at the University of Maryland Graduate School, and a member of the Educational Advisory Board of the National Tax Journal.

Now, Mr. Chairman, I presume that my short summary will be printed by the committee, so let me summarize it extemporaneously and focus on four areas which I do not think have been or will be covered by the other speakers.

Number 1, I think it should be clear to the committee that the capital gains area is by far the most important quantitative area for tax reform before the U.S. Congress this year. As you can see by the chart on page 3 of the summary, the treatment of capital gains is by far the most important reason why the average tax rate begins to fall after individuals earn $100,000 or more. So quantitatively, it is the most important source of inequity in our tax system.

Secondly, the magnitude involved as to the tax losses: as most professional economists and students of public finance would agree, because the fact that capital gains are seriously undertaxed, the magnitude of revenues lost will range up to $100 billion over the next generation. In fact, if capital gains were treated as ordinary income as they were between 1913 and 1921 and when there was a marginal tax rate as high as 77 percent, the U.S. tax system would generate $8.5 billion more in revenues. Furthermore, if the present loophole of not taxing capital gains at death were closed—and this loophole allows $20 to $25 billion worth of gains to escape through the tax net—this would generate approximately $3 billion. So, I am saying that you have before you an area worth $100 billion or more of revenues over the next generation.

Now, I know my friends from the stock exchange will always discuss the 100 million or more people affected by their holdings of stock but I think that some people may not realize that in fact some two-thirds of the gains, capital gains, on long-term security transactions are received by individuals with incomes above $25,000 and in fact, as you can see on the table which is on page 2, you have over 80 percent of the stock and the gains on that stock being held by some 4 million individuals according to statistics of the U.S. Treasury Department. So that in fact, what you have now is a system which allows some 4 million individuals to receive a very low tax burden on their capital transactions whereas on the other hand, you have the anomaly that the total tax burden, Federal, State, local, and social security taxes, on the income group from zero to $2,000 of income as measured by the Council of Economic Advisers is 44 percent which is a relatively shocking figure. I think this should be brought to the attention of the committee.

Senator GORE. What percent?

Mr. HINRICHS. Forty-four percent of the income of the income group from zero to $2,000 goes out in the form of Federal, State, local, and social security taxes.

Now, this, of course, is a fairly high percentage because the income base is very low but the point I am trying to make is that other income groups in society pay a fairly high share of total taxes on income whereas we have this flow of capital gains, about $20 to $25 billion being realized every year in terms of transactions, plus another $20 to $25 billion every year being transferred at death, and this total flow, $40 to $50 billion of capital gains, pays less than 10 percent as far as Federal taxation, which is about $4 billion or so which we pick up in terms of capital gains revenue.

Now, what are the alternatives? What are the possible solutions? I suggest really three solutions.

No. 1, you could in fact within a system of income averaging and by lowering the top rates down to 50 percent or even below, you could include capital gains as ordinary income. This would enormously simplify the tax system as well as H.R. 13270 and it could be supported on grounds of both equity and economic growth.

The economic growth and capital mobility argument is used often as a bogeyman to reject any taxation on capital gains whatsoever. This is simply not true, at least on the basis of any scientific studies that have been made, and by the way, I do not regard the interview study done by Merrill, Lynch, Pierce, Fenner, & Smith as to be the epitome of scientific research because obviously, in an interview study when you ask the people what they would do if you raise or lower their income tax I imagine few would say they are going to buy more stocks if you raise the tax on stocks, but if you look at the actual number involved you find different things.

The second point is that there are strong equity grounds and economic grounds for having a holding period of 12 months. Indeed, the holding period was at 2 years between 1922 and 1934, then it shifted down in a graduated system to 12 months and then back to 18 months until 1942. So, there is strong precedent here in the United States and elsewhere for a holding period of 12 months.

In the analysis done at the Treasury, the effects on transactions would be, of course, to lower transactions slightly which means you lower transactions by about 1 percent, whereas as we know, in the New York Stock Exchange itself, transactions have increased by 100 percent over the last 5 years alone. So, therefore, I do not think there will be imminent collapse of the American economic system if the holding period were moved to 12 months which is the holding period we as wage earners and others have, and I think it would be only fair if those in capital gains would receive the same holding period.

Thirdly, the most important thing that could be done would be to close the $20 to $25 billion loophole of letting this amount of capital gains escape at death. This would generate approximately $3 billion and should in fact be supported by the financial community because the only serious lock-in effect, would be by those individuals who would hold onto their assets so they would pass them on to their heirs. In fact, this would be supported from the economic growth point of view on the grounds that the heirs of these 4 million who once more have 80 percent of the security gains locked up, might in fact be encouraged to work a little bit more if they received less in their inheritances. So that on that ground the increase in capital mobility

from eliminating this loophole at death might stimulate both stock transactions and economic growth.

If there is any time left, I would like to save it for any questions. All I am saying is unless this committee does something in this area the American public will be had to the tune of $100 billion over the next generation.

Thank you.

Senator ANDERSON. Any questions?

Senator BENNETT. I have no questions.

Senator GORE. By what rule of logic or social justice would you hold that a person making a profit of $10,000 in the stock market next year should pay at a lower rate than one who made $10,000 working with his hands or his mind?

Mr. HINRICHS. If anything, the system should be the other way around as in the Anglo-Saxon tradition of giving a lower rate to so-called earned income as in fact is done in most of the systems of the world where unearned income pays a higher tax rate.

In the United States we have been doing that slightly upside down in the sense of wage earners usually paying a higher rate than so-called unearned income, such as capital gains income and dividend income. And I might add capital gains in the United States were treated as ordinary income between 1913 and 1921.

In a sense, if I can continue with the philosophy of capital gains taxation, there seems to be a great misunderstanding as to the change in both the public finance theory and in the facts surrounding capital gains. Before it was assumed in the old British system that you always tax the fruit of the tree but you never touch the tree or, if I can mix a metaphor, this would kill the goose that lays the golden egg or the tree that sprouts the golden apple, whichever the case may be.

Senator GORE. Golden Delicious apple.

Mr. HINRICHS. Right. And the point being that now you have in fact people with some wealth who no longer are fruit-pickers. They are tree-growers for a living. Over half of the income of those with incomes above $100,000 flows from caiptal gains basically on an every year sort of thing. So, it is not the special nonrecurring windfall gain that goes to the widow. This is primarily a flow of income to those in the upper income categories. It is why, as Senator Long pointed out in New Orleans back in 1965 to the convention of the National Tax Association, you have this severe horizontal inequity among the upper income groups. And the way to eliminate that is to simply classify capital gains as ordinary income because for most people it is ordinary income and that in conjunction with income averaging and in conjunction with the top rate for everybody at no more tha 40, 45, 50 percent, you gain revenue and you simplify the law and you eliminate this enormous inequity which we have today.

Senator GORE. If Congress should think it wise and just and equitable to give a preference to earned income over unearned income, would you have it begin with lower brackets, top brackets or all brackets?

Mr. HINRICHS. Well, it seems obvious to me that if you would give you any preferences, you would start with the lower bracket based on their ability to pay and you would support such things as the Administration has in terms of a low income allowance. Possibly

another way to support such a philosophy would be to shift your deductions or your exemptions of $600 into specific tax credits.

You see, this way in a sense you will provide more of an exclusion from taxation for those who are at a subsistence level because now, of course, the $600 deduction means $420 in savings to the man in the 70 percent bracket but only means $84 in actual cash savings to the fellow who is in the 14 percent bracket.

Senator GORE. You are aware, I take it, that the administration has recommended that a preference be given to so-called earned income in the higher brackets while reducing——

Mr. HINRICHS. It seems to me that this necessarily complicates things and as this whole H.R. 13270, as pointed out by the Chairman, is a horribly complex measure. Now, if you want to simplify it and you would eliminate the need for any preference for earned income at all if you would shift into a combination of capital gains taxed as ordinary income. Then all ordinary income regardless of the source would be taxed at a much lower, more reasonable rate schedule going up to maybe only 40 or 45 percent for everybody without any exceptions for any class of income.

Senator GORE. Would it seem surprising to you that in a democratic society, in one 5-year period, the progressivity in the Federal income tax will be all but abolished by reducing the top bracket from 91 percent in 1964 to 50 percent in 1969?

Mr. HINRICHS. Actually, that has affected the progressivity of the system very little because virtually nobody pays those high rates. Only a few really are involved in those rate categories. What you have done in essence is to provide, as Senator Long has pointed out earlier, some equal taxation for the rich which they should have as well as equal taxation for the poor. Now, the point I am focusing on——

Senator GORE. What do you mean?

Mr. HINRICHS. The rich should be taxed more equally than the poor. So because of this, I think it is almost irrelevant what the rate is above 50 percent because the wealthy have never paid it substantially. The average tax rate——

Senator GORE. Well, that is no justification for it.

Mr. HINRICHS. It is a justification——

Senator GORE. The fact that there are loopholes by which the wealthy can avoid paying the prescribed rate, is no justification for eliminating progressivity.

Mr. HINRICHS. It is a justification to a degree that a law is a bad law if you cannot enforce it and I as a liberal would rather have a law that has a top rate of 40 or 50 percent which can be enforced rather than have a maximum 25-percent rate on capital gains for those transactions during a person's lifetime. This is much lower than, let us say, the average wage earner. As Philip Stern said, you Senators may be paying in the 40- and 50-percent bracket which is not fair to you. Why should you pay in the 40- to 50-percent area when Philip Stern or John D. Rockefeller pays 25-percent or less?

Senator GORE. I think one of the Rockefellers testified before the Ways and Means Committee that he never enjoyed any income tax liability.

Mr. HINRICHS. As I recall, he pointed out he would be happy to

give, just in a noble spirit, something like 5 percent a year to the Federal Government.

Senator GORE. He did not say 5 percent of what.

Well, if this bill should be passed in the form recommended by the administration, take two men as an example. Taxpayer A with a wife and two children and an earned income of $10,000 a year will receive a tax reduction by this bill of $57. His cost of living has increased more than that in the last 3 months. This same proposal would give to taxpayer B, the highest paid corporate executive of last year, with an earned income of $795,000, a tax reduction of $116,000. This is proposed in a so-called democratic society.

What would be your reaction to that?

Mr. HINRICHS. Based on those premises you are absolutely right if that were the only choice.

Senator GORE. I am right about what?

Mr. HINRICHS. You are right in that you obviously should not give more to those who have than those who have not. But that is not the only alternative. If you give such a substantial reduction to the upper income group, you take away, as in the Noxon proposal, $1.6 billion from the lower income group. Oddly enough this adds up to $1.6 billion from the income groups from zero to $10,000 and this would be the amount which would flow to the reduction of the corporate income tax. And so I am saying if that were the only alternative I would agree with you completely, but I am saying it is not the only alternative.

The way to make a substantial breakthrough, especially in other areas such as simplifying the tax law, is to move into the capital gains area, in terms of the 12-month holding period, in terms of taxing gains at death which is good for $3 billion a year, and in terms of the ultimate reform to simplify it. This would be with lower rates for everybody including the poor as well as the rich by including capital gains as ordinary income. As Sheldon Cohen told me the other day, you would simplify the tax code like this. I do not know whether you can put that on your machine.

The CHAIRMAN. Push it together like an accordian, you mean.

Mr. HINRICH. Yes.

Senator GORE. Since you and I are establishing such an affinity, perhaps I will venture to ask you if you would also say that I am right in suggesting that the most equitable tax reduction is to leave the rates as they are and raise the personal exemption so as to give the most tax relief to the man in greatest need of it that is the man with children to feed, clothe, and educate.

Mr. HINRICHS. Essentially, this would be true if you change the exemption from a deduction to a tax credit and then eventually as——

Senator GORE. Tax credit is not worth too much for the fellow——

Mr. HINRICHS. As I mentioned before, a $600 deduction, if you double this, then you simply create huge revenue losses, the major beneficiaries being the middle and upper middle classes, whereby it would help lower income groups more if you change the $600 deduction, as the Kennedy administration suggested in 1963 for older folks, to, let us say, a $150 or more tax credit. In fact to provide a stimulus in conjunction with the Nixon welfare program rather than give the tax credit back as a negative income tax for poor groups, you could

provide some carry-forward of these tax credits to future years so that you have a zero marginal tax bracket for those who become employed and are job trained and move up the income ladder.

Now, this would make much more sense than simply doubling the standard deduction from $600 to $1,200, for example. So, I am saying if you want to give back money, give it in terms of dollars rather than deductions from the income tax base which benefits the rich at $70 a 100 and the poor only $14 a 100.

Senator GORE. Thank you.

The CHAIRMAN. Mr. Hinrichs, I regret I did not hear the first part of your testimony. I was called from the room temporarily and I came in in the middle of this interesting colloquy between you and Senator Gore. I was so intrigued by the fact that you seem to agree with some of my views that I find myself agreeing with some of your views.

Talking about the general theory of how you ought to go about trying to finance this Government, it seems to me that we ought to start out by recognizing, (a), we cannot do it all with an income tax. I wish we could. I see you are nodding. You agree?

Mr. HINRICHS. Right.

The CHAIRMAN. But we can do a lot of it with an income tax. We can get a lot of money out of income taxes and we do.

Now, trying to figure what is the maximum we can do and how we can do it most equitably, I think we have to arrive at a second conclusion. I arrived at it reluctantly. We just cannot get any huge amount of money through an income tax, by getting it all out of the rich. I wish we could but unfortunately, there are just not that many of them, so then we have to think in terms of taxing somebody else. We have to reach down and tax the middle class and those people are really the ones who are carrying the big burden of this Government. I am sure you know that. And while we do not collect as much out of each one as we do from the rich, we have so many more prospects to work on there that we get a lot of money out of middle income brackets.

Then we proceed to reach down and get what we think we can afford equitably and fairly from the poor and there one can make a case that here are some poor people paying an income tax where perhaps we should be giving them a welfare tax rather than extracting an income tax check from them. I understand all of that.

Now, logically, one would think that the fair way to do this would be to determine about how much of this revenue you want to raise out of each class of taxpayers by income brackets, and having done that, you then try to see how much you can get and you try to write a law that will treat all people fairly and equally insofar as possible.

Now, when you look at the upper bracket payers, I think you are right. When you say that if you go beyond the 50 percent tax rate and the Government starts taking more than half of a man's income, you provide that man with so many reasons why he should not subject himself to that tax—either by not making an investment or by doing something which he can do such as making a charitable contribution to his own foundation—that you just do not get the money you are hoping to get. The result is that you look at the frustrating experience of the 90 percent rate and the frustrating experience of the 77 percent rate by just bringing in the tax returns and finding that

the people you are trying to tax are not paying anything near what the rates of taxation would indicate.

Now, I would think that if we work on the principle of trying to tax a large income, less exceptions, less exemptions—I am not talking about the personal exemptions, that is available to all and I agree with that—but as we take away advantages from some, we should try to give those advantages to that poor fish who really is actually paying at that rate with the result that you then put everybody in the position that they pay some reasonable amount of taxes, hopefully a large amount if they are rich and they have the incentive to go ahead and do business.

Do you agree when you go above the 50 percent bracket, you are reaching toward the point of diminishing returns?

Mr. HINRICHS. It seems to me and to most people in the public finance area that you are reaching after shadows when you get above 50 percent, on two grounds.

No. 1, I think for many people it would seem basically fair not to take more than half of a person's income.

Secondly, usually the wealthy can find loopholes faster than the Internal Revenue Service or the Treasury can close loopholes. So, what you do is end up with an unfair, unenforceable system once you go above 50 percent. But even though most of the money is in what you would call the middle class, I would not simply ignore the upper middle class and the rich class because as in table 2, the total assets of the so-called top wealth group, that is the one which files Federal estate taxes upon death, that this group of 4 million individuals with gross assets of above $60,000, has in fact a total body of assets of over $1,000 billion, which is $1 trillion, and in that you have approximately $400 billion worth of capital gains. Now even a 1-percent net wealth tax would generate $10 billion and you would find in fact a fiscal dividend which would not be as evanescent as a cloud above San Clemente.

The CHAIRMAN. Well, my father thought that that kind of tax would be a good idea. He got in trouble advocating that.

Mr. HINRICHS. Basically, you would have the last adverse economic growth effects from that because when you tax wealth as such, you give the gentleman an incentive to work harder so he can pay his tax bill rather than as now you give him a free ride. So, I am saying there is wealth above the category of, let us say, $50,000 of income. The people really losing today in a relative sense are the young rising middle class entrepreneurial groups from $15,000 to $50,000 who pay very high taxes relative to other groups in our society. And so, I think you still can get something from the group with incomes above $50,000 because as we have seen from the chart, their average tax rates do fall and their average rates run at only about 30 percent a year. If you raise it up to 45 percent, truly nobody is going to starve and yet you could generate by these two capital gains proposals I mentioned, as much as $5 to $10 to $15 billion a year.

So, there is money available and if you take it away from the low-income people to give it to corporations as under the Nixon plan, you may not have the most equitable of all worlds.

The CHAIRMAN. It just seems to me we ought to recognize at some point you reach the point of diminishing returns and that there is

nothing to be served by doing that. Once you have reached that point, even though you may find it unkind and might not like the idea of having some millionaire make enough money to where after taxes he can keep $3 or $4 or $5 million, if what you are doing is trying to raise money and you have put the taxes so heavy that you are getting less rather than more, then you ought to think in terms of finding a better way to raise revenue.

I think that you and I are pretty much in agreement that that is about the way we ought to handle that point, I think.

Mr. HINRICHS. Yes. Along with that same point I think you would probably also favor certain ideas which have been circulated by, in a sense, both the left and the right, from people like Earl Rolf, or Jack Stockfisch or Norman Ture, who would say that probably the simpler system would be to have a simple proportional tax rate, say 30 percent for everybody, but then you would have very high personal exemptions combined with even a negative income tax so that you have increasing average rates for everybody but the same marginal rate, so you do not have any disincentive effects and this rate would apply to not only capital gains but also corporations and individuals. You would eliminate the great travesty we have now upon both justice and simplicity by a great melange of rates which confuses everybody and at the same time allows John Paul Getty to pay only $500 a year in income taxes.

Senator FANNIN. At that point, do you agree that one of the most serious problems facing us today is our ability to compete with foreign industries?

Mr. HINRICHS. Yes, This is true. This is true.

Senator FANNIN. We are talking in theory. Of course, it is all right in theory to come to some conclusions just as you came to the conclusion that going from 6 to 18 months—I think you said—would lower the transaction by only 1 percent.

Mr. HINRICHS. Yes. This is basically according to looking at the statistics as to the distribution of the gain realizations and transactions over time. In other words, there is a slight increase in transactions after the 6-month holding period but it is relatively minor compared to the total amount of transactions.

Senator FANNIN. But you are reading people's minds, I think, when you come to that conclusion because you do not know what attitude they might take.

Mr. HINRICHS. No. I am looking at the distribution of securities realizations and you find that, No. 1, there is a slight hump of realizations after 6 months, so we know that some people do hold for 6 months obviously, and we also know, as in an article in the National Tax Journal which I wrote, that it is primarily those in income brackets above $100,000 who are holding for that period because at that point, you see, it is to their advantage. Why should anybody pay at that point 91 percent or now 77 percent if he can hold for another month and only pay 25 percent?

Senator FANNIN. But certainly from the standpoint of the number that would still stay in the investment group, when they change from the 6-month period to the 12-month period——

Mr. HINRICHS. Those surveys were primarily bought and paid for by either the New York Stock Exchange in the earlier Louis Harris

survey back in 1963 or the recent survey by Merrill Lynch, Pierce, Fenner & Smith and those surveys are nonscientific. You do not find out what happens in the real world by asking people what they would do in the future.

Senator FANNIN. But you are coming to a conclusion but you do not accept their conclusions.

Mr. HINRICHS. No. I am looking at the facts of what real people did in fact in the real world.

Senator FANNIN. They are talking to real people. You are not.

Mr. HINRICHS. I am talking about people who put their cash where their mouth was and looked at when they bought and sold stocks.

Senator FANNIN. We are in disagreement. There is no point in arguing about it but I think the surveys certainly should be given some attention.

Mr. HINRICHS. Of course, they should be and it is possible——

Senator FANNIN. Some reliable concerns.

Mr. HINRICHS. Nobody knows all the answers. They could be right: I could be wrong but I am saying that most scholars who have looked at this question would seriously discount the legitimacy of such.

Senator FANNIN. One is a theoretical conclusion, the other is practical, brought about by direct contact, but in any event let us go to the next thing.

You talked about what would be done as far as capital gains are concerned. Here we are. We are talking about the foreign competition. Canada does not have capital gains tax and they feel this provides greater amounts of investment capital. We know that in many of the European countries, certainly in Great Britain, we have seen an incentive program promulgated on the idea of not having the high capital gains tax and still you are talking about the taxing capital gains the same as you do just ordinary income.

Mr. HINRICHS. No. 1, for many people it is ordinary income as I mentioned the treegrowers versus the fruitpickers of long ago.

No. 2, there is no statistical correlation between capital gains taxation and economic growth rates. In Great Britain there was no capital gains taxation until the early fifties and Britain certainly was no paragon of economic growth in the first half of this century.

Thirdly, we have had a faster growth rate in the last 8 years than Canada. So, there is no statistical relationship between the capital gains rates and the growth rate of a country, especially when our capital gains rates merely get people into the Broadway theater, into dry holes, into raising prize bulls and racehorses.

Senator FANNIN. I think you are getting a little ridiculous. The incentive system has been brought about to a great extent by the capital made available through capital gains. I do not think we can discount that.

Mr. HINRICHS. I think essentially capital comes from the use of capital and not the trading of secondhand paper on the New York Stock Exchange. It comes from entrepreneurs who are making investments, from discoveries, innovators, inventors, plus workers.

Senator FANNIN. You get down to the small business level and look at what has been involved over the years and, if following your theory, under present-day consideration you say that a firm was worth a million dollars 10 years ago and today they sell for $2 million and you

would take the revenue that has been produced therebetween there and then take off the inflationary trend, that this is taking care of a great deal of it, then where do you stand? You are really invading capital, are you not?

Mr. HINRICHS. No. The point is that everyone else is subject to inflation. If I were working, let us say, 10 years ago for $5,000, now I make $10,000, I may be in a higher income tax bracket. Nobody gives me a rebate for inflation; so, therefore, why should capital in a sense be protected from inflation when nobody else is?

Senator FANNIN. But you were paying accordingly for your purchases 10 years ago.

Mr. HINRICHS. Now my purchases are twice as much.

Senator FANNIN. But the man who had a business that has increased in value, supposedly the sale price, but as far as his purchasing today as compared to 10 years ago it is not in that relationship.

Mr. HINRICHS. Except the way it works out once more is that you come to the ultimate question would a change in capital gains rates affect either capital mobility or economic growth and there is no certain answer that it would destroy the economy. As in other countries, economic growth is really a function of other things. If we wanted to speed up economic growth you would put back the investment tax credit. I mean, if that is what you wanted. Now, we do not really want the great capital goods explosion. We want to fight inflation now. So, therefore, you are wise to, of course, repeal the investment tax credit, but I am saying that it all depends on what you want.

Now, the only question gets down to is it fair for the average income tax rate to fall once you get over $100,000 worth of income? Is it fair to tax the working man with income from $5,000 to $50,000 more than to tax the individual who may not be working at all but may be buying and selling paper?

Senator FANNIN. Of course, now, I certainly agree from the standpoint of preference to earned income. We are not arguing that point, but we are, I think, in a different position as far as providing jobs is concerned, and I am thinking about our ability to compete with other industries in foreign countries. When we realize what is happening now, the automotive industry is one, we are now an importer as far as our balance is concerned in the automotive industry, with our electronic industry, and many others. So, I am talking about jobs in the future and talking about the way we can provide investment capital to make us more competitive and this is what worries me and it does not seem to concern you.

Mr. HINRICHS. Well, I certainly sympathize with your goal of economic growth. I am saying it depends on what you want. Now it was my feeling that the country is moving toward a reordering of social priorities whereby more investment was needed in urban development or in maybe State and local public facilities, in social infrastructure, in housing, in the private sector, and the way to get money there is to in a sense remove money from the corporate sector.

Senator FANNIN. But this money is coming from private industry, and because of the advantages that have accrued in these different areas you are talking about and the improvements that have come about. Employment of more people has come about from private in-

dustry. We hear expressions every day from Government that this must be done by private industry.

Mr. HINRICHS. It is also said that the public sector seems to be somewhat starved for funds or at least is looking for a fiscal dividend to invest in certain areas. So, I am saying that the capital is there and will be fully employed with wise Government policies. So, it is a question of where you want to spend it.

Senator FANNIN. You say the capital is there. Where is it now for the small businessman, at SPA? We are trying every way we can to provide sufficient capital and we have not been able to do so.

Mr. HINRICHS. And what is the reason for that?

Senator FANNIN. Well, I think one reason is because of the increased taxation.

Mr. HINRICHS. Oh, the taxation has relatively——

Senator FANNIN. What we are talking about now is increasing your own capital gains. We are moving in an additional amount of capital investment that would be available.

Mr. HINRICHS. But the real capital is in terms of machines, buildings, amount of work and all this capital would still be there. It is a question of where it is employed. I am saying it is the Government and the people who want to reorder these priorities and put more into housing.

Senator FANNIN. You said it could still be there but still I know Secretary Kennedy although he is very much for removing the investment tax credit, did state that we must provide some sort of a tax system that will give incentive for modernization of our plants and equipment so we can compete with other countries of the world.

No further questions, Mr. Chairman.

The CHAIRMAN. Thank you very much, sir.

(Dr. Hinrichs' prepared statement follows:)

REFORMING CAPITAL GAINS: THE $100 BILLION MISUNDERSTANDING

(By Dr. Harley H. Hinrichs *)

SUMMARY

1. Professional economists and students of public finance generally agree that the capital gains provisions of H.R. 13270 are an improvement over existing tax law. The Treasury proposals are not.

2. Further significant improvement can be made:

(a) Treating capital gains as ordinary income in the context of income averaging and lower top rates (to 50% or below) would be the most significant tax reform that the Senate could accomplish. This would:

Generate up to $8.5 billion in new revenues making other reductions and reforms possible.

Enormously simplify the tax code (and H.R. 13270).

Advance both equity and economic growth.

(b) Closing the $3 billion loophole of allowing $20 billion in capital gains annually to escape taxation by transfer at death would eliminate the present reward of of a tax-free step-up in basis. This would:

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—Unlock capital now frozen in anticipation of the tax-free transfer at death. The financial community would serve its best interest by promoting such a reform. Furthermore, this reform combined with the House-passed 12-months holding period would increase capital mobility and improve the allocation of resources. Indeed the Treasury recommended it in 1963.

—greatly improve the equity of the tax system and at the same time generate up to $15 billion between 1970 and 1975. As a minimum start capital gains accrued after January 1, 1970, can be included; better yet, past gains (some $400 billion in gains outstanding held by some 4 million top wealth-holders) represent a potential federal revenue flow of nearly $100 billion which should not be allowed to escape over the next generation.

BASIC DATA SUMMARY FOR CONSTRUCTIVE REALIZATION OF CAPITAL GAINS AT DEATH

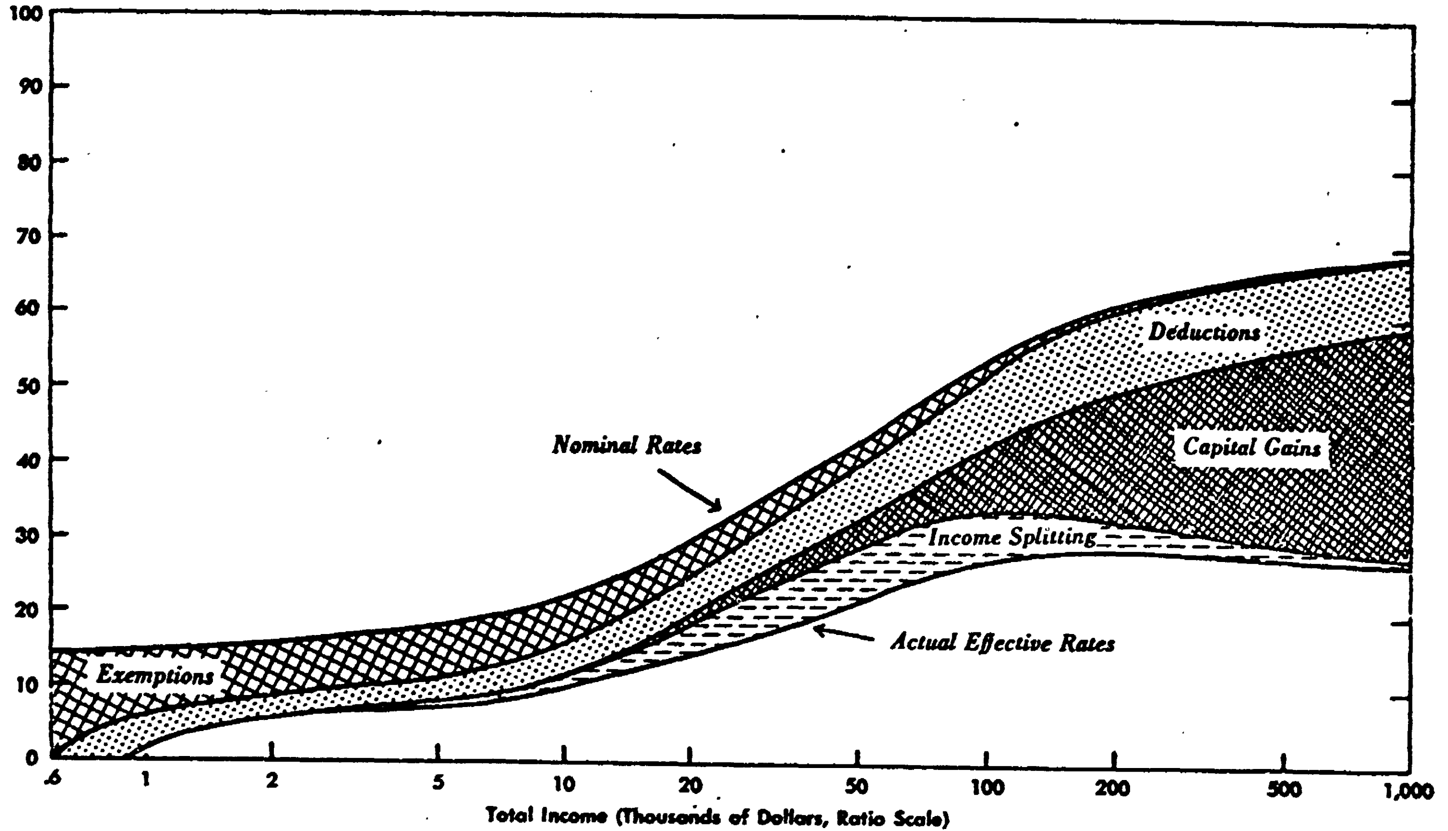
[In billions of dollars]

Appreciable assets	Individual wealth			Decedents' wealth			Decedents' unrealized capital gain		
	Total	Top [1]	Other	Total	Top	Other	Total	Top	Other
1953:									
Real estate	442.6	70.1	372.5	9.757	1.552	8.205	4.545	0.853	3.692
Stock [2]	127.2	105.7	21.5	3.487	2.983	.504	1.463	1.312	.151
Noncorporate equity	187.4	20.0	167.4	4.498	.480	4.018	1.397	.192	1.205
Total	757.2	195.8	561.4	17.742	5.015	12.727	7.405	2.357	5.048
1958:									
Real estate	633.3	114.0	519.3	13,934	2,509	11.425	6.521	1.380	5.141
Stock	252.0	216.7	35.3	5.797	4.985	.812	2.437	2.193	.244
Noncorporate equity	243.8	31.7	212.1	5.850	.760	5.090	2.059	.304	1.755
Total	1,129.1	362.4	766.7	25.581	8.254	17.327	11.017	3.877	7.140
1963:									
Real estate	800.0	160.0	640.0	17.600	3.520	14.080	7.390	1.760	5.630
Stock	400.0	350.0	50.0	9.200	8.050	1.150	3.890	3.540	.350
Noncorporate equity	300.0	45.0	255.0	7.200	1.080	6.120	2.270	.430	1.840
Total	1,500.0	555.0	945.0	34.000	12.650	21.350	13.550	5.730	7.820
1968:									
Real estate	1,300.0	250.0	1,050.0	28.600	5.500	23.100	12.490	2.750	9.740
Stock	580.0	500.0	80.0	13.300	11.500	1.800	6.470	5.750	.720
Noncorporate equity	500.0	100.0	400.0	12.000	2.400	9.600	5.040	1.200	3.840
Total	2,380.0	850.0	1,530.0	53,900	19,400	34.500	24.000	9.700	14.300

[1] Gross estate tax filers (assets over $60,000).
[2] Stock held by individuals but excluding personal trust fund held stock.

Source: Harley H. Hinrichs, Center for Political Research; estimates for 1953–63 originally prepared for the Office of Tax Analysis and these Hinrichs estimates are published with their methodology in Martin David, "Alternative Approaches to Capital Gains Taxation," Brookings Institute, 1968, p. 100.

FIGURE 4-4. Erosion of Statutory Bracket Tax Rates Through Various Provisions of the Individual Income Tax, 1964 Act[a]



Source: Joseph A. Pechman, *Federal Tax Policy* (Brookings Institution, 1966), p. 66.

[a] Based on 1962 incomes, with rates applicable beginning Jan. 1, 1965.

STATEMENT OF THOMAS L. WATERBURY, PROFESSOR OF LAW, UNIVERSITY OF MINNESOTA

Mr. WATERBURY. Mr. Chairman, I am Thomas Waterbury, University of Minnesota Law Faculty. I am here to urge the amendment of the House bill to provide for realization of the gains tax upon a gratuitous transfer of property, inter vivos or at death on a comprehensive basis.

The general topic of realization at death has come up this morning. It was brought up by two other witnesses, Mr. Bixler and Mr. Hinrichs. I have submitted a statement which outlines the problem in specific terms, that is to say, states the principal sections of the tax law that would be affected by this chance. One is section 1014, which now provides for a new basis for appreciated assets held until death. There are some exceptions to that but they may be ignored for present purposes.

The practical effect of this, I take it, is clear. A person buys a stock for $10,000, holds it over a period of time until it achieves a value of $50,000, and dies. His successor to the stock will acquire a Federal income tax basis of $50,000 which means that the successor may sell the stock without paying gains tax.

My recommendation to the committee also extends to the realization of unrealized gains in the event of an inter vivos gift. Here the present law is different. The section principally involved is 1015. Since 1920, this section, and its predecessors have provided that the donor's basis carries over to the donee. Illustratively, going back to my hypothetical, if the man bought the stock for $10,000, held it until it appreciated to $30,000 and gave it to a child, the child would receive it at a basis of $10,000 and if the child then sold it, the child would pay the gains tax on the $20,000 of appreciation.

This is commonly referred to as a carry-over basis rule in contrast to the foregiveness at death rule of section 1014.

I suggest that the practical effect of the carry-over basis rule may not be very different than that of the forgiveness at death rule in particular cases, however. For instance, the donee still has to sell the asset to realize a gain. If the donee retains the asset until he dies, the gains tax will be forgiven. Or if the donee is a trustee, he may continue to hold it for the duration of the trust and a private trust in this country may endure for a very long period of time. So, it is not inconceivable that an asset which was regarded as a durably satisfactory investment could remain in trust in its appreciated status for 100 years and be distributed ultimately to the beneficiaries of the trust. The distribution would not be a taxable event, and the gains tax would not then be collected until the distributees chose to sell, or died and achieved gains tax forgiveness.

Senator WILLIAMS. How would you relate that with the inheritance tax? They both come due at death.

Mr. WATERBURY. Yes. Well, I suppose I would relate it in this way, sir. I would say that it is different because people who realize their gains during their lives or people who earn some other kind of income which is realized during their lives have to pay an income tax on their

gains and what, if anything, they have to transmit to beneficiaries when they die is what is left over after the income tax is paid.

Senator WILLIAMS. As I understand it, you are suggesting that you eliminate the capital gains foregiveness at death.

Mr. WATERBURY. Right.

Senator WILLIAMS. Now, if a man leaves an estate, you are charging the capital gains first and then would your inheritance tax come on the remainder?

Mr. WATERBURY. Exactly. The Kennedy administration's realization at death bill which was brought to the Ways and Means Committee in 1963 proposed a deduction on the estate tax return for the amount of gains tax realized at death.

Senator WILLIAMS. Now, in gifts to universities, are you suggesting that anybody who gives an appreciated stock or appreciated value of a gift to the university, that they should pay the regular tax on the appreciation before they give it or how would you explain that?

Mr. WATERBURY. You can accuse me of cowardice, because I work for a university that would like some endowments, but seriously, that is a different issue and I do not speak to it.

Senator WILLIAMS. No. They are the same issue. We are talking about capital gains and appreciated stocks.

Mr. WATERBURY. Then let me state why I think it is different.

Senator WILLIAMS. I understood you to say that a man could make a gift and get the advantage of the full market value of the gift and I thought you were criticizing that. Now, the suggestion has been made to charge him some tax, and I am asking you were you recommending that those who make gifts to universities pay tax on the appreciated value of the gift at the time they make the gift?

Mr. WATERBURY. My answer is "No," I do not recommend it and I do not oppose it, either. I put it to one side and here is why.

Senator WILLIAMS. We have to either recognize or——

Mr. WATERBURY. I understand that.

Senator WILLIAMS. I would like to have the benefit of your opinion because in your position I recognize you as an authority.

Mr. WATERBURY. I take it that——

Senator WILLIAMS. I am sure in your classes you insist on an answer.

Mr. WATERBURY. Very good.

Senator WILLIAMS. And I would really welcome an answer.

Mr. WATERBURY. Good. Let me give you one that will take a couple of minutes to lay out.

Senator WILLIAMS. Take your time.

Mr. WATERBURY. As I see it, the realization at death issue is in this posture. I think the Congress has legislative discretion here, within the Constitution, to amend the income tax law in the way that I suggest. I have an article that was published a couple of years ago that went into that at length. I have some reprints for the Finance Committee staff if they are interested.

I also think that as a matter of legislative drafting you could provide for this without any more difficulty than has been encountered in drafting other provisions in the code. So, I do not think that that is a serious problem.

I mention that because the Ways and Means Committee had some trouble at the drafting level in 1963 according to one of their releases.

I also do not think that this is fundamentally a problem in economics. That is to say—let me back up. I think it is a problem of legislative policy.

All right. What are the legislative policy considerations? There has been a good deal of discussion this morning about the capital needs of the economy. I am certainly for capital in the economy. I am also for the accumulation of wealth. I teach wills, trusts, estate planning, and related courses in the law school, so I make my living by worrying about the problems of people who succeed in accumulating some. I did investigate the economic aspects of this problem in the article I referred to and it seems to me that the importance of economic factors is relatively minor. So, I do not think that economic factors ought to be regarded as decisive by the Congress.

So what else is there? In the case of gifts to charity, the legislative policy considerations are what kinds of charities do you want to subsidize and how do you want to go about doing it?

Now, I am not an authority on charities. I teach trusts, so I know something about charitable trusts. But I am not an authority on charities. And I know that a great deal of charitable endowment does stem from gifts to charity by people of great wealth. And so I know that there is a substantial interest on the part of various charitable organizations in retaining that source of endowment.

I would think on the basis of my analysis of the noncharitable transactions that you ought to realize gains in the case of a gift to charity too. But after all, the Kennedy administration did not recommend it. The Kennedy administration recommended that there not be realization in the case of transfers to charity.

I am saying even if you conclude that you ought not to do it in that case, I think that there is a clear case and a strong one for doing so in the case of noncharitable gifts and that is simply this. Statistically it is perfectly clear the primary beneficiaries of private wealth that is transferred by gift or at death, exclusive of transfers to charity are the families of the people who transfer the wealth. And I think that the indefensible thing about gains tax forgiveness at death is simply this. If you exempt a lot of capital gains altogether from tax, the effect is a subsidy to the inheritance of property. I am certainly not against the inheritance of property. I make my living from it. But it does not seem to me that we can justify an exemption from gains taxation as a subsidy to the inheritance of property when we tax, as has been pointed out repeatedly here this morning, relatively modest personal service incomes that are required to provide a reasonably adequate level of family maintenance, and at a substantial rate.

That is it.

Senator WILLIAMS. That is an excellent answer and I understand your position as far as estates are concerned but perhaps it is my confused mind. Did you or did you not recommend that gifts to universities be taxed on the unrealized income by the recipients at the regular rate or at any rate at the time of the gift, and also in the event that a man in his estate wills a substantial bloc of stock to the universities, should that be taxed at capital gains rate or at regular rates prior to the gift and deducted from the gift?

Those are the two questions I would like to have answered. Perhaps you answered them but I just did not quite understand.

Mr. WATERBURY. I did, but I did it pretty fast.

Senator WILLIAMS. Just a short answer.

Mr. WATERBURY. One, yes, I do recommend it. Two, I do not recommend it as strongly in the case of transfers to charities as in the case of transfers within the family.

Senator WILLIAMS. Well, you recommend it be printed in a little lighter print but be done.

Mr. WATERBURY. What I am really worried about is this. I think enough of the importance of realizing gains at death in the case of transfers within the family so that I would not like to see that change in the law lost because of the unwillingness of the Congress to withdraw a subsidy to charitable giving which the Congress felt, all things being considered, ought to be retained.

I would say if that is your concern, leave the law as it is in the case of the transfers to charities but make the change in the case of transfers to private individuals.

Senator WILLIAMS. I do not know what the position of Congress or my own to be. I was just trying to get your position and I wanted it clear. So, I think I have that clear now.

Senator BENNETT. Mr. Chairman, I have one question. If you forbid or if you require the payment of capital gains at death, you will effectively destroy the existence of closely held family corporations.

Mr. WATERBURY. Thank you for the question. I do not think you will. Certainly, you need not for these reasons.

One, I do not say that it is desirable that the aggregate burden of taxes imposed at death on estates be substantially increased. If the Congress is concerned about the aggregate burden of taxes imposed at death, then I would say, fine. Enact realization of the gains tax at death so that everybody pays an income tax and all people who have accumulated wealth start even and make such reductions as you think appropriate in the burden of the death tax.

Senator BENNETT. But you cannot balance those two because the forces that create the two factors are completely different.

Mr. WATERBURY. I guess I do not appreciate the point, sir.

Senator BENNETT. Well, here is a man who started out with a fruit stand and $1,000 and by the time of his death he has got a million dollar enterprise.

Mr. WATERBURY. All right.

Senator BENNETT. But here is another man who started out with $900,000 and at his death he has got a million dollar enterprise. So the capital gains burden at his death is very different and yet both of them have a million dollar estate to transfer on which the estate tax must be identical.

Mr. WATERBURY. Well, I guess now I know why I did not understand you. Why do you think that it is wrong to collect more taxes at the death of the fellow whose estate includes $900,000 of capital appreciation than from the estate of the fellow whose estate includes only $100,000?

Senator BENNETT. Well, you said you were going to ameliorate the tax by reducing the rate so that the burden would be approximately the same as it is now, and, of course, you cannot do that.

Mr. WATERBURY. You can do it in the aggregate. All right. You are worried about liquidity problems and the retention of control of family enterprises in particular cases, then. You are not worrying about the aggregate impact of taxes.

Senator BENNETT. Well, we have to take both into consideration in this committee.

Mr. WATERBURY. All right, of course you do.

Senator BENNETT. All right.

Mr. WATERBURY. I think that in particular cases—I go into this in this article that I wrote which as I said is available to the staff—I think there is no doubt that liquidity problems can be very serious in particular cases, in the case of closest held business. They are certainly not serious in the case of a great many. One of the most common estate planning transactions that I teach and that is discussed in the literature and that is handled by practitioners, is to arrange among a group of associated businessmen who are the stockholders in a closed corporation or partners in a partnership for the purchase by the survivors of the interest of a deceased stockholder or partner at death.

Senator BENNETT. Yes, but I am talking about——

Mr. WATERBURY. And that takes care of——

Senator BENNETT. I am talking about the family situation, the members of which do not have the assets to buy each other out at death. All their assets are involved in the same business.

Mr. WATERBURY. The question is whether or not they will be forced to sell a family business that they might want to retain.

Senator BENNETT. That is right.

Mr. WATERBURY. I would say to that two things. One, from the standpoint of the economy, even if they have to sell it the business may not suffer. The buyer may do just as good a job of running it as the family did.

Senator BENNETT. Have you tried to find a market for a closely held business?

Mr. WATERBURY. Many of my friends have.

Senator BENNETT. I think you have a theoretical appreciation or a theoretical approach to a very practical problem and why should you force the family out of the business? Why should we use tax policy to forbid the transfer from one generation to another?

Mr. WATERBURY. Well, let us put it this way. If the Congress wants to enact a realization at death scheme that says that it shall not apply to closed corporations and define them, go ahead. There is a lot of wealth in this country in respect of which there are unrealized gains at death that does not consist of closed corporate wealth. Go ahead and tax that. If a man owns at his death a million dollars' worth of listed securities that have $800,000 of appreciation, there is no reason not to realize gains at that man's death because somebody else owns the small business you are talking about.

Senator BENNETT. Well, I do not want to continue this, but you are facing the problem we face. You close one loophole or you attempt to legislate special legislation to take care of a situation.

Mr. WATERBURY. Can I make a final point, Senator?

Senator BENNETT. All right.

Mr. WATERBURY. We have in the estate tax law now, have had since 1958 if I recall correctly, a section which was put in there in order to

solve the problem you have been speaking of. It permits in the case of closely held business an installment payment of the estate tax over 10 years.

Senator BENNETT. I recognize that.

Mr. WATERBURY. Now, let us focus on this for a minute. The estate tax escalates in its rates a good deal higher than the capital gains tax. Therefore, the liquidity problem or the problem of coming up with the money to pay the tax can be much more serious in the case of the estate tax than in the case of the gains tax.

Now, here is where my point comes in. If the thought is that the gains tax—the burden of taxes imposed at death on closely held business is excessive, one thing you can do is to cut estate tax rates. Another thing you can do is to permit, as the Kennedy administration recommended in 1963, that these provisions for the payment of the estate tax over 10 years in the case of these businesses be extended to cover realization at death.

What I am saying is, in other words, if you are concerned about not forcing sales of some assets, you do not need to go to the extreme of continuing a general exemption of gains from tax in order to give relief in those situations.

Senator BENNETT. At what rate would you tax these capital gains, the present tax rate or, as the previous witness suggested, the normal income tax rate?

Mr. WATERBURY. I am not an advocate of subjecting capital gains to taxation at ordinary income rates. There is a good deal of debate with a narrower range that is illustrated by the difference between the Kennedy administration's proposals as to capital gains in 1963 and the proposals in the House bill. The House bill increases the rates. The Kennedy administration would have reduced the gains tax rates.

I do not have a settled conviction as to whether they should stay where they are or go up or go down. All I am saying is, decide, on the basis of whatever factors you gentlemen find persuasive, what the gains tax rate should be and then collect it.

Senator BENNETT. One rate to be applied under all circumstances?

Mr. WATERBURY. Yes. Applied at death or applied in the event of a gift.

Senator WILLIAMS. I have just one other question here. Speaking of capital gains rate and we are all—I noticed here in the charts that a man with a $10 million estate would automatically pay $6,088,000 in inheritance tax which is 60 percent of it and in our State, and most States, he would pay a sizable State inheritance tax.

Now, say he leaves an estate of $10 million and pays a little over $6 million in Federal taxes. The State tax is estimated at about a million and a half. Now, that would leave him about 25 percent of his estate and you are suggesting that we should put before that—we will assume for the moment that this $10 million is all capital gains. You would suggest an extra $2.5 million capital gains tax under existing rates or it would be three and a quarter million under the bill, is that correct?

Mr. WATERBURY. Incorrect. One, I am not fond of the higher brackets of the Federal estate tax. If you gentlemen can agree with me and you would like to reduce them, you do so with my blessing.

Two, I honestly think that in a case such as you pose, the odds are

very small that an estate of that size containing that kind of appreciation would be subjected to anything like those rates. I do not say it will never happen. But do not forget that the Federal gift tax puts an enormous premium on inter vivos gifts. It is imposed at three-fourths of the rates of the estate tax to begin with, and if you split an estate between gifts and transfers at death, you reduce the ceiling rate very, very much.

Also, do not forget that people who succeed in accumulating $10 million ordinarily receive competent counsel. Competent counsel will call these possibilities to their clients' attention. Not all people have private beneficiaries in whom they are seriously interested. The largest estate I ever had anything to do with—I wish I had been counsel for the executor, but I was not—was over $100 million and it went almost entirely to charity. But if such a person has private beneficiaries, I think substantial gifts and that in the usual case there, Senator, in a case such as that which you describe, with very great appreciation, the odds are quite high that a lot of that appreciation will have occurred after gifts have been made.

Senator WILLIAMS. Well, to speak to the case that you said you were administrator of, $100 million, under existing law——

Mr. WATERBURY. No, I was not administrator. I just had a little bit to do with a very small problem in connection with a very large estate.

Senator WILLIAMS. Well, on that particular estate the Government would collect about $75 million in inheritance tax and in addition to that there is a State inheritance tax.

Mr. WATERBURY. They did not get much of any because it nearly all went to charity.

Senator WILLIAMS. And, of course, you are recommending as it goes to charity, to the colleges, that that should have been taxed likewise?

Mr. WATERBURY. I think that would be preferable but I repeat if you do not want to do that—I am sure my dean would have limited enthusiasm for it—if you do not want to do that, do not do it but please still do realize gains at death for private individuals.

(Mr. Waterbury's prepared statement follows:)

A Recommendation that H.R. 13270 be Amended to Provide, Comprehensively, for the Realization of Capital Gain or Loss on Transfers of Capital Assets by Gift or by Death, and that Unrealized Gains in Respect of Property Held in Trust be Taxed Once in Each Generation—And a Comment Upon a Related Aspect of Federal Estate and Gift Tax Reform

STATEMENT OF THOMAS L. WATERBURY, PROFESSOR OF LAW, UNIVERSITY OF MINNESOTA

Let me first state the change in the gains tax law which I am supporting. At least since 1918, the federal income tax law has provided that assets owned by a decendent at his death should acquire a new cost basis for federal income tax purposes in the hands of the decendent's successors. The Section of the Internal Revenue Code of 1954 which so provides is Section 1014. This new cost basis is equal to the market value of the assets at the date of death (with limited exceptions which may be ignored for present purposes). The result of this new basis is to permanently eliminate the payment of gains taxes on any appreciation in the value of such assets during the period of the decedent's ownership. (E.g., if A bought shares of X stock for $10,000 thirty years before his death, and still held them at his death when they were worth $50,000, the new basis would be $50,000, and no gains tax would be due if A's executor sold the shares in the course of administration of A's estate.) Of course, this new basis at death can

wipe out deductions for unrealized capital losses too—if an asset declines in value between the date that a decedent acquires it and the date of his death. But since investors are more prone to retain their successful investments than their unsuccessful ones, the principal consequence of this new basis at death is the "forgiveness" of the gains tax on appreciation.

(The change in the gains tax law that I am supporting would realize these gains at death, requiring payment of the gains tax in a decedent's final federal income tax return, which will be filed by his personal representative after his appreciation in X stock in A's final income tax return, and pay a gains tax on this appreciation. This change in the law is commonly referred to as a change from "gains tax forgiveness at death" to "gains tax realization at death," and I will use this terminology here.

I also support the realization of unrealized gains in the event of an inter vivos gift of an appreciated asset, the gain to be taxed to the donor in the year of the gift. In the case of gifts made since 1920, the donor's cost basis has "carried over" to the donee. The Section of the Internal Revenue Code of 1954 which so provides is Section 1015. (Again, there are some refinements which may be ignored for present purposes.) This statutory solution is commonly referred to as a "carry-over basis rule," and I will use that term here.

It is true that the carry-over basis rule of Section 1015 does not immediately result in gains tax forgiveness, as does the forgiveness at death rule of Section 1014. Indeed, if the donee immediately sells the property, any gains will immediately be taxed. But the donee may not sell. If an individual, he may retain the property until his own death and achieve forgiveness of the gains tax. If a trustee, he may retain the property throughout the term of the trust (which may be a century or more), and then distribute it (in a non-taxable transaction) to terminal beneficiaries.

Realization at death has been discussed academically for years, and was recently proposed to the Congress. The Kennedy Administration presented restrained proposals of this kind to the Ways and Means Committee of the House in 1963. The Committee failed to approve them. Why, then, do I revive the topic at this time?

In a few words, the reason that I think realization at death may have been rejected by the Ways and Means Committee in 1963 because of errors of judgment in developing and supporting the proposal, and that I have some arguments to offer in support of realization at death which the Finance Committee and ultimately the Congress, may find to be persuasive.

The Kennedy Administration presented its realization at death proposals as part of a revision of capital gains taxation which included a lowering of gains tax rates, and advocated realization at death primarily on the ground that if an investor knew that he would have to pay gains taxes on his appreciated assets at death if not before, the "lock-in" effect of the gains tax would be reduced. That is, investors would be less likely to regain appreciated assets that, gains taxes aside, they would prefer to sell in order to make more attractive alternative investments, if they knew that they would ultimately have to pay the gains tax anyway.

I am not a formally educated economist, but I have a basic understanding of public finance, and have worked to some extent with public finance economists. I have studied the economic aspects of realization at death in general, and the "lock-in" problem in particular, with some care. I was ultimately able to summarize the results of that work in about nine pages of a Law Review Article. My conclusions, in most pertient part, are as follows:

"This brief look at the economic gains tax forgiveness and realization at death suggests that it does not matter much to the national economy which choice is made.

"Apparently, the 'lock-in' effect of conditioning the gains tax, inter vivos, upon a voluntary transfer would be somewhat reduced by realizing gains at death, thought the national economic significance of the change seems sight." [1]

There is evidence that the Ways and Means Committee is not much impressed with the "lock-in" problem in the current proposals of the House Bill to somewhat increase capital gains tax rates and lengthen the required holding period.[2] But even if one *is* impressed with the economic importance of keeping gains tax rates down in order to minimize "lock-in" effects, it does not follow that realizing gains at death would solve the "lock-in" problem. The central difficulty with gains tax realization at death as a "lock-in" remedy is that it is only helpful insofar as owners of appreciated assets decide whether to retain or sell them

"in contemplation of death"—that is, with an eye to the alternative of holding the assets until they die in order to avoid the gains tax. And it is not very easy to accept the idea that the national economy is heavily dependent upon the investment decisions of people (or those of the investment advisers of people) who expect to die soon enough so that holding appreciated assets until death appears as a prominent alternative to "selling now."

Having concluded myself that the Kennedy Administration's economic case for gains tax realization at death was not a very strong one, I have supposed that the Ways and Means Committee might have reached the same conclusion. And if they did, the Committee may also have thought that this realization at death proposal ought not to be enacted until a further case was made for it.

I have spent a substantial amount of time investigating the subject since the Kennedy Administration's proposal was advanced, and have emerged from that investigation wit ha further case that I find persuasive. This case of mine was published in the *Minnesota Law Review* in the Fall of 1967,[3] and I have brought along some reprints for such use (if any) as the Finance Committee Staff might wish to make of them.

Much of this Law Review discussion is concerned with essential technical matters which need not be reviewed here. Thus this discussion includes an investigation of the constitutionality of gains tax realization at death. (I am satisfied, for reasons elaborated there,[4] that the Finance Committee need not hesitate to support gains tax realization at death because of constitutional doubts.) And this discussion concludes with a review of the technical drafting problems that would be encountered in giving legislative expression to gains tax realization at death. (I am satisfied, for reasons elaborated there,[5] that the Finance Committee need not hesitate to support gains tax realization at death because of drafting difficulties.)

What I want to discuss here are the basic reasons why I think that gains tax realization at death should become a part of our income tax law, immediately, and on a comprehensive basis. These reasons are not elaborate. They are as follows.

First, most gifts and transfers at death of appreciated assets are made to, or in trust for the benefit of, members of the transferor's family.[6] (Transfers to charity are not uncommon, particularly in disposing of large estates, but they raise distinguishable questions regarding the appropriate scope and character of subsides to charitable giving, so I put them to one side for purposes of this discussion.)

When we forgive the gains tax at death by giving the deceased property owner's successors a basis for his appreciated assets equal to their market value at his death, the practical result, then, is very largely a subsidy to the tranfer of wealth within the family. The result is a subsidy because forgiving the gains tax leaves more wealth in the hands of the family than would be the case if the gains tax had to be paid. This fact alone is not a reason for opposing gains tax forgiveness. I have developed at length in the Law Review discussion already referred to my reasons for believing that the interests of families in the financial security and opportunities of their successive generations are important social interests which are entitled to respect under our progressive income, gift and death tax structure.[7] The objection to the subsidy afforded by gains tax forgiveness is that it is an irrationally distributed one. This is my next point.

Family interests are of fundamental importance in our society, for the obvious reason that the society is by and large composed of families. The family is our foundational social unit. Therefore it makes no sense to have a tax structure which contains subsidies to the financial security and opportunities of the members of *some* of the families in the society, to the relative detriment of the financial security and opportunities of the rest, unless those subsidies can be justified as achieving something of importance for the society that could not as readily be achieved without them.

Gains tax forgiveness at death cannot pass this test.

No significant national economic interests are served by forgiveness at death that could not be served, equally well, by offsetting changes in the tax law that do not involve comparable subsidies. (I do not say that gains tax forgiveness cannot be supported by economic arguments. As my late teacher Grover Grismore used to say of the Law of Contracts. "You can find authority for anything." Indeed, I know of an estate planner who is full of economic arguments in favor of forgiveness at death. I only say that, if the Finance Committee consults professional economists of good competence in this matter, they will support my conclusion.)

More specifically, gains tax forgiveness does not have peculiar value to the economy as a source of incentives to work, save or invest.[8] And gains tax forgiveness does not have peculiar value to the economy as a subsidy to the formation of private capital.[9] And gains tax forgiveness is not required in order to avoid economically undesirable liquidation problems in administering the estates of decedents.[10] And gains tax forgiveness certainly does not contribute to eliminating the "lock-in" problem in an economically indispensable way. (It will be recalled that the Kenedy Administration advocated realization at death as a solution to the "lock-in" problem.)

And, turning from the interests of the eocnomy as a whole to family interests, gains tax forgiveness is not a plausible subsidy to family interests in the inheritance of property.

Assuming that family interests in the inheritance of property are entitled to due consideration in designing the tax structure, gains tax forgiveness is not a plausible subsidy to family interests in inheritance. It is true that a fellow who gives his appreciated assets to the members of his family inter vivos, or retains them until his death and then transfers them to his spouse, or children, or other relatives, has demonstrated that he wanted the transferees to have the assets. But another who has found it necessary, or desirable, to sell his appreciated assets during his lifetime scarcely demonstrates, by selling them, that he is less interested than the first in the economic welfare of his spouse, or children, or other relatives. What he has demonstrated instead is that he thought it was a good ideal to sell. Logically, this decision does not involve any rejection of the interests of one's family.

Also, in terms of the priority of family interests, it is hard to see why the family interest in inheritance should be subsidized to a greater degree than the family interest in current maintenance. There are more families in the society that have an immediate interest in an adequate level of annual maintenance than there are families that have an immediate interest in the inheritance of material amounts of property. Yet we have found it necessary to resort to mass taxation under the federal income tax, and hence to raise a great deal of revenue from families that have relatively modest incomes. If we are to continue to do this, it seems inevitable that we will not be able to exempt incomes that are reasonably required to fund an adequate level of current family maintenance. And if this last is so, it seems inevitable that gains tax forgiveness at death will remain vulnerable to the objection that family interests in the inheritance of property ought not to be subsidized in preference to family interests in an adequate level of current maintenance. The gains tax, after all, is levied at preferential rates, which are not notably progressive at the maximum—even under the House Bill, which would increase the maximum gains tax rate to one-half the maximum tax rate on ordinary income.

It is true that the inheritance of property is restrained by federal gift and death taxes which do not apply to family income that is devoted to maintenance expenditures, but it does not follow that these taxes are adequate substitutes for collecting the gains tax at death if not before. The basic reason is that federal estate and gift taxes apply in the same way to family wealth, whether or not it was accumulated with the aid of the subsidy of gains tax forgiveness, and without regard to the extent to which its accumulation was otherwise impeded by the income tax. It does not seem practicable, therefore, to use these taxes to perform the function of gains tax realization at death.

Gains tax realization at death is not objectionable, either, on the ground that it would result in excessive taxation of the inheritance of property, because of our pre-existing federal estate and gift taxes. Any such exception necessarily assumes that family wealth which has been accumulated without the aid of gains tax forgiveness is *now* exposed to excessive taxation under the existing gift and estate tax laws. Instead, gains tax realization at death should be enacted, and federal gift and estate tax rates would then be reviewed in the light of the fact that they will be imposed as a *second*, or subsequent, tax on family wealth that has already been reduced by the income tax.[11]

The foregoing will suffice as a terse statement of my general case for gains tax realization at death. I have also said that realization at death should be enacted on a comprehensive basis. Something should be said about this, though apart from one's view of the persuasiveness of the general case, the question of comprehensiveness is inevitably a matter of addressing particular questions, and many more of them are addressed in my Law Review discussion, already referred

to, than can be addressed here. For present purposes, four, hopefully well-chosen, points may be made.

First, would it not make sense to have a reasonably substantial exemption, in order to avoid reducing "small estates" by realization at death? I think not, in view of the very low level of exemption permitted under the income tax for incomes devoted to family maintenance. Exemptions on grounds of administrative convenience (*e.g.*, in respect of personal belongings, and household furnishings, which, with the exception of a few categories of valuables, are likely to be worth less than their cost on the second-hand market) would, of course, be appropriate.

Secondly, since a surviving spouse in community property states is regarded as the owner of one-half of the spouses' community property, presumably one-half of unrealized community property gains ought not to be realized on the death of the first spouse to die. Therefore, in order to achieve equality of treatment for surviving spouses in non-community property states, ought there not to be an "equalizing" exception to realization at death for appreciated property passing to a surviving spouse? I think not, despite the availability of analogies to income-splitting between spouses, and to the federal estate tax marital deduction. Income splitting between spouses, unlike gains tax forgiveness, does not exempt income from taxation, and, unlike a carryover basis rule, does not permit indefinite future deferral of the income tax—income splitting between spouses only reduces the tax rate, and capital gains already benefit from a preferential rate. And an exemption of a deceased spouse's unrealized gains from realization at death, insofar as his appreciated assets were transferred to his surviving spouse (perhaps subject to a ceiling of one-half by analogy to the community property situation and the estate tax marital deduction) could result in the forgiveness, or indefinite deferral, of tax on a very large amount of gain. Again, in view of the low level of exemption permitted for incomes devoted to family maintenance under the income tax, this does not seem sensible. So I think that, in this situation, the way to equalize treatment of surviving spouses in common law and community property states is to apply realization at death to both the deceased and the surviving spouse's share of unrealized community property gains. (I do not suggest that there is a strong case for such equalization; arguably, the co-tenancy of community property spouses should be recognized for realization at death purposes. After all, there *are* differences between the marital property rights conferred by community property statutes, and those generally prevailing in other states.)

Third, if gains tax realization at death is to be enacted comprehensively, does it not follow that life insurance gains should be taxed to the owner-insured of a life insurance policy, who "gains" the proceeds by his death? Analytically, this is a difficult question, which is treated at greater length in my Law Review discussion than seems appropriate here.[12] For present purposes, suffice it to say that, at least in the case of the proceeds of "pure" life insurance (*i.e.*, proceeds in excess of policy reserves—policy reserves contain an element of accrued, but untaxed, interest) purchased to insure the policy beneficiaries against the premature loss of the income-producing capacities of the insured, I think the answer is no. Statistically, the families of "bread-winners" are unlikely to be fully insured against the loss of future income through the premature "bread-winner" deaths. So the proceeds of insurance on such a decedent's life are unlikely to equal the provision which the insured would have made for the policy beneficiaries, had he lived out his productive expectancy. Arguably, as a matter of social insurance, the surviving contemporaries of such under-insured decedents ought to make the latters' income tax contributions to the cost of government, leaving the life insurance proceeds for dependents.

To be sure, owners of appreciated assets may die prematurely too, but they will not in the average case, and asset appreciation is not normally created by the death of the owner of the asset. Conversely, "pure" life insurance gains are created by a death that is statistically premature.

Fourth, and finally, what should be done to insure that unrealized gains are realized, periodically, in the case of assets which appreciate in the hands of a multi-generation trustee? I think that such realization should be provided for in the course of enacting realization at death legislation. But the kind of case in which this problem arises is one involving enough factual detail to require a rather lengthy illustration, and since the same sort of illustration will be required in connection with my next, and final, topic, economy of words will be served by deferring this final point.

So much for the comprehensiveness of the realization at death remedy that I recommend. It remains to supplement the general case for realization at death, and the particulars just discussed, with some attention to an unmanageable topic that is broader that either, *viz:* assuming that a comprehensive realization at death remedy of the sort just described would improve the income tax structure, would it not be preferable, in terms of fairness, to postpone the adoption of this remedy, pending other reforms in the income, estate and gift tax law to eliminate more flagrant instances of subsidies to family interests in the inheritance of property?

I addressed this topic in a limited way in the Law Review discussion previously referred to,[13] suggesting that the adoption of realization at death ought not to be deferred on this final ground. I have not changed my mind. But since the publication of that discussion, I have about finished another (regarding the avoidance of gift and estate taxes by means of multigeneration transfers in trust) in the course of which I have given this topic further thought. Hence some of the comments which follow.

Again, only an illustrative discussion is possible here. For illustrative purposes, let us consider the relative priority of enacting gains tax realization at death, and of doing something equally comprehensive to eliminate the avoidance of gift and estate taxes by means of multi-generation trusts (which, under present law, can insulate family wealth from federal estate and gift taxation for a century or more). Let me illustrate this estate and gift tax problem (referred to in a current American Law Institute study[14] as "The Generation-Skipping Problem") with a hypothetical case, which, in its federal estate and gift tax aspects, seems quite realistic.

CASE A

In 1932, anticipating the imminent permanent enactment of the federal gift tax, A, aged 55, transferred stock in several family corporations of the market value of $1,000,000 to "independent" trustees (who were nonetheless reliably interested in maintaining business connections with A and A's family). A's federal income tax basis for the stock was $100,000 (its value on March 1, 1913). The trustees were authorized to retain this stock, and to participate in corporate reorganizations, and were directed to pay the trust income to A's daughter D, aged 30, for life, and then to her surviving daughter G, aged 5, for life, the principal to be distributed upon G's death to her then-surviving issue per stirpes, or if none then over to other issue of D.

Now, in 1969, the trustees hold stock in several additional corporations in which A's family is interested, but this stock was all acquired in the course of income tax free corporate reorganizations, so that all of the stock held by the trustees still has an aggregate basis of $100,000. Its market value, however, is now $10,000,000. A is deceased, having paid no gift or estate taxes in respect of the trust property, which was of the market value of $6,000,000 when A died in 1960. D is now aged 67. When she dies, no estate taxes will be payable in respect of the trust property. G is 42, and has four children, ranging in age from 20 to 10 years. When G dies and the trust property is distributed, no estate taxes will be payable in respect of the trust property. Thus the actuarial probabilities are that the first estate tax liability to which this trust property will be exposed will be in another 50 to 70 years, upon the successive deaths of G's children. Thus far, no gains taxes have been paid by the trustees in respect of the appreciation in the value of the trust property which has occurred since 1913. Conceivably, no gains taxes will be payable at all in respect of this appreciation, for the trustees *might not* make a taxable sale of this stock prior to the termination of the trust on G's death, the distribution itself would not be a taxable event, and G's four children *might* retain their stock until their deaths, and if gains tax foregiveness is still in the income tax law in 50 to 70 years, their successors will get a new basis for the stock equal to its then market value.

This hypothetical case is surely atypical in its assumption of a trust principal that has never been exposed to an income tax, and in its assumed deferral of gains taxes for more than 50 years. Also, the emphasis placed upon the possibility of further deferral for another half-century or more is conjectural. These aspects of the case, do, however, highlight the final point regarding the need for a comprehensive realization at death remedy which was previously deferred—that there must be some provision for periodic realization of gain in the case of assets held in trust over several generations, if such trusts are assuredly to be

prevented from postponing the realization of gains over very long periods of time.

Such a supplemental remedy would be necessary in cases, such as Case A, in which successive generations of trust beneficiaries did not have a sufficient interest in the trust property to cause that property to be included in their estates for federal estate tax purposes at death. And since the gains tax is not a notably progressive version of the income tax, it is hard to see why the opportunity for such prolonged deferral should be permitted to remain open—even though the retention of an appreciated asset in a trust for more than a generation may be more or less unusual.

Moreover, unless a currently enacted realization at death remedy *were* extended to multi-generation trusts such as this, the current and future beneficiaries of such trusts would certainly enjoy a dramatic preference over the beneficiaries of much more modest contemporary and future accumulation of wealth, if realization at death were comprehensively applied to the latter. Opponents of realization at death in the case of smaller estates could certainly argue very forcefully that if the spouses and children of contemporary decedents of modest wealth should accept realization at death in order to achieve a tax structure that did not exalt family interests in the inheritance of property over family interests in adequate annual maintenance, later issue of past decedents of great wealth who have succeeded (to date) in avoiding our federal gift and estate taxes should join the parade!

So much for the question whether a supplementary realization at death remedy ought to be applied to such trusts. Let us turn, in conclusion, to the question whether there is a stronger case for devising and enacting a generation-skipping remedy to deal with prolonged federal estate and gift tax avoidance via such transfers as that involved in Case A, than for proceeding with gains tax realization at death.

In my earlier Law Review discussion,[15] I answered in the negative, essentially on the ground that a generation-skipping remedy was, in its application to *future* transfers, primarily a vehicle for collecting *second and subsequent* rounds of gratuitous transfer taxes, while gains tax realization at death was merely a vehicle for collecting an initial (and not very progressive) income tax. The underlying thought was simply that a less progressive tax is easier to justify than a more progressive tax because the appropriate degree of progression in a tax structure is an intrinsically vexed question.

I should have added that the income tax should be the first tax imposed upon unrealized appreciation in order to apply estate or gift taxes to a base that has in all cases been reduced by an initial income tax (either an ordinary income tax on personal savings used to purchase an asset which does not appreciate, or a gains tax on realized gain if an asset which does not appreciate is purchased with the proceeds of sale of an appreciated asset previously held, or a gains tax realized upon a gift or transfer at death of an appreciated asset). And I should have emphasized the importance of this to achievement of a reasonably even-handed gift and death tax system.

Also, I should have qualified the argument I did make. The levy of another progressive tax upon an accumulation of family wealth once in each generation is not a repeated levy upon previously taxed wealth to the extent of unpredictable asset appreciation occurring during the intervening generation. As to that appreciation, it is an *initial* progressive death tax.

Also, there is a basic argument in favor of progressive gift and death taxes which qualifies my family-interest oriented arguments, and which merits attention. That argument rests on the assertion that we do not permit the accumulation of very large personal fortunes primarily out of regard for family interests in the inheritance of property, but out of regard for the advantge to our economy of having people who have great skill in making investment decisions in control of investable wealth. (This is not an economic argument to the effect that these economic advantages are in fact very substantial. The point is, merely, that our practices in this regard have been justified primarily upon economic grounds. I think this is true.

The next step in the argument is the assertion that, once the person whose economic skills accumulated the wealth is deceased, there is abruptly less economic reason to leave the wealth in a few hands. A good many economists of undoubted fidelity to the free market system, and of undoubted professional stature, accept this view. This is an economic argument, centering on incentives to accumulation.

If one accepts these economic views, there is a pretty strong case for relatively heavy progressive gift and death taxation of very large accumulations of wealth (*e.g.*, at maximum rates substantially in excess of 50 per cent).

And hence, if one accepts these economic views, there is a pretty strong case for exposing large accumulations of the past to substantially progressive gift and death taxation as soon as possible—particularly if they were initially accumulated without being exposed to such taxes as in Case A.

And there a number of historical facts about the evolution of our progressive taxes on incomes, estates and gifts to suggest that there may be quite a few real cases which more or less involve the kind of estate and gift tax avoidance illustrated in Case A. Some of these are synopsized in the following extract from my Law Review discussion, previously referred to:

> To briefly review some familiar history, progressive taxation in this century began with the enactment of a progressive income tax which, by its basis rules and exemption of gratuitous receipts, treated past accumulations as sacrosanct. Several years later, an estate tax was added which permitted an accumulation of wealth, once exposed to the tax, to escape further death taxes for the period of perpetuities if the transferor chose to take full advantage of his chance to make a multigeneration transfer in trust. Gains tax forgiveness at death accompanied the estate tax, allowing the transferor to defer further gains taxes on appreciation in the transferred property for the full term of the trust, and indeed, beyond it if no realization was required in the course of terminal distributions of principal.
>
> A gift tax was not permanently added for another decade and a half, during which interval, a well-advised inter vivos transferor could achieve all of the multigeneration trust blessings above-mentioned, except gains tax forgiveness at death, without sustaining the initial burden of paying the estate tax.[18]

(It might not be amiss to add that no such philosophy as that just outlined is reflected in the American Law Institute's recently recommended "Additional Tax" solution to the "Generation-Skipping" problem.

On the contrary, the American Law Institute would not apply its Additional Tax to past generation-skipping transfers. There is a good reason on the facts for this position. The Additional Tax is a generation-skipping "remedy" that is vulnerable to astute pre-planning, and at the same time one that could penalize failure to pre-plan very severely. Consequently, were the Additional Tax to be commonly applied to past and future generation-skipping transfers, the past ones (necessarily designed without regard to it) would probably be much the more heavily burdened.

I do not mean to endorse the Additional Tax. Instead, for reasons that are elaborated in an article to be published in a few months, I think the Additional Tax is a generation-skipping remedy better calculated to perpetuate the generation-skipping problem than to relieve it.)

To sum up, I am still of the opinion indicated at the outset—that the enactment of a comprehensive scheme for realizing gains at death is a better first step to take in bringing the burdens of the income tax upon family interests in maintenance and inheritance into a more plausible relationship to one another than a program of reform involving the federal estate and gift taxes, which treats as irrelevant the inescapably relevant question whether these taxes are being imposed upon wealth that has been exposed to the income tax, and which ignores the fact that it is easier to justify rigor in the collection of a less progressive gains tax rather than a more progressive gift or death tax.

Nonetheless, I am more respectful of the case for relatively heavy progressive gift and death taxation of very large accumulations of wealth than I was a couple of years ago. And I suppose that the enactment of a comprehensive realization at death statute, which would yield gains tax revenues from many smaller estates, would tend to enhance the appeal of that case.

So perhaps acceptance of these realization-at-death arguments of mine would lead to more unfavorable adjustments in taxing the inheritance of property than I had thought earlier.

Even so, I urge the Finance Committee to weigh my arguments with care, because I think it of importance to the morale of the society that national policies which have a substantial effect upon important family interests be designed thoughtfully enough so that they are reasonably defensible.

The financial burdens placed upon families of modest income by the federal income tax are, I think, heavy enough to have a substnatial effect upon family

interests in adequate current maintenance. Unfortunately, I think that family interests in the inheritance of property now enjoy a relatively favored status, and while I think these interests are of importance and entitled to respect under the income, gift and estate tax structure, it seems well to face the fact that they are relatively narrow interests when compared with those in adequate current maintenance. (It must not be forgotten that the opportunities afforded the children of families with modest incomes are affected in important ways by the level of maintenance that prevails.)

As a person who teaches law school courses which, in the main, are relevant to estate planning, I am constantly faced with the question whether the tax law in this area "makes sense." I have found law students to be an admirably pragmatic lot, but they are not oblivious to questions of reasonableness. It is very possible that, since I deal more with students than with practicing lawyers and the trust industry, I attach much more importance to this matter than the community at large.

Conversely, it is entirely plain that the practicing estate planning bar, and the trust and other related industries, have their own build-in biases in this area.

So the question boils down to one of informed, political judgment, which is why I have ventured to bring it to the Finance Committee of the United States Senate.

FOOTNOTES

[1] Waterbury, A Case for Realizing Gains At Death In Terms of Family Interests, 52 Minn. L. Rev. 1, 55 (1967).
[2] H.R. 13270, Sections 511, 514.
[3] Waterbury, *supra* Note 1.
[4] *Id.* at 6–15.
[5] *Id.* at 56–64.
[6] *Id.*, Note 82, at 17–18.
[7] *Id.*, at 18–28.
[8] *Id.*, at 54–55.
[9] *Id.*, at 52–54.
[10] *Id.*, at 49–52.
[11] For instance, the revenue yield of gains tax realization at death might be employed to fund reductions in the burden of federal estate taxes on small- and medium-sized estates.
[12] Waterbury, *supra* Note 1, at 38–42.
[13] *Id.*, at 42–47.
[14] Federal Estate and Gift Taxation, Recommendations of the American Law Institute and Reporters' Studies (1969).
[15] Waterbury, *supra* Note 1, at 44–47.
[16] *Id.*, at 45.

Senator WILLIAMS. That is all. The committee adjourns until 2:30.

(Whereupon, at 12:15 p.m., the committee was adjourned, to reconvene at 2:30 p.m., this day.)

AFTERNOON SESSION

The CHAIRMAN. The meeting will come to order.

The first witness this afternoon will be Mr. John Seath, vice president for taxes, International Telephone & Telegraph Corp. We are pleased to have you, Mr. Seath.

STATEMENT OF JOHN SEATH, VICE PRESIDENT AND DIRECTOR OF TAXES, INTERNATIONAL TELEPHONE & TELEGRAPH CORP.

Mr. SEATH. Mr. Chairman——

The CHAIRMAN. You are the vice president of I.T. & T. for taxes. That is a mighty important job, Mr. Seath. That company pays a lot of taxes.

Mr. SEATH. Well, I am glad you feel that way about it. I know I do.

My name is John Seath. I am vice president and director of taxes for International Telephone & Telegraph Corp.

I am appreciative of this opportunity to present what I hope will be considered a constructive view of restricted stock plans. We urge that

the tax treatment presently accorded to restricted stock plans under long-standing Treasury regulations be continued for plans which offer restricted stock to the employees of the issuing corporation or a subsidiary.

Numerous articles have been written over the last 15 years about the scarcity of management talent in the United States today. Unfortunately, the articles are factual. In the statement we are submitting today we provide examples of how small closely-held corporations are able to offer to managers large blocs of these stock at very low prices. At the time of offer the basic values are generally in senior securities with little equity in common, which means the stock price can be very low—even in pennies. Shortly after the manager accepts the offer to purchase this stock at this very low price, the company goes public at a much higher price, with a corresponding huge gain to the employee taxed at capital gain rates after 6 months holding.

This type of enticement is difficult, if not impossible, for us to combat. One of our weapons, in fact a[illegible]t our only weapon aside from the fascination of working for a corporation that is alive and moving forward constantly, is our restricted stock plan. This plan offers shares of the employing corporation to employees at half of the market value, but the employee may not keep any gain through market appreciation unless he remains with the corporation at least 5 years for 5 percent of the shares, and 25 years or retirement, if that is earlier, for the whole gain.

A plan such as this permits us to reward diligent employees and gives the employee a strong reason to remain with and to work for the success of the corporation. The point here is that this is not a gimmick plan; particularly not a tax gimmick plan. It is a plan to provide our management employees with a real financial interest in their company and a reward for their endeavors through market appreciation, if their endeavors are successful.

It is no answer that the needs of industry can be met through the use of qualified stock options. The changes in the Internal Revenue Code of 1964 have made these options, while still usable and needed, not particularly attractive as an employee incentive in view of the decline of market prices, the higher rate of interest on borrowed funds, the fact that 100 percent of market prices must be paid for the shares, and that the shares must be held a minimum of 3 years.

It has been said that the present treatment of restricted stock plans constitutes "an unwarranted and unintended benefit." It has been alleged that there are abuses under the law as presently written. It also has been argued that the change in the treatment of restricted stock plans proposed in the House bill would correct an inequity.

As far as the so-called unwarranted and unintended benefit is concerned, perhaps it should be remembered that when Mr. Dillon was Secretary of the Treasury and testified before the Ways and Means Committee during consideration of the Revenue Act of 1964, he called the present regulations specifically and favorably to the attention of the committee.

If there have been abuses which, as we understand it, means the granting of the right to purchase shares in a corporation other than the employing corporation or its parent, then we respectfully suggest that the way to correct the abuse is to limit restricted stock plans to

shares of the employing corporation or its parent. It makes little sense to destroy a whole structure of management compensation for a few abuses, especially when the abuses may be corrected.

The present interpretation of the law has been in existence since 1959. Taxpayers desiring to set up plans to provide an incentive to retain their management employees have been able to obtain rulings from the Internal Revenue Service that such plans were in accordance with the Internal Revenue Code. Suddenly we are faced with a turnaround by the Treasury saying that for the last 10 years if it didn't understand the law, and even if it did understand it, it should be changed.

We feel strongly that this House provision has been hastily considered, in that it would not provide revenue for the Treasury. In fact, examination of the examples given in our written statement shows that the revenue would be even greater if the rate reduction on individuals is enacted as proposed.

The House Ways and Means Committee report, in commenting on the restricted stock provision, says:

> The revenue impact of this provision is believed to be negligible in terms of any pickup in revenues from existing law. This is because restricted stock plans, for the most part, have the effect of transferring tax liability from the employees to the company.

Also, the report prepared by the staffs of the Joint Committee on Internal Revenue Taxation and the Committee on Finance says that the revenue impact of restricted stock plans would be less than $2.5 million.

The administration has proposed that the provisions of the House bill dealing with the deferred compensation and lump-sum distributions be deleted and left for further consideration. Also, we should like to suggest that any provision characterized as providing an unintended and unwarranted benefit which, after the proposed change, can only result in lower revenue to the Government, be sent back for further consideration.

Mr. Chairman, we have prepared for your review a more detailed statement which has been submitted to the clerk of the committee. I wish again to thank you for the opportunity of presenting our views on this bill.

The CHAIRMAN. Thank you, Mr. Seath. When you say that the House bill was hastily considered, even though the House spent a lot more time working on it than we will have available, am I to think there are a lot of things in here like this that were hastily considered? There is no doubt in my mind. I hope we will have enough time to consider your suggestion and, if it has merit, that it will be agreed to. Thank you very much.

Mr. SEATH. Well, sir, I think that sometimes we use a shotgun to kill mice and that is kind of drastic. You know, if you let off a shotgun in the house you will do more damage than the mice ever could do.

Senator BENNETT. Just one comment. I am becoming more and more aware of the fact that one of the basic problems we face in this bill is the danger of what various provisions will do to incentive.

Mr. SEATH. Well, that is true. I mean, here the job is to retain management and management is scarce. In the large corporations you have professional managers, and how do you retain them? You have to give

them the opportunity to accumulate something more than a pension after 25, 30, 40 years of service.

Senator BENNETT. Well, it is not only in this field but in many other aspects of the bill.

Mr. SEATH. That is true.

Senator BENNETT. To the extent that the tax laws of the past have provided incentive, it seems to me that many features of this bill are intended to take that incentive away.

Mr. SEATH. Well, you see, when you talk about reform, you have to look carefully at what the word "reform" means. Does it mean to remake or to correct an abuse? And here I think what is forgotten is that when these provisions were passed originally, they were carefully considered. They were not something that slipped through.

Senator BENNETT. No further questions.

The CHAIRMAN. Let me ask you one more thing about your plan at I.T. & T. Your company had a lot of subsidiaries and unless the Justice Department stops you I assume you are going to try to acquire more subsidiaries. That doesn't make me mad. So far as I know there has been no violation of the general tenor of trust or antitrust laws. Some people evidentally feel that there is just something wrong about being big, period. But are these stock options that you are talking about do they involve stocks in one of the subsidiaries or stock in the parent company?

Mr. SEATH. Parent company only—I.T. & T.

The CHAIRMAN. In other words, if I.T. & T. acquires a subsidiary and one had a stock in that subsidiary, then if the sub does real well he might conceivably make a large gain, but what he could contribute toward moving the whole company ahead would be relatively small compared to what he would contribute in his own individual company which might be a subsidiary.

Mr. SEATH. Well, that is true. You see, all of these things are weighed by our I.T. & T. compensation committees and it is the—these things are not limited to a few people but, for example, the last award was to something like 800 people. Now, that goes pretty far down the management scale. You don't have 800 very highly paid people. You have a lot of middle management and these are the people we need to retain. So that the compensation committee considers the individual's position in the company or subsidiary in determining what his award should be.

This applies to foreign employees as well as domestic.

The CHAIRMAN. And the stock he is receiving in terms of stock incentive if he stays with the company is stock in the parent company.

Mr. SEATH. That is correct.

The CHAIRMAN. Thank you very much.

Mr. SEATH. Thank you, sir.

(John Seath's prepared statement follows:)

STATEMENT OF JOHN SEATH, VICE PRESIDENT AND DIRECTOR OF TAXES, INTERNATIONAL TELEPHONE AND TELEGRAPH CORPORATION

SUMMARY

Mr. Chairman and Members of the Committee, my name is John Seath. I am Vice President and Director of Taxes for International Telephone and Telegraph Corporation.

I am appreciative of this opportunity to present what I hope will be considered a constructive view of restricted stock plans. We urge that the tax treatment presently accorded to restricted stock plans under long-standing Treasury regulations be continued for plans which offer restricted stock to the employees of the issuing corporation or a subsidiary.

Numerous articles have been written over the last fifteen years about the scarcity of management talent in the United States today. Unfortunately, the articles are factual. In the statement we are submitting today we provide examples of how small closely-held corporations are able to offer to managers large blocs of these stock at very low prices. Shortly after the manager accepts the offer to purchase this stock at very low prices, these companies have gone public at much higher prices, with a corresponding huge gain to the employee taxed at capital gain rates after six months holding.

This type of enticement is difficult, if not impossible, for us to combat. One of our weapons, in fact about our only weapon aside from the fascination of working for a corporation that is alive and moving forward constantly, is our restricted stock plan. This plan offers shares of the employing corporation to employees at half of the market value, but the employee may not keep any gain through market appreciation unless he remains with the corporation at least five years for 5% of the shares, and 25 years or retirement, if that is earlier, for the whole gain.

A plan such as this permits us to reward diligent employees and gives the employee a strong reason to remain with and to work for the success of the corporation. The point here is that this is not a gimmick plan; particularly not a tax gimmick plan. It is a plan to provide our management employees with a real financial interest in their company and a reward for their endeavors through market appreciation, if their endeavors are successful.

It is no answer that the needs of industry can be met through the use of qualified stock options. The changes in the Internal Revenue Code of 1964 have made these options not particularly attractive as an employee incentive in view of the decline of market prices, the higher rate of interest on borrowed funds, the fact that 100% of market price must be paid for the shares, and that the shares must be held a minimum of three years.

It has been said that the present treatment of restricted stock plans constitutes "and unwarranted and unintended benefit." It has been alleged that there are abuses under the law as presently written. It also has been argued that the change in the treatment of restricted stock plans proposed in the House Bill would correct an inequity.

As far as the so-called "unwarranted and unintended benefit" is concerned, perhaps it should be remembered that when Mr. Dillon was Secretary of the Treasury and testified before the Ways and Means Committee during consideration of the Revenue Act of 1964, he called the present regulations specifically and favorably to the attention of the Committee.

If there have been abuses which, as we understand it, means the granting of the right to purchase shares in a corporation other than the employing corporation or its parent, then we respectfully suggest that the way to correct the abuse is to limit restricted stock plans to shares of the employing corporation or its parent. It makes little sense to destroy a whole structure of management compensation for a few abuses, especially when the abuses may be corrected.

The present interpretation of the law has been in existence since 1959. Tax payers desiring to set up plans to provide an incentive to retain their management employees have been able to obtain rulings from the Internal Revenue Service that such plans were in accordance with the Internal Revenue Code. Suddenly we are faced with a turnaround by the Treasury saying that for the last ten years it didn't understand the law, and even if it did understand it, it should be changed.

We feel strongly that this House provision has been hastily considered, in that it would not provide revenue for the Treasury. In fact, examination of the examples given in our written statement shows that the revenue would be even greater if the rate reduction on individuals is enacted as proposed.

The House Ways and Means Committee report, in commenting on the restricted stock provision, says: "The revenue impact of this provision is believed to be negligible in terms of any pickup in revenues from existing law. This is because restricted stock plans, for the most part, have the effect of transfering tax liability from the employees to the company." Also, the report prepared by the staffs of the Joint Committee on Internal Revenue Taxation and the Committee

on Finance says that the revenue impact of retricted stock plans would be less than $2.5 million.

The Administration has proposed that the provisions of the House Bill dealing with the deferred compensation and lump sum distributions be deleted and left for further consideration. Also, we should like to suggest that any provision characterized as providing an unintended and unwarranted benefit which, after the proposed change, can only result in lower revenue to the Government, be sent back for further consideration.

Mr. Chairman, we have prepared for your review a more detailed statement which has been submitted to the Clerk of the Committee. I wish again to thank you for the opportunity of presenting our views on this Bill.

STATEMENT

Mr. Chairman and Members of the Committee, we would like to submit for your serious consideration our views with respect to the Tax Reform Bill of 1969, H.R. 13270, which is now pending before your committee. We urge that the tax treatment presently accorded to restricted stock plans under long-standing Treasury regulations be continued for plans which offer restricted stock to the employees of the issuing corporation or a subsidiary.

There has been a myriad of articles written on the subject of the scarcity of management talent in the United States today. ITT, like other companies, needs to retain the management it has in the face of talent "raiding" by other companies. Our problems are real. A national business magazine once referred to ITT as, in effect, a management training school, because our success as a company led other companies to lure management personnel with offers of remunerations we simply would not match. We need to retain our managers for our shareholders and our employees—and to do so we have to give our management an interest in ITT's business future.

It is difficult for professional managers, most of whom enter industry from modest backgrounds with their managerial capacities as their only capital, to translate the carrying of vast responsibilities into savings which compare to those amassed by their neighbors who, for example, may have invested in local enterprises such as an automobile distributorship, or similar enterprises. About the only way that a prefessional manager of a large company can do so is to be given an opportunity to earn an ownership interest in his employer's business. We believe that the restricted stock plan which our shareholders have authorized is an appropriate way to do this, since it makes acquisition of such an ownership interest financially practicable. It also provides the employee with an incentive to remain with our company because his future is then linked with ours. Also, it results in no revenue loss to the Treasury under existing rules, in contrast to the current proposals.

Our plan is not limited to high-level executives. It is open to virtually all of our employees in key management, which number in excess of 1100 in the U.S. Employees are offered the opportunity to purchase restricted stock at ½ of the current market price. They have all the customary rights of ownership of the stock, except that the stock is restricted so that under specific conditions all or part of the stock must be re-sold to the corporation at its original purchase price if the employee-owner leaves before retirement, or 25 years of service. Restrictions requiring re-sale of the stock to the company gradually are removed over the employee's period of service. Specifically, 5% of any of the shares purchased become free of restriction after 5 years of service, and another 5% become free for each additional year of service until 15 years of service have been completed. The remaining 50% is generally not freed until the employee has 25 years of service after the purchase or reaches age 65, whichever happens first.

This plan is not a "gimmick" plan—it is a carefully designed employee benefit plan that works. And we need it as an important incentive to retain our management.

We have had numerous cases where our managers have been approached by small, closely-held corporations and have left us because of the opportunities to make substantial long-term capital gains through stock ownership interest. We could not match the opportunities these smaller companies offered, often at bargain prices, because the stock is made available at low cost prior to a public offering at a much inflated price. Let me give you but three examples from our files:

Executive	Shares offered	Offering price per share	Market price	Estimated gain
Mr. A	22,000 20,000	$18.00 .20	$27.00	$734,000+
Mr. B	50,000	4.50	20.00	775,000+
Mr. C	42,700	13.63	39.25	1,300,000+

We have to compete against offers like these. It is idle to maintain, as the House Ways and Means Committee Report indicates on Page 87, that employees can be given an adequate stake in their employer's business through "statutory stock options." To those who maintain that statutory stock options solve this problem, we refer you to an article by the distinguished New York Times business correspondent, Mr. John J. Abele, in the Business Section of the New York Times of Sunday, September 7, 1969. This article shows clearly that statutory stock options, especially in a period of declining stock prices, are not only of no value to employees but, even worse, encourage employees not to stay with but to leave their employer in order to obtain new statutory stock options at depressed market prices. (A copy of Mr. Abele's article is attached.)

Even if stock prices were to rise, statutory options would still not be attractive as long as interest rates remain at present levels, since the net cost (after receipt of dividends) of the borrowings necessary to exercise statutory options would be prohibitive. Further, the change in the treatment of interest cost contained in H.R. 13270, limiting deductibility to $25,000 plus investment income, if enacted, could further increase the effective cost of statutory stock options by not allowing a tax deduction for interest paid on at least a portion of the borrowings. The Treasury Department's recommendation that interest on funds borrowed for the purchase of stocks be allowed as a deduction is one which we heartily endorse, but we believe that to be effective that type of interest must also be eliminated from "allocable deductions."

It should also be noted that the three year holding period required for capital gains to apply to the sale of stock received on the exercise of qualified options is far longer than the normal holding period. The fact that a qualified option is at 100% of market value, whereas restricted stock is at 50%, means larger borrowings and is an additional reason why qualified stock options are no longer attractive.

Thus, the restricted stock plan which ITT and many other corporations use is truly a long-range plan which serves desirable corporate ends. And it is not a tax gimmick, or, as Treasury testimony indicates, "an unwarranted and unintended benefit."

These plans are set up under rulings issued by the Treasury under long-established regulations. In fact, during the consideration by the Congress of the Revenue Act of 1964, Secretary Dillon called the Treasury regulations specifically and favorably to the attention of the Ways and Means Committee. See Hearings before the Committee on Ways and Means (88th Cong., 1st Session) on the President's 1963 Tax Message—Part 1, p. 466.

Under existing law, an employee who receives stock subject to substantial restrictions realizes ordinary income at the time the restrictions lapse. The amount of such income is equal to the lesser of:

(i) the difference between the purchase price paid by the employee for the stock and the fair market value of the shares (determined without regard to restrictions) at the time of purchase; or

(ii) the difference between such purchase price and the fair market value of the shares at the time the restrictions lapse, whichever is the lesser.

However, under the Treasury proposal, contained in Section 321 of the House Bill, the employee will realize income when the restrictions lapse in an amount equal to the difference between the purchase price paid by the employee for the stock and the fair market value of the stock at the time the restrictions lapse. (In other words, the initial spread existing between the unrestricted fair market value of the stock at the time of transfer and the actual purchase price no longer limits the amount of ordinary income taxable to the employee when the restrictions lapse, even though such initial spread was the *maximum* compensation intended by the employer.)

It must first be recognized that the new rules make restricted stock plans generally unworkable because of the high tax impact on employees, a high-tax impact that the employee can probably only meet by selling his stock—thus defeating

the very purpose for which the plan was set up. Secondly, and equally important, it must be recognized that the new rules do not have a significant effect on overall tax revenues; they do not serve to bring additional income tax revenues into the U.S. Treasury. To the extent that the new rules occasion more taxable income to the employee, the employer will be entitled at the same time to a larger deduction for the amount of compensation realized by the employee. Thus, considerations other than Government revenue must underlie the proposal.

Further, if the employee sells his stocks after the restrictions lapse, the proposed regulations will result in a significant loss of tax revenues to the Treasury, as pointed out in the Ways and Means Committee report on the Tax Reform Bill.

For example, assume a married employee in the 45% bracket (taxable income about $36,000) purchases restricted stock at 100 with an unrestricted fair market value of 200. In four years, the restrictions lapse and the employee sells the stock for 300, its value at that time.

Present law:	
Tax on income to employee:	
Compensation $100 (200–300) at 45 percent	$45
Capital gain $100 (300–200) at 22.5 percent	22.5
Total tax to employee	67.5
Deduction to employer: Compensation $100 at 48	48
Net tax paid to Treasury under present regulations	19.5
Proposed amendment:	
Tax on income to employee:	
Compensation $200 (300–100) at 45 percent	90
Capital gain 0 (300–300)	0
Total tax to employee	90
Deduction to employer: Compensation $200 at 48 percent	96
Net tax loss to Treasury under proposed regulations	(6)

(The above figures do not take into account the surtax which would increase the loss to the Treasury.)

Certainly, any tax proposal that can simultaneoutly cause responsible corporate employers to object and, at the same time, reduce Treasury revenues is one that deserves careful consideration.

We understand that the present Treasury regulations have been subject to abuse by a few taxpayers. We recommend and heartily support any changes in the law to correct the abuses—such as a requirement that the restricted stock must be stock of the employer corporation, or a corporation that controls the employer corporation, or even a requirement denying restricted stock benefits to 5% or more shareholders of the employer corporation, or 5% or more shareholders of an affiliate of the employer corporation. However, to do away entirely with restricted stock plans simply because abuses have been found would be causing hardship to those who have not abused the law.

The ITT restricted stock plan was adopted by the management and shareholders to give its employees an incentive to remain with us on a career basis—an incentive which is not effectively provided by other types of stock plans.

Thus, while we believe that abuses should be corrected, we urge that there is no reason for the enactment of a provision which will result in no increased revenues, but which will impede the efforts of large corporations to attract and retain its management. It is this management which corporations need to keep moving forward in order to continue the activities which provide employment for thousands and which benefit the economy and the nation.

[From the New York Times Sunday, Sept. 7, 1969]

BEAR MARKET HURTS STOCK OPTIONS

(By John J. Adle)

Stock options, like stock prices, aren't what they used to be.

Options are a favorite device of many corporations to attract or retain executives. Theoretically, they are supposed to increase an executive's incentive by helping him to obtain a stock interest in his company.

But the bear market in stock prices has put a decided crimp in the attractiveness of options granted in more bullish days.

As a result, many executives are glumly viewing options that were supposed to be an important part of their compensation package, but, at today's stock prices, are worthless.

To Pearl Meyer, the situation points up some basic weaknesses in option plans. The vanishing value of options, she contends, has caused considerable discontent in executive suites and reduced the incentive the options were supposed to build.

Mrs. Meyer is director of research for Hensley Associates, Inc., a lending executive recruitment concern that also serves as a consultant on executive compensation programs to many large corporations.

"Stock options are not a sound, continuing method of executive compensation," Mrs. Meyer said in an interview last week. "Options are worthless in a declining stock market and the effect on executive morale can be devastating."

In Mrs. Meyer's view, options "concentrate the interest of an executive on the price of his stock, not the value. The whole thing depends on how the market is going. It's a game, a bet."

In a typical option arrangement, a company may grant an executive an option to buy a certain amount of stock at a price determined by the market value on the day the option is granted.

An executive earning $30,000 a year, for example, may be given an option to buy 1,000 shares of a stock selling at $30 a share. If the price of the stock later rises to $40 a share, the executive can net a tidy profit. But if the price of the stock goes down to $20 a share, his option is worthless.

Using the Dow-Jones industrial average as an analogy, Mrs. Meyer declared: "Suppose you received an option to buy shares of the Dow-Jones Average Company in February, 1966, at $1,000 a share. There wouldn't have been any time in the last three years when that option would have been of any value to you."

One result, Mrs. Meyer noted, is that many executives holding worthless options from their present employers are inclined to look for jobs elsewhere in the hopes of receiving options arrangements that will be more profitable for them.

A TIME TO MOVE

For executives in this category, she said, "the most sensible time to move is when the market is down."

Because the amount of shares involved in option plans is usually related to an executive's salary, executives who receive options when a stock is at a low level are able to receive more shares than executives with comparable salaries who received options when the stock was at a higher price.

In the case of a stock selling at a $30 a share, a $30,000-a-year executive might receive an option for 1,000 shares. But if the price goes down to $20 a share, an executive at the same salary level would receive an option for 1,500 shares.

One result, Mrs. Meyer noted, is that some executives have to interview job candidates who will receive more attractive option arrangements than the interviewers themselves have.

Mrs. Meyer said that option arrangements could be equally troublesome when the stock market is rising. A strong market, she said, may result in some executive making such substantial paper profits on their option stock that the only way they can cash in on their profits is to leave the company and sell the stock.

Mrs. Meyer said there were a number of other methods of executive compensation that, in her opinion, serve the best interests of both the company and the executive.

One alternative to the standard qualified stock option plan, she said, is a nonqualified option plan, one that does not qualify for capital gains treatment because of some restriction. The terms of these plans are not as confining as regular plans, she said, and can be varied to meet particular situations.

Other possible alternatives, Mrs. Meyer said, include deferred compensation plans, stock bonus arrangements and profit-sharing plans.

The CHAIRMAN. Our next witness will be Mr. John A. Cardon of Washington, D.C.

STATEMENT OF JOHN A. CARDON OF WASHINGTON, D.C., ACCOMPANIED BY JOHN M. SKILLING, JR.

Mr. CARDON. Mr. Chairman, my name is John Cardon, I am a partner in the local law firm of Lee, Toomey and Kent. I am accompanied by my partner, Mr. John Skilling, Jr.

I have for over 25 years specialized in Federal tax and other legal aspects of tax qualified pension and profit sharing plans as well as plans of deferred compensation. I appear here today as an interested practitioner in opposition to section 331 of the bill which deals with deferred compensation payments.

Although the statement that Mr. Skilling and I filed also covers section 515 of the bill with respect to the taxation of lump sum distributions from qualified employee plans, I do not intend to address myself to that subject this afternoon.

Before specifying my objections to section 331, I would like to make two general observations. First of all, deferred compensation plans vary in their coverage from a few to very many employees. They are not confined to providing benefits for a few select top executives. Many deferred compensation plans are designed to provide payments to broad numbers of employees reaching down into middle income brackets.

Mr. Skilling and I have written many contracts for small employers, covering their executives, maybe just one or two executives, in a salary range of $15,000 to $20,000. These are certainly not the so-called "fat cats."

The second point I would like to make is that deferred compensation promises, which are contemplated by section 331, are not funded. The employer does not set aside an amount in trust or segregate its assets in any other way to meet the deferred compensation obligation. The employee has nothing more than the bare unsecured promise of an employer to pay a future amount. These are not comparable to trust arrangements or to annuity contracts where the employee has security behind the promise.

There are several objections to section 331.

(1) Deferred compensation is in no sense of the word a tax loophole. Under present law every dollar of deferred compensation is taxed to an employee at ordinary income rates. Payments under deferred compensation plans are not capital gains. The employer takes no tax deduction until the payment is actually made and then in the amount of the payment.

The principal benefit of deferred compensation to an employee is that it tends to level out his total earnings over a period of time and thus acts as an averaging price. I submit that this is a perfectly legitimate tax objective. It is not tax evasion. It is true that one of the attractive features of deferred compensation to an employee is the anticipation that he might be in a lower tax bracket when deferred compensation payments are ultimately made to him but there is no guarantee that this will in fact be the case. There are numerous instances where just the opposite is true, either because the employee has other income, his status has changed, or tax rates have been increased.

(2) Deferred compensation serves many corporate purposes. These arrangements have been used for many years, wholly apart from the tax consequences as a method of attracting and retaining valuable employees. This is particularly true in the case of smaller companies which cannot afford the fixed annual cost of a pension plan or large current salaries. More often than not, forfeiture provisions are provided for in these arrangements to further encourage the employee to stay with the employer.

Deferred compensation also provides a method whereby an employer can provide additional retirement income when benefits under a qualified pension plan are felt to be inadequate.

Under many deferred compensation arrangements the ultimate payout is keyed to the value of the employer's stock. In these situations deferred compensation provides the employee with a direct and real stake in the business.

(3) Section 331 introduces undue complexity into the tax law. A mere reading of the provisions of section 331 is enough to demonstrate that the computational processes involved would be tremendously complicated.

Assume, for example, that an employee had worked for a company for 25 years, and under a deferred compensation plan he is entitled to receive upon retirement $25,000 a year for 10 years. Ignoring for purposes of simplicity the exception for amounts earned prior to 1970 and the $10,000 exclusion, the employee must make three computations.

(A) He computes his tax in the year of receipt including $25,000 of deferred compensation as ordinary income.

(B) He throws back $1,000 to each of the 25 years in which he worked for the employer, computes the additional tax in each of those years, assuming that the records are available, and totals the additional tax.

(C) He adds $1,000 to each of the 3 highest taxable years in his last 10 taxable years, again assuming the records are available, computes the additional tax thereon, averages it, and then multiples it by 25. The higher tax resulting from either A or the lower of B or C is the tax due for the year of receipt, I think.

As if this were not enough, however, in the following year when the taxpayer receives another $25,000 payment, he must go through the entire procedure again, but this time taking into account the number of deferred compensation he received in the first year and including it in the flowback process. More complex computations would be required where payments are made in stock having a fluctuating value or where other features of the deferred compensation plan are present, such as a requirement of continued employment, prohibition against noncompetition and the like.

No revenue or tax equity reasons can be cited to justify this complex compliance problem.

(4) There is a potential loss of tax revenue in section 331. The provisions of section 331 of the bill impose such a penalty on deferred compensation plans that it is quite likely such arrangements will be discontinued in the future.

This means that current cash payments of salary will probably increase, particularly with lower rates on earned income. Moreover, the

increased cash salaries would be included in the pension base for pension plan purposes and thereby give rise to an increased current tax deduction for the employer. The net result is likely to be a loss of revenue to the Treasury. At any rate, a shift away from deferred compensation and into current compensation most certainly will add an inflationary factor to the economy contrary to at least one of the major purposes of this bill.

(5) There are inconsistencies in the bill. Section 802 adds a provision which would limit the marginal tax rates on earned income to 50 percent. While treating earned income more favorably under section 802, the bill deals harshly and unfairly with another form of income. This is deferred compensation in section 331.

There is no rationale for this inconsistent treatment.

(6) There is a departure from traditional concepts under this bill. The proposed treatment of deferred compensation modifies radically the concepts of the cash method of accounting and the annual accounting period. Both of these concepts have been fundamental in our tax system and no adequate revenue purposes have been demonstrated for so drastic a departure from them. Present rules have worked satisfactorily for quite a number of years and have the support of court decisions and administrative rulings.

In conclusion, I submit that there is in fact no real problem of tax avoidance in the area of deferred compensation, that deferred compensation serves a useful and valuable purpose wholly apart from the tax consequences and that the suggested solution in this bill is far worse, both in terms of compliance and in terms of concept, than the evil which it allegedly seeks to correct. At the very least, Mr. Chairman, we agree with the Treasury's suggestion that that matter not be contained in this bill and that they have a chance to look at this in the general concept of compensation as a whole.

Thank you, Mr. Chairman.

The CHAIRMAN. Mr. Cardon, you made a very fine statement. I don't know whether everything you say is correct about this thing, but it appears that much of what you say is clearly correct. And incidentally, for your benefit and others who appear in the afternoon session, because the Senate is in session we just can't have as many Senators present.

I think the record ought to indicate that you will be well represented in your views when the committee considers these matters. The staff is working with us in preparing these summaries. Here is your statement that was prepared for us before you arrived. Our staff follows this very carefully and if you hadn't said it, I was going to say what the Treasury has said about this matter:

> We will undertake a comprehensive study of both qualified and non-qualified plans. Our study will be completed and will result in recommendations to the Congress without extended delay. For these reasons and because of the basic difficulties in these provisions of the bill.

That is the ones you are talking about—

> The Administration recommends that this provision be deleted from the present bill.

Now, in addition to that I am advised by the chief of staff of the joint committee that that 50 percent income limitation was intended

by the Ways and Means Committee to have been available here and it was omitted by inadvertence.

Mr. CARDON. I am glad to hear that, Mr. Chairman.

The CHAIRMAN. I have been personally inclined to think we would do just as well to omit the whole section as was suggested.

Mr. CARDON. I agree.

The CHAIRMAN. Thank you very much.

Mr. CARDON. Thank you.

Senator BENNETT. I have no questions.

(John A. Cardon's prepared statement follows:)

STATEMENT OF JOHN A. CARDON AND JOHN M. SKILLING, JR., OF LEE, TOOMEY & KENT

SUMMARY

I. Deferred compensation (§ 331)

The proposal for taxing deferred compensation should not be adopted.

(1) Deferred compensation is fully taxable at ordinary income rates and in no sense represents a tax loophole.

(2) Deferred compensation serves many corporate purposes: It attracts and holds employees; it provides supplemental retirement income; and, when awarded in the corporation's own stock, it creates additional employee incentive. Moreover, its use is not limited to a few highly paid executives, but is applicable to many employees at many levels.

(3) The proposal is unduly complex and presents a disproportionate compliance burden.

(4) Adoption of this proposal may well cause a loss of tax revenue, and most certainly will be inflationary by encouraging current cash payments of compensation rather than deferment.

(5) The proposed treatment of deferred compensation modifies radically the concepts of the cash method of accounting and the annual accounting period. Both of these concepts have been fundamental in our tax system. No adequate revenue purpose has been demonstrated for so drastic a departure from these basic concepts.

II. Distributions from qualified plans (§ 515)

The proposed method of taxing lump sum distributions from qualified employee plans should be rejected.

(1) Such distributions represent the accumulation of employer contributions and increment thereon over a period of many years. The proposal to tax post-1969 employer contributions on a five-year "averaging" is neither realistic nor equitable.

(2) The proposal would substitute a complex set of rules for a very simple tax computation under existing law. Data needed to compute the tax liability under the proposal is not readily obtainable, nor is it always available to the taxpayer.

(3) The adverse effects of the proposal will be felt by all plan participants receiving lump sum distributions and not merely by those whose taxes on such distributions might be increased.

(4) The attempt to provide a five-year forward averaging will result in overpayment of taxes by some retired individuals who can least afford it and yet prevent them from recovering overpayments for a period of five years.

STATEMENT

This statement is submitted by John A. Cardon and John M. Skilling, Jr., in opposition to Sections 331 and 515 of H.R. 13270 dealing with the taxation of deferred compensation and the taxation of lump sum distributions from qualified pension, profit sharing and stock bonus plans.

The undersigned are members of the law firm of Lee, Toomey & Kent, 1200 18th Street, N.W., Washington, D.C. 20036, and have for a number of years specialized in Federal income tax and other legal aspects of qualified pension, profit sharing and stock bonus plans, as well as nonqualified plans of deferred compensation. Our clients have included both large and small corporations representing a cross-section of American industry.

In view of this experience, we desire to bring to the attention of the Committee certain aspects of the proposed changes in the Internal Revenue Code which would be affected by Sections 331 and 515 of the pending Bill.

PART I. DEFERRED COMPENSATION

Section 331 of H.R. 13270 adds a new § 1354 to the Internal Revenue Code to deal with the taxation of deferred compensation. This new section provides for a minimum tax on deferred compensation payments in excess of $10,000 per year determined by "throwing back" such excess to each year in which it is deemed to have been earned (the period of employment or such lesser period as the Secretary shall determine). Alternatively, the taxpayer may compute the minimum tax by using the average increase in tax in the three highest of the last ten years and multiplying that by the number of years over which the deferred compensation is deemed earned. In any event, however, if the actual tax in the year of receipt is higher than the lower of the minimum tax computations, the higher tax will be due.

The objective of this provision is to tax an employee on deferred compensation payments at the time he receives them, but at the higher of (a) the tax he would have paid had he received the deferred compensation in the year it was earned, or (b) the tax he would pay on the deferred compensation in the year it is actually received. The alleged purpose of the proposed revision is to discourage taxpayers from taking advantage of the fact that they may be in a lower tax bracket after they retire from full-time employment.

We are opposed to any changes in the taxation of deferred compensation, and specifically to Section 331 of the Bill, for the following reasons:

(1) Deferred Compensation Is In No Sense of the Word a "Tax Loophole"

Under present law every dollar of deferred compensation will be taxed to an employee at ordinary income rates, not as capital gain, and the employer will get no tax deduction until the time of payment. Actually, the principal benefit of deferred compensation to an employee is that it tends to level out his total earnings over a period of time more closely associated with his life rather than his years of employment. Thus it acts as an averaging device and any benefit arising from the difference in tax rates from year to year is incidental.

It is true that one of the attractive features of deferred compensation to an employee is the anticipation that he might be in a lower tax bracket when deferred compensation payments are ultimately made to him, but there is no guarantee that this will, in fact, be the case. There are numerous instances where just the opposite is true, either because the employee has other income or because he is a widower and thus subject to taxation at single taxpayer rates, or because the tax rates have been increased (e.g., a year in which the surcharge is applicable). Moreover, even in those cases where the tax rates are lower in the year of receipt, the difference in rates is usually small and it has not been demonstrated that it represents a significant method of tax avoidance.

(2) Deferred Compensation Serves Many Corporate Purposes

Deferred compensation has been used for many years, wholly apart from tax consequences, as a method of attracting and retaining valuable empolyees, not only in the top echelons of management, but also in middle management. This is particularly true in the case of smaller companies who cannot afford the fixed annual cost of a pension plan or large current salaries. More often than not forfeiture provisions are included to further encourage employees to stay with an employer. Deferred compensation arrangements constitute one of the major tools of corporate management in acquiring and retaining capable employees.

Deferred compensation also provides a method whereby an employer can do something more in the way of retirement income for some of its employees. In many instances benefits provided by qualified pension and profit sharing plans are felt to be inadequate to do the job desired in middle and upper management ranks, and deferred compensation can serve to supplement such a retirement program.

Under many deferred compensation arrangements the ultimate payout is keyed to the value of the employer's stock. In such case there is an obvious incentive on the part of the employee to increase such value so that the amount

he ultimately receives will be that much greater. Deferred compensation can thereby provide the employee with a direct and real stake in the business.

Deferred compensation plans are utilized by thousands of companies, large and small, representing a very large segment of the business community. We submit that these arrangements are not devices limited to a few highly paid employees who are in a financial position to demand them. On the contrary, many companies realize that orderly succession in executive ranks is vital to the success of any enterprise and therefore apply such plans broadly to technical and managerial personnel at many levels.

(3) Section 331 Introduces Undue Complexity

A mere reading of the provisions of Section 331 of the Bill is enough to demonstrate that the computational process involved would be tremendously complicated. Assume, for example, that an employee had worked for a company for 25 years, and under a deferred compensation plan he is entitled to receive upon retirement $25,000 a year for 10 years. Ignoring for purposes of simplicity the exception for amounts earned prior to 1970 and the $10,000 exclusion, the employee must make three computations:

(a) He computes his tax in the year of receipt by including $25,000 of deferred compensation as ordinary income.

(b) He "throws back" $1,000 to each of the 25 years in which he worked for the employer, computes the additional tax in each of those years (assuming the records are available), and totals the additional tax.

(c) He adds $1,000 to each of the three highest taxable years in his last 10 taxable years (again assuming the records are available), computes the additional tax thereon, averages it, and then multiplies by 25.

The higher tax resulting from either (a) or the lower of (b) or (c) is the tax due for the year of receipt. As if this were not enough, however, in the following year when the taxpaper receives another $25,000 payment he must go through the entire procedure again, but this time taking into account the amount of deferred compensation he received in the first year and including it in the throw back process.

While the computations required in the example cited are highly complex, they are far simpler than the computations which would be required for many deferred compensation plans, where payments are made not in cash but in stock having fluctuating values and where other features, such as continued employment, non-competition, etc., add to the complexity of determining when an amount is earned and thus the calculations involved.

When it is recognized that the majority of the people affected by this provision are relatively unsophisticated taxpayers, this additional computational burden which *must* be complied with is simply intolerable. No revenue or tax equity reasons can be cited to justify this complex compliance problem.

(4) Potential Loss of Tax Revenue to the Treasury

The provisions of Section 331 of the Bill impose such a penalty on deferred compensation plans that it is quite likely such arrangements will be discontinued in the future. This, of course, means that current cash payments of salary will probably increase, particularly with lower rates on earned income. Moreover, the increased cash salaries would be included in the pension base for pension plan purposes, and thereby give rise to an increased current tax deduction for the employer.

The net result is lightly to be a loss of revenue to the Treasury. Although it is impossible to estimate this potential revenue loss, it is clear that the shift in emphasis away from deferred compensation and into current compensation may not only cost the Treasury money, but most certainly will add an inflationary factor to the economy contrary to at least one of the major purposes of this Bill.

(5) Inconsistencies in the Bill

Section 802 of the Bill adds a provision which would limit the marginal tax rate on earned income to 50%. We believe this provision is a step forward in the taxation of earned income. It is anomalous, however, that while the Bill treats earned income favorably in Section 802, it turns around and deals harshly and unfairly with another form of earned income, i.e., deferred compensation, in Section 331. Thus the Bill increases taxes on deferred compensation while reducing taxes on other forms of earned income. There is no rationale for this inconsistent treatment.

(6) Departure from Traditional Concepts

The proposed treatment of deferred compensation modifies radically the concepts of the cash method of accounting and the annual accounting period. Both of these concepts have been fundamental in our tax system, and no adequate revenue purpose has been demonstrated for so drastic a departure from them. The provisions of this Bill represent one more abberration from standard accounting and tax concepts and one more patch on the crazy quilt of the taxation of employee benefits.

In addition, it should be pointed out that the present rules have worked satisfactorily for quite a number of years. Through court decisions and administrative rulings the questions of whether an employee has income at the time he receives a promise to pay from his employer and whether such a promise (regardless of the financial condition of the employer) is equivalent to placing an amount in trust for an employee have been settled long ago, and there has been no indication from the Internal Revenue Service or the Treasury Department that these rules have been abused or that any change in them is required except possibly in the context of an overall revision relating to employee benefits.

CONCLUSION

It is submitted that there is in fact no real problem of tax avoidance in the area of deferred compensation, that deferred compensation serves a useful and valuable purpose wholly apart from the tax consequences, and that the suggested solution in this Bill is far worse, both in terms of compliance and in terms of concept, than the evil which it allegedly seeks to correct.

PART II. DISTRIBUTIONS FROM QUALIFIED PENSION, PROFIT-SHARING, AND STOCK BONUS PLANS

Section 515 of the Bill would amend §§ 402(a)(2) and 403(a)(2) of the Code with respect to the taxation of lump sum distributions from qualified pension, profit sharing and stock bonus plans.

Under the present provisions of the Code, a lump sum distribution from a qualified plan or trust made on account of an employee's termination of service or death after termination of service is taxable as a long term capital gain to the extent it exceeds amounts which the employee contributed under the plan. The Bill would change this rule with respect to that portion of a lump sum distribution which represents the amounts contributed by the employer after December 31, 1969.

We strongly urge the Committee to reject the proposed change for the following reasons:

(1) The Existing Rule Is a Fair and Reasonable One

Distributions from qualified pension and profit sharing plans at retirement, death or other termination of employment represent contributions, earnings, and gains from investments accumulated over many years. Many employees work for the same employer for 30 years or more and a lump sum distribution of his pension or profit sharing benefit at retirement represents employer contributions to the plan and investment experience thereon over a considerable period of time. It is obvious that a lump sum distribution cannot be taxed to the recipient as ordinary income all as of the year in which received without unduly reducing the amount available for the employee's retirement or for the protection of his beneficiary in the event of his death. Realizing this, Congress incorporated in the Revenue Act of 1942 provision for taxing lump sum distributions as long term capital gains, the net effect of which is to average out the tax impact and avoid depleting the employee's benefits.

This basic approach to the problem has been in the Code for some 27 years. It was amended in 1951 and 1952 to avoid taxing unrealized appreciation in employer securities included in a lump sum distribution and in 1954 it was extended to cover lump sum distributions on the death of an employee after his retirement and lump sum distributions from annuity plans. Thus, the legislative history of §§ 402(a) and 403(a)(2) has been to extend, rather than to restrict, the capital gain treatment of such payments.

The proposed change would tax the recipient on amounts representing employer contributions made after 1969 on the basis of a so-called five-year forward averaging. As pointed out in more detail below, such treatment is not a true averaging method and is not a reasonable substitute for the existing rule. It is

inequitable to tax the employee on a distribution on the basis of the five-year spread when, in fact, he may have been in the plan for as long as 30 years or more. We submit that the existing rule is far more equitable.

(2) The Present Rule Is a Simple One and Easy To Administer

Complexity in our tax laws is of growing concern, not only to the Government but to taxpayers throughout the country. The present provisions of the Code afford a method of taxing lump sum distributions which is easy to understand by taxpayers and is easily administered. Basically, the only computation which has to be made by the employee is the determination of what he contributed to the plan. The balance of a lump sum distribution is taxed to him as a long term capital gain. Thus, the employee need only divide the balance by two and include the resulting figure in his gross income and compute his tax in the normal manner. Having done this, his tax liability with respect to that distribution is a closed matter.

By contrast, the proposed rule would subject the individual to several complicated steps at the end of which his tax liability would remain unsettled for several years. Specifically, the following steps would have to be taken:

Step 1: Compute the amount of the employer contributions made after 1969.

This computation is not as simple as it appears at first blush. In many pension plans, the employer's contributions are determined on the basis of aggregate costs reflecting the mortality, turnover, years of service and salary of the group of covered employees as a whole. The amount contributed for any one individual is not ordinarily determined. It can be determined but only upon rather elaborate actuarial assumptions. In no case could the average employee himself determine the figure. Under present law the employee can always determine his own contribution, which is the only portion of a lump sum distribution he need identify in computing his tax liability.

Even where employer contributions are allocated to the individual accounts of plan participants, the proposal will require the employer to maintain accounting records in such a way as to show the post-1969 contributions separately. The information will have to be supplied by the employer since the employee has no other way of obtaining it. Moreover, the employee will have to be given an explanation as to the significance of the information and the difference in tax treatment between contributions made before and after January 1, 1970. The problem of communicating and explaining the information to the employee will impose a substantial burden on the employer.

Step 2: Compute the amount of forfeitures included in the distribution.

The Report of the Committee on Ways and Means (Part I, p. 155) states that for purposes of determining the post-1969 employer contributions forfeitures will be treated as contributions made by the employer. (Forfeitures are amounts relinquished by reason of an employee's termination of employment before he has acquired a fully vested right to a benefit.) Accordingly, another figure will have to be developed which is not always identifiable on an individual basis—i.e., where the cost of benefits is figured on an aggregate basis. Even where forfeitures are allocated on an individual basis the rule will require an extra computation of an amount which the employee is not able to determine for himself.

A further question is raised as to whether or not certain amounts which were contributed to a plan prior to January 1, 1970, but reallocated upon forfeiture on or after such date will retain their status as pre-1970 contributions subject to the present rule. If so, it will be necessary to further break down forfeitures between those attributable to employee contributions prior to 1970 and those attributable to employer contributions after 1969.

Step 3: Deduct the amount developed under Steps 1 and 2 from the total amount distributed.

Step 4: Determine the tax on the balance under the present rule applicable to long term capital gains.

Step 5: Determine the tax due on the employee's taxable income without the amount of post-1969 employer contributions.

Step 6: Determine the tax liability which would be due by including 20% of the amount of post-1969 employer contributions in the employee's taxable income for the year in which the distribution is made.

Step 7: Subtract the tax liability determined under Step 5 from the tax liability determined under Step 6 and multiply the result by 5. The product is the tentative tax liability of the employee which must be paid in the year the distribution is received.

Step 8: Five years later, recompute the tax liability which would have resulted from including 20% of the post-1969 employer contributions in the employee's taxable income for the taxable year in which the lump sum distribution was received and in each of the following four years.

In this connection, it should be noted that the averaging device in Step 8 is a different one from that contemplated in Steps 6 and 7. Thus, the employee must not only recompute his tax liability but he must do it on a different basis.

Step 9: If the amount determined in Step 8 exceeds the amount determined in Step 7, the employee is considered to have made an overpayment of his tax and may file a claim for refund.

It would appear that the distribution of the employee's interest in a lump sum amount in one year would also qualify for the income averaging rules proposed under Section 311 of the Bill and the employee could compute his tax liability thereunder. In order to take advantage of the averaging under Section 311, however, the employee would have to face yet another set of complex computations.

It is submitted that there is no necessity for providing for such a complicated method of taxing a distribution. The proposed rule would require *every* taxpayer who receives a lump sum distribution to compute his tax liability twice for each of the five years from his retirement or other termination of employment. This is particularly objectionable when considered in light of the fact that the rule is applicable to employees who have reached retirement age and who may not be entirely able to cope with the necessary computations and record-keeping involved in the proposed rule.

(3) The Complexities of the Proposed Rule Would Be Felt by All Employees Under Qualified Plans and Not Merely by Those Whose Tax Liabilities Would Be Increased

The Report of the Committee on Ways and Means (p. 154) indicates that the proposed rule is aimed at moderating the tax benefits to taxpayers with adjusted gross incomes in excess of $50,000. Whether or not this is a valid objective, the face remains that *all* employees under qualified plans will have to follow the complex rules outlined above if the proposal is adopted. It has been estimated that some 25 to 30 million employees are currently covered by qualified pension and profit sharing plans and that this number will grow to approximately 40 million by the year 1980. Without attempting to estimate what percentage of employees receive lump sum distributions, it is obvious that a very substantial number of taxpayers will be required to follow the computations of the proposed rule. It is highly questionable whether the relatively small revenue gain anticipated from the proposed rule outweighs the disadvantages to millions of taxpayers who will be affected by it.

(4) The Proposed Rule Is Not a True Averaging Device

The purpose of an averaging rule is to spread an unusual item of income over a period of years to achieve a more realistic tax liability and avoid fluctuations in income. However, under the proposed rule the tax on a lump sum distribution is determined initially on the employee's situation in one year—the year in which the distribution is made. Starting with income for that year, the employee must add 20% of the post-1969 employer contributions received as part of a lump sum distribution and recompute this tax liability and multiply it by five. If the employee happens to have unusual items of income such as termination of employment payments, his income for the year of distribution is apt to be inflated. Such a distortion of income is very likely to occur merely because of the fact that the employee receives a lump sum distribution in that year. The receipt of that payment alone will inflate his income.

Admittedly, the so-called five year forward averaging rule (Step 8 above) is a true averaging device but this is not applicable until five years after the distribution has been made. In the meantime, the employee has paid his tax based upon his circumstances in the year of distribution and has been deprived of the use of the overpayment during the five-year period. This is particularly objectionable in view of the fact that the proposed rule is applicable to retired employees who are the relatively older taxpayers. It makes little sense to require an employee to overpay his tax at a time when he might need the money to provide for his retirement and the security of his beneficiaries. The crowning blow is the fact that he will have to file a claim for refund. This means engaging an attorney or other professional to prosecute the claim, thereby incurring an additional expense to recover what was rightfully his in the first place.

CONCLUSION

The proposed rule is far too complicated to be practical. The existing rule is a much simpler method of taxing a lump sum distribution, is far easier to administer and, on balance, provides a fair and reasonable system of taxation. The proposed rule should be rejected.

Respectfully submitted,

LEE, TOOMEY & KENT,
JOHN A. CARDON,
JOHN M. SKILLING, Jr.

The CHAIRMAN. Mr. Arthur Wood, president, Sears, Roebuck.

STATEMENT OF ARTHUR M. WOOD, PRESIDENT, SEARS, ROEBUCK & CO.; ACCOMPANIED BY CHARLES W. DAVIS, TAX COUNSEL; AND T. D. BOWER, OF THE TAX DEPARTMENT, SEARS, ROEBUCK & CO.

Mr. WOOD. Mr. Chairman, I am Arthur M. Wood, president, Sears, Roebuck & Co. With me today are Mr. Charles W. Davis, tax counsel, and Mr. T. D. Bower, member of Sears' tax department.

The CHAIRMAN. Mr. Davis is well known to us here. He served at one time over on the House committee staff before he decided to depart for the lush green fields of private enterprise, for which I don't blame him.

Mr. WOOD. Well, we are glad he is in our lush forest.

I do appreciate the opportunity to appear on behalf of Sears and the 200,000 employees who are participants in Sears' profit-sharing plan. The taxation of lump-sum distributions to retiring employees is a matter of very vital concern, since the assets received from our profit-sharing plan provide for the retirement security of the great majority of our employees.

I would like to explain briefly how our profit-sharing plan works. Each employee deposits 5 percent of his compensation up to a maximum of $750 each year. Thus, he participates only on the first $15,000 of his annual compensation. This limitation is provided so that higher paid employees do not share unduly in the fund.

The company contributes a percentage of its profits before taxes on a sliding scale and that percentage is now 11 percent, which is the maximum that the company can contribute. These amounts, employee deposits and the company contributions, are invested primarily in Sears, Roebuck & Co. stock. Each employee has his own account in the fund, and he receives at each yearend an annual statement showing the details of his account, including the specific number of Sears shares that are credited to his account.

After the employee has been with the company for 5 years, his interest in the account is vested and if he leaves the company, he can withdraw his entire credit. Importantly, after 5 years the fund member is entitled to direct how the shares of Sears stock in his account can be voted. So in truth he becomes a shareholder, although the shares are held in trust.

Sears employees, because of profit sharing, are truly partners in the business. They own a share of Sears, Roebuck & Co. through profit sharing. And, because of this, they have an extra incentive to do the best possible job for us every day of the year.

Now, there is no doubt that the company has benefited because of the loyalty and devotion of its employees. And there is no doubt that our employees have benefited because of their participation in our profit-sharing fund.

When an employee leaves the company, he receives distribution of all the assets credited to his account, and most always he takes the shares of Sears in kind.

In addition he receives the cash value of the miscellaneous investments credited to his account. And this combination for tax purposes is a lump-sum distribution.

As I indicated, these are the assets which provide for the retirement security of the employee and his family. They are the accumulation of a lifetime career of work. Last year you might be interested to know that the average distribution to employees who retired with from 25 to 30 years of service had a value of just over $100,000.

Now a word about the present tax treatment.

Senator BENNETT. That is the average per capita distribution.

Mr. WOOD. The average employee who has served our company for between 25 to 30 years withdrew just over $100,000 in net value of Sears' stock and his miscellaneous investments on his retirement from the company.

Senator BENNETT. That is rather amazing. Do many other companies have that much equity available to their employees when they retire?

Mr. WOOD. There are a number of companies who have had profit-sharing plans in existence for as long as Sears. Procter & Gamble is one.

Of course, having had a plan in existence during the life-time of work of an employee, and in this case the example of 25 to 30 years, means that he has deposited his savings, the company has made its contribution, and the investment in stock has grown with America, has grown with our company. Since it remains intact, it has ridden through the ups and downs of the market. This stock has appreciated many times over.

Now, there are literally thousands of companies today with profit-sharing plans, because they recognize the great incentive that is provided for their employees in having a share of the business.

The CHAIRMAN. That is a pretty good way to make a capitalist out of a working man, I would say.

Mr. WOOD. That is exactly what happens and General Wood said for years when he was chairman of our company and chairman of the trustees of the fund—that our employees are capitalists.

Now, a word about the present tax treatment of profit-sharing distributions. The present law provides long-term capital gains treatment for distributions made in 1 year on account of separation from the service. These provisions have their origins with the Finance Committee of the Senate and they date back to 1942. The provisions for long-term capital gains treatment of lump-sum distributions are well understood not only by our thousands of employees but all the employees in profit sharing across the country.

The House bill, H.R. 13270, and specifically section 515, drops capital gains treatment for the company contribution that is made to profit-sharing funds. Under the House bill when an employee leaves the company and receives his accumulated interest in the profit-shar-

ing fund, that portion of the account which represents the company contributions would be taxed as ordinary income. The House bill makes this prospective and would apply to company contributions made starting from January 1 of 1970.

To alleviate the effect of bunching company contributions in one tax year, that is, the year of withdrawal, the House bill provides a method for averaging the tax in the year of distribution. And I would like to——

The CHAIRMAN. Incidentally, this sound system wasn't made by Sears. [Laughter.]

Mr. WOOD. I would like to take just a couple of minutes to go through the type of computation that would be necessary for the retiring profit-sharing member to handle this part of the tax on his lump sum distribution. The taxpayer first computes his income in the year of retirement without including the company contribution. He then recomputes by including 20 percent of the company contribution in his gross income. He multiples the increase in tax thus obtained by five in order to obtain his tax liability for the year of distribution. The House bill then provides that 5 years later the retiree, the taxpayer, may recompute the tax on the employer contributions by assuming that 20 percent of the contribution was received in the year of retirement. And 20 percent in each of the 4 successive years. If this results in a lower tax than that paid in the year of retirement, the employee would be entitled to a refund.

Now, our study indicates that in most cases the taxpayer would make this recomputation and be entitled to a refund. We base this on the probability that following his retirement he would be in a lower tax bracket because of the discontinuance of his regular wage or salary. These computations which are called for by the House bill are complicated. They would confuse the taxpayer, because by that time in most cases he would be a senior citizen, and they would add burdens to the Internal Revenue Service in auditing the claim for refund.

We feel that capital gains treatment is easier to handle. It is understood by profit-sharing members the country over, and it is the proper way to tax the profit-sharing accumulation which has been the subject of risk over the entire period of his carrer.

The employees profit-sharing account is truly a capital asset on which the employee bears the risk of gain or loss depending on the fortunes of his company and of the other companies in which the funds may be invested. He is just like an ordinary investor in that he has capital at risk during his career since it is invested in stock.

Now, an incidental effect of the long-term capital gains treatment is that it does provide an excellent method of averaging. I think this was taken into consideration years ago when it was originally adopted. Our studies show that the method provided by H.R. 13270 after the refund claim would result in approximately the same tax for the average retiring employee as the capital gains tax. The House bill really provides a complicated method of averaging, and it wouldn't permit the taxpayer to know his final tax liability until 5 years after his retirement.

Just one more point I would like to mention is the unrealized appreciation in the shares of Sears stock which are taken by the retiring

employee. Under present law Sears stock taken in a lump-sum distribution is taxable at its cost to the profit-sharing fund. The tax on the appreciation in its value is thus postponed until the employee sells his stock.

This treatment, which would not be changed by the House bill, is in our judgment entirely proper. A profit-sharing member should not have to pay tax on the appreciation in the employee stock purchased for him by the profit-sharing fund until he sells the stock. At retirement he takes only the direct control, the legal title of those shares which have been held for him in trust during his employment years. Since other purchasers of stock are not taxed until they sell their stock, until they have realized their appreciation, a profit-sharing member in our judgment should get the same treatment. And we certainly are pleased that the House bill continues this treatment. We urge with all our conviction the importance of maintaining this aspect of tax policy.

So, with one final reference to section 515 of the House bill, if the Finance Committee should agree with the House that the employer contributions to profit sharing should be taxed as ordinary income, then we certainly hope that a better method of averaging can be found, one which avoids the possibility of the 5-year wait to determine final tax liability. We feel that the peace of mind of our profit-sharing members would certainly be enhanced if they can know what their tax is, if it can be determinable, and paid in the year of retirement.

Thank you very much.

The CHAIRMAN. Thank you very much, Mr. Wood. You made a very fine statement. I certainly don't want to do anything to unduly confuse or place in doubt the rights of Sears employees in the profit-sharing plans. You have a lot of employees in my State, my hometown, and all over the country, I am sure. I guess——

Mr. WOOD. We are represented in all the States.

The CHAIRMAN (continuing). Sears is in every State of the Union, are you?

Mr. WOOD. Yes.

The CHAIRMAN. So if we so confuse your pension plan to where it is difficult to administer and where people can't understand how to use it, we will be creating a problem on a nationwide basis, won't we?

Mr. WOOD. I think so. Thank you.

Senator WILLIAMS. No questions.

Senator BENNETT. No questions except a word of commendation. I wish every employer in the United States had so liberal a plan. I remember being picked up one day by a Sears chauffeur and being told he had something like $160,000 under Sears' plan and this is something that I wish every company could produce for its employees.

Mr. WOOD. Thank you. We are very happy that our employees have this retirement security and that the country has been good to them and good to Sears, Roebuck. Thank you very much.

(Arthur M. Wood's prepared statement follows:)

STATEMENT BY ARTHUR M. WOOD, SEARS, ROEBUCK AND CO.

SUMMARY

A. Change in Law Made by H.R. 13270

Section 515 of H.R. 13270 would change the taxation of employer contributions included in lump sum distributions from profit sharing plans. Sears, in its own

interest as an employer, and in the interest of its employes, believes this change should not be enacted.

B. How Sears Profit Sharing Plan Works

The Sears Profit Sharing Plan was established in 1916. The employes contribute 5% of their compensations, up to $750 per year. Participation in the Plan is limited to $15,000 per year compensation. The Company contributes up to 11% of its profits to the Plan each year. The major portion of the Plan's assets is invested in Sears stock. The employe's interest in the Plan is fully vested after five years service, and most employes take the Sears stock credited to their account when they leave.

C. Review of Present Law and Proposed Change

Under present law, complete distributions because of separation from service are treated as long term capital gains. The tax on appreciation in any employer's stock included in such distributions is postponed until the stock is sold.

This present, well-established tax treatment would be changed by the House Bill. Under the House Bill all employer contributions made for years after 1969 which are included in a complete distribution would be taxed as ordinary income in the year of the distribution under an averaging method. A later recomputation of tax would be permitted for the year of retirement and the four subsequent years on the assumption that 20% of such employer contributions were included in income in each of such years. If this resulted in a lesser tax than was paid under the averaging method in the year of retirement, the employe would be entitled to a refund.

In other respects, present law would continue. The balance of the taxable amount of the distribution would be taxed as long term capital gain, and tax on appreciation in employer stock would be postponed until the stock is sold.

D. Capital Gains Treatment Should be Retained in Its Present Form

An interest in a profit sharing plan is an investment at risk over a long period, and therefore, is entitled to capital gains treatment just as is any other investment. This is true of employer contributions as well as employe contributions and earnings. Capital gains treatment is fair, easy to understand, and workable, and is a desirable method for alleviating the effect of the "bunching" of income accumulated over many years of service and received by the employe in one year. The change made by the House Bill is complex and would be difficult for employes to understand and for the Internal Revenue Service to administer. It generally requires the retiring employe to overpay his tax in the year of retirement and to seek a refund five years later.

The final tax liability of the average employe does not, in the long run, appear to be significantly different under Section 515 of the House Bill than under present long term capital gains treatment, and therefore, capital gains treatment should be retained. If for some reason it is considered imperative that employer contributions be taxed as ordinary income, then an averaging device ought to be found which arrives at a final and proper tax liability at the time of retirement, and which is reasonably easy for retiring employes to understand.

E. Tax on Unrealized Appreciation in Employer Securities Should be Deferred

Since its inception in 1916, Sears Profit Sharing Plan has been invested primarily in Sears stock. The employes are part owners of the Company, and thus have a real stake in its future. This results in an identity of interest between Sears and its employes. The loyalty and hard work of thousands of employes is largely responsible for Sears growth over the years. This growth has in turn benefited the employes, as Sears stock has increased in value almost sixty times since 1916. Employes generally take their Sears shares with them when they retire. Because of this the deferral of tax on unrealized appreciation in employer securities is of the utmost importance. The House Bill properly recognizes that such appreciation should not be taxed before it is realized through a sale. The retiring employe, when he leaves, does not receive cash but only receives direct legal title to stock which was already his. He should be treated just as anyone who purchases securities directly, and should not be taxed on the appreciation until he sells the stock. Taxing unrealized appreciation would work a hardship on him because he would have to borrow money or sell some of his stock to pay his tax.

STATEMENT

This statement is presented on behalf of Sears, Roebuck and Co. and its 200,000 profit sharing employes with respect to the change which would be made by Section 515 of the Tax Reform Act of 1969 in the taxation of distributions from profit sharing plans. The Act, as passed by the House of Representatives, would tax that part of a complete distribution from a profit sharing plan consisting of amounts contributed by the employer after 1969 as ordinary income, rather than long term capital gain as under present law.

This change should not be enacted. Long term capital gains treatment should be retained in its present form in recognition of the fact that an interest in a profit sharing plan is an investment at risk over a long period and is entitled to such treatment. Capital gains treatment is fair, workable, and easily understood, and is a good method of taxing "bunched" income. The change which would be made by the House Bill is extremely complex, and would be difficult for employes to understand, and for the Internal Revenue Service to administer. It would in most cases require employes to overpay their tax at the time of retirement, and then to seek a refund of the overpayment five years later.

Before discussing the proposed tax change, I shall first describe the Sears Profit Sharing Plan.

DESCRIPTION OF SEARS PROFIT SHARING PLAN

The Sears Profit Sharing Plan was established on July 1, 1916, more than fifty-three years ago. Its purposes were threefold—to permit employes to share in the Company's profits, to encourage the habit of saving, and to allow employes to accumulate a sum sufficient to provide for their retirement. While the plan has been amended many times over the years, these basic purposes have remained the same.

Under present rules all regular employes are eligible to join the Plan after one year's service with the Company. Although membership is voluntary, over 90% of those eligible to join do join. As a member of the Plan, the employee contributes 5% of his own tax-paid salary to the Plan each year, up to a maximum of $750 (5% of $15,000). This means that the employe participates in the Plan only on his first $15,000 of earnings. (Prior to the current year the maximum participation was $10,000 of annual earnings.) This limitation was adopted specifically to prevent the higher paid employees from participating unduly in the Plan.

The Company also makes contributions to the Plan each year, based on a sliding percentage of its net profit before taxes. The maximum percentage is 11% of pre-tax profits, and it is expected that the Company will contribute this maximum amount during the current year. The Company contributions are allocated to the members under a formula which takes into account each employe's contributions, years of service, and age.

Since the inception of the Plan in 1916, its assets have been invested primarily in Sears stock. As of December 31, 1968, Sears stock constituted about 86% of the Plan's total assets, and other securities accounted for the remaining 14% of its assets.

Each employe has his own account in the Plan and receives an annual statement showing the details of his account, including how much he contributed during the year, his allocable share of Company contributions, and the earnings on the investments in his account. To the extent amounts credited to his account are invested in Sears stock, his statement shows the actual number of shares he owns. To the extent such amounts are invested in other securities, his statement shows their dollar value.

The employe's account in the Sears Plan becomes fully vested after he has been with the Company for five years. After an employe's account is vested, he can instruct the trustees of the Plan as to how to vote the Sears stock in his account at the shareholders' meetings. Also, he is then entitled to take with him the full amount credited to his account if he leaves the Company for any reason. Sears shares credited to his account are generally distributed to him in kind rather than being converted into cash.

From this brief description, it can be seen that Sears employes are the true owners of their profit sharing investments throughout their working careers. They are not guaranteed any definite benefit on retirement, but assume the risk of gain or loss just like any other investor. Also, they are very definitely partners in Sears business. Since the Plan is largely invested in Sears stock—it now owns

about 22% of the Company's outstanding stock—the employes themselves stand to gain significantly from any success which the Company may have. This gives Sears employees a real stake in the Company's future and in the American free enterprise system.

The actual dollar value of any particular employe's benefit from profit sharing obviously cannot be determined in advance since it will be dependent on his years of service, the increase or decrease in value of the investments in his account, and other factors. However, it is possible to show the benefits which Sears employes who have already retired have received. Using 1968 as an example, the Plan's records show that employes who retired in that year with twenty-five to thirty years service received, on the average, cash and Sears stock with a combined value of $100,401. Employes with longer service would generally have received more. Those with shorter service would, on the average, have received less.

PRESENT LAW AND CHANGES MADE BY HOUSE BILL

With this background on how the Sears Plan works, I should like to discuss the tax treatment of profit sharing distributions. Under present law, which has been in effect for over twenty-five years, complete distributions from profit sharing plans are taxed as long term capital gains, if they are made in one taxable year as a result of the employe's separation from service with his employer. In addition, where the distribution includes securities of the employer corporation, these securities are valued at their original cost to the plan. Thus, the unrealized appreciation in such securities is not taxed until the employe later sells them.

The House Bill would change present law so as to tax as ordinary income, rather than as long term capital gain, that portion of a profit sharing distribution which is made up of employer contributions attributable to years after 1969. A special averaging device is included so as to minimize somewhat the effect of the "bunching" of income in the year of retirement. Under this averaging device, one-fifth of such employer contributions is added to the employe's other income and a tax is computed on it. This tax is then multiplied by five to arrive at the total tax on such employer contributions. In addition, the House Bill provides for a recomputation of the tax for the taxable year of retirement and each of the four following taxable years. In making this recomputation the retired employe assumes that 20% of such employer contributions was includible in his income in the year of retirement, and the remaining 80% was includibly ratably over the four years immediately following retirement. If this recomputation results in a lesser tax than was paid in the year of retirement (and it probably will), the employe is entitled to a refund.

Other than the change in the handling of company contributions, the future tax treatment of profit sharing distributions would be the same as under present law. That is, to the extent that a distribution is attributable to earnings of the plan over the years and to realized appreciation in the value of plan investments, the distribution would be treated as long term capital gain. Also, change would be made in the tax treatment of the unrealized appreciation in employer's securities distributed in kind. Tax on such unrealized appreciation would continue to be deferred until it is realized through a sale of the stock.

There are other changes made by the House Bill which, although not specifically directed toward profit sharing, could have an effect on the calculation of tax on profit sharing distributions. One of these is the removal of the 25% maximum tax rate on long term capital gains. Another is that Section 311 of the House Bill makes the general income averaging provisions of the Code (Sections 1301 through 1305) applicable to long term capital gains. Thus, under the House Bill a retiring employe would have two alternatives in computing the tax on his profit sharing distribution. One of these would be to use the special averaging device and the refund provisions described above. The other would be to use the general income averaging provisions of the Code.

COMMENTS ON TAX TREATMENT OF PROFIT-SHARING DISTRIBUTIONS

Our purpose in presenting this statement is to point out the essential fairness of the present method of taxing profit sharing distributions. There are two fundamental principles which we feel are important—first, profit sharing distributions are taxed as long term capital gains, and second, the tax on unrealized appreciation in employer securities is deferred until the employe sells the securities. These principles should be retained.

I. REASONS FOR RETAINING LONG-TERM CAPITAL GAINS TREATMENT IN ITS PRESENT FORM

A. *Long term capital gain treatment of employer contributions is correct*

There are two major reasons why capital gains treatment is especially appropriate for lump sum distributions from a profit sharing plan. First, capital gains treatment was developed for and has been traditionally applied to situations where income accumulated over a number of years is "bunched" into one year. Lump sum distributions from profit sharing plans, which have been accumulated over many years of service and received by the employe in one taxable year, are an excellent example of the type of bunched income for which the capital gains method of taxation was developed.

Second, capital gains treatment should be applied to lump sum distributions from profit sharing plans because the individual employe's profit sharing account is an investment at risk throughout his working career. He is the true owner of his profit sharing investments, whether arising from his own contributions or from his employer's contributions. His interest in his profit sharing account is subject to the same risks that any investor in securities takes. If the investments turn out well, the employe enjoys the gain. On the other hand, if the investments turn out badly, the employe suffers the full loss. Thus, the employe's profit sharing distribution should be entitled to capital gains treatment and it should not be fragmented so as to tax a part of it as ordinary income.

The fact that a portion of the employe's interest in his profit sharing account may originate from the employer's contribution, and thus may be attributable to the employe's own labor, does not make it any less a capital asset and should not require that this portion of his distribution be taxed as ordinary income. As an example of this, let us consider the individual entrepreneur who builds up the goodwill of his business through his own hard work over a long period of years. He is permitted to have capital gains treatment on the sale of this goodwill when he retires and sells his business even though it resulted from his personal labor. An employe's profit sharing account should be entitled to equivalent treatment.

B. *Long term capital gains treatment is a better averaging device than is provided under the House bill*

The House Bill proceeds on the theory that the employer contributions included in a profit sharing distribution constitute compensation, and therefore, should be taxed as ordinary income. It then recognizes the inequity of bunching this income into one taxable year, and adopts an averaging device and refund provisions to solve this problem. However, we submit that averaging is better accomplished, with less burden to the taxpayer, by applying the present long term capital gains treatment. It arrives at a fair result with a minimum of complexity and is superior to the averaging device contained in the House Bill.

The usual Sears employe begins working with the Company when he is just starting his career and is in the lower tax brackets. He then works his way up and probably earns his highest salary in the year of retirement. While long term capital gains treatment taxes only half of his distribution in the year of retirement, it does so at tax rates which begin at the employe's *highest* rate for that year and go *upward* from there. Thus, it results in a sizable tax and is generally a good averaging device for determining the tax on the employe's profit sharing distribution which was built up over an entire career, perhaps thirty or forty years or more.

Long term capital gains treatment arrives at a fair result even for the few employes who ultimately reach a high position in the Company. Such employes have generally started at the bottom of the ladder and worked their way up over a long period of years. For a good part of their career they were generally in the lower tax brackets and it is not at all improper to tax them at rates lower than the bracket in which they find themselves at retirement. It should be noted also that the House Bill would eliminate the 25% maximum tax rate on long term capital gains, and if enacted, this in itself would raise the tax on employes in the higher tax brackets.

The averaging device provided by Section 515 of the House Bill is not satisfactory. Under this averaging device the employe computes the tax on one-fifth of the post-1969 employer contributions and then multiplies that result by five. One problem with this approach is that it assumes that the employer contributions were earned over a five year period even though they were generally earned over an entire career. A more serious problem, however, is that one-fifth of the post-1969 employer contributions is added on top of all other income in the year of retirement. This includes both the employe's salary and the capital gains portion

of his profit sharing distribution. Thus, the year of retirement is generally his very highest income year and the employer contributions would be taxed at these high rates.

The House Bill makes a serious attempt at correcting this problem through the use of the refund provisions which treat 80% of the post-1969 employer contributions as taxable ratably over the four years subsequent to retirement. Our rough calculations indicate that the average Sears retiree would be entitled to a significant tax refund five years after retirement, and that after he receives his refund his net tax liability would not be greatly different than under the present capital gains treatment. Thus, an important objection to the averaging provisions of the House Bill is that they deprive the employe of needed funds in the year of retirement and the four subsequent years.

The law should provide a reasonable opportunity for the employe to pay his correct tax in the first instance. Preferably this should occur in the year of his retirement, as is the case with long term capital gains treatment. However, if the theory is to be followed that only 20% of the employer contribution is to be taxable in the year of retirement, and the remaining 80% ratably over the four subsequent years, the employe should pay his tax each year on the pro rata amount taxable in such year. He should not pay tax on the entire amount of employer contribution in the year of retirement, and then be required to seek a refund at the end of five years.

C. The change in the treatment of employer contributions is extremely complex in its application

Long term capital gains treatment also has the advantage of being easy to understand. It has been the law for over twenty-five years and people are familiar with it.

The treatment under the House Bill, on the other hand, is quite difficult to understand. It would require a number of complex calculations to determine the employe's tax for the year of retirement. First, a calculation would be made of the tax on the employe's income, including his salary and the capital gain portion of his profit sharing distribution, but entirely excluding the post-1969 employer contributions. Another calculation would be made of the tax on this same income plus one-fifth of the post-1969 employer contributions. The difference in these two tax figures would then be multiplied by five, to determine the total tax on the post-1969 employer contributions. This amount would then be added to the tax on the employe's other income to arrive at the total tax liability for the year of retirement.

Then, five years after retirement a recomputation would be made of the tax for the year of retirement and each of the succeeding four years. It would be based on the assumption that 20% of the post-1969 employer contributions is includible in the retired employe's income in each of these years. The total tax on the employer contributions computed on this basis for the five year period would then be compared with the tax the employe paid on the employer contributions in the year of retirement. If this total tax is less than that paid in the year of retirement, the employe would be entitled to a refund of the difference.

To illustrate how this proposed change in the law would work, we have attached to this statement an exhibit showing the steps which an employe would have to take in complying with this new provision. This new provision would obviously be far more complex than merely including 50% of the gain in income at the time of distribution as is presently done in the case of long term capital gains.

D. The refund provisions of the House bill present other serious practical problems

There is another very practical problem which would arise from the new averaging device and the refund provisions. This is the fact that the elderly retiree may never remember to apply for a refund five years after retirement, and if he does emember he may well have lost or misplaced vital records from the intervening years.

As a matter of fact, the Internal Revenue Service would have a similar problem. In order to determine if an employe were really entitled to a refund, the Service would have to audit the employe's returns for the previous five years. Some of these may have been filed in other Internal Revenue Districts and may be difficult to locate. We believe that these refund provisions would cause serious administrative problems to the Service as well as to the employe.

In summary, we believe that long term capital gains treatment of profit sharing distributions is fair, has the advantage of being easy to understand, and is a good method of taxing "bunched" income. We recommend that such treatment be retained.

II. UNREALIZED APPRECIATION IN EMPLOYER SECURITIES SHOULD NOT BE TAXED AT THE TIME OF DISTRIBUTION

Ever since its inception in 1916, the Sears Profit Sharing Plan has been invested primarily in Sears stock. The Rules of the Plan make specific provision for such investment, so that "depositors may, in the largest measure possible, share in the earnings of the Company".

Consequently, Sears employes are not only the true owners of their profit sharing accounts, but also the owners of a large portion of the Company for which they work. Through profit sharing, they own 22% of the Company, and this gives them a real stake in its future, and makes their interest and that of the Company, inseparable and indivisible. They are entrepreneurs just as much as any man who owns his own business.

Through the loyalty and devotion which their ownership in the Company has inspired, the Company has prospered and grown. In 1916, when the Plan was started, Sears was a mail order house with sales of $137,000,000. At the end of 1968, Sears had 11 catalog order plants and 818 retail stores, and its sales for that year were over $8 billion. This great growth in our business could not have come about without the loyalty and hard work of thousands of employes.

Of course, this is a two way street. While the Company's growth has been due largely to the loyalty of its employes, the employes have benefitted greatly from that growth. Since 1916, the price of Sears stock has increased almost sixty times, and through their interest in the Plan, employes have shared in this increase.

Even when an employe retires from Sears, he retains his ties with the Company. Sears retirees generally take their Sears stock with them when they leave, and continue as shareholders during their retirement years.

At Sears, profit sharing and the principle of investing in Company stock are one and the same thing, and therefore, the deferral of tax on unrealized appreciation is of the utmost importance. The House Bill recognizes the fact that it would be inequitable to tax away such appreciation before it is realized through a sale of the stock. The retiring employe does not receive cash but only receives direct legal title to the stock which was purchased for him previously and held for him throughout his employment. Individual purchasers of securities are not taxed on appreciation in securities which they own until that appreciation has been realized through a sale, and profit sharing plan members should not be treated differently.

To tax the employe on unrealized appreciation would work an undeserved hardship on him. Generally, he would not have the money to pay his tax, and would either have to borrow or liquidate a portion of his investment in his Company. Either of these courses would impair his retirement security substantially and would be undesirable.

The present tax treatment of employer securities is entirely proper and should be retained.

CONCLUSION

In conclusion, we believe that the House Bill properly recognizes that tax on unrealized appreciation in employer securities should be deferred. However, the change in the treatment of employer contributions provided in Section 515 of the House Bill should not be enacted. It is extremely complex and will be very difficult for retiring employes to understand. In addition, it will require them to overpay their tax in the first instance, and then obtain a refund without interest five years later.

The present long term capital gains treatment is proper because it recognizes the fact that an interest in a profit sharing plan is an investment at risk over a long period. It is fair, easy to understand, and provides a good averaging device for taxing profit sharing distributions. If in spite of this fact, it is considered imperative to change the tax treatment of employer contributions, a better averaging device should be found than that provided in the House Bill. Such a device should be reasonably simple in its operation. It should provide for the employe's tax liability to be finally determined at the time of his retirement and should obviate the necessity for reliance upon refund procedures.

EXHIBIT

SAMPLE COMPUTATIONS OF TAX UNDER TAX REFORM ACT OF 1969 FOR COMPLETE DISTRIBUTION FROM SEARS PROFIT-SHARING PLAN BECAUSE OF SEPARATION FROM SERVICE

A. Assumptions

It is assumed that an employe begins working for Sears on January 1, 1971, at a starting salary of $4,700 a year and retires at the end of 1995 after twenty-five years service at a final salary of $18,650 per year. It is further assumed that Company contributions to the Profit Sharing Plan are allocated to the employe's account each year in amounts approximately equal to those being allocated to employes currently, and that Sears stock appreciates at a rate of 6% a year and pays dividends of about 2% a year on its market value.

In the year of retirement, it is assumed that the employe has no income other than his salary and that the employe does not elect general income averaging on his distribution. In subsequent years, his dividend income on Sears stock and his other income is assumed to be $1,900 per year.

B. Taxable value of employe's profit-sharing distribution

Under these assumptions, the following analysis shows the taxable value of the employe's distribution at retirement:

Total value of account (Sears stock)	$87,150
Less: Total of employe's annual deposits	13,460
Total	73,690
Less: Appreciation on Sear stock	33,654
Taxable value of account	40,036
Employer contribution included in taxable value—Ordinary income	28,718
Balance of taxable value—Long-term capital gain	11,318

C. TAX COMPUTATION UNDER TAX REFORM ACT OF 1969

1. Tax in year of retirement	Tax on income other than employer contributions	Tax on income including 20 percent of employer contributions
Income:		
Salary	$18,650	$18,650
Profit-sharing distribution:		
Company contributions $28,718, 20-percent includible		5,744
Balance of taxable value $11,318, 50-percent includible	5,659	5,659
Gross income	24,309	30,053
Less: 2 exemptions and $2,000 standard deduction	3,200	3,200
Taxable income	21,109	26,853
Tax on above at proposed rates	4,473	6,310
Computation of total tax:		
Tax on income excluding employer contributions		4,473
Tax on employer contributions:		
Tax on 20 percent of employer	1,837	
Contributions ($6,310–$4,473)	×5	9,185
Total tax in year of retirement		13,658

2. SUMMARY OF ACTUAL TAX RETURNS FOR FOLLOWING 4 YEARS

	Years after retirement			
	1	2	3	4
Total gross income	$1,900	$1,900	$1,900	$1,900
Tax liability (low income allowance applicable)	0	0	0	0

3. RECOMPUTATION OF TAX FOR FOLLOWING 4 YEARS INCLUDING 20 PERCENT OF EMPLOYER CONTRIBUTIONS IN INCOME

	Years after retirement			
	1	2	3	4
Gross income per returns filed	$1,900	$1,900	$1,900	$1,900
20 percent of company contribution	5,744	5,744	5,744	5,744
Total gross income	7,644	7,644	7,644	7,644
Less 2 exemptions and 15 percent standard deduction	2,347	2,347	2,347	2,347
Taxable income	5,297	5,297	5,297	5,297
Tax liability	813	813	813	813

4. COMPUTATION OF REFUND DUE

Tax paid on employer contributions in year of retirement (see 1 above)	$9,185
Tax due if 20 percent of employer contributions was includable in each of 5 years:	
Tax due for year of retirement (see 1 above)	1,837
Tax due for remaining 4 years (see 3 above, 4 times $813)	3,252
Total tax due	5,089
Net refund due at end of 5 years	4,096

The CHAIRMAN. Mr. Raymond Giesecke, chairman of the board of the Council of Profit Sharing Industries.

STATEMENT OF RAYMOND H. GIESECKE, CHAIRMAN OF THE BOARD OF DIRECTORS, COUNCIL OF PROFIT SHARING INDUSTRIES; ACCOMPANIED BY STANLEY D. NOBLE, PRESIDENT, COUNCIL OF PROFIT SHARING INDUSTRIES; AND JOHN R. LINDQUIST, LEGAL ADVISER TO McGRAW-EDISON

Mr. GIESECKE. My name is Raymond H. Giesecke. I am president of the McGraw-Edison Co., the principal offices of which are located in Elgin, Ill. Today I speak for the Council of Profit Sharing Industries, a nonprofit association of approximately 1,500 companies of all sizes, from three or four employees to thousands of employees, having profit-sharing plans covering some 1½ million employees in all types of enterprises located throughout the United States. There are probably around 6 million people including dependents who are involved in, or dependent upon, the profit-sharing plans established by members of the council.

I am chairman of the council and a member of its board of directors. The headquarters of the council are at 29 North Wacker Drive, Chicago. The company by which I am employed has had a deferred profit-sharing plan for over 16 years and is a member of the council.

I am accompanied today by the president of the council, Mr. Stanley D. Noble on my right, and by the legal adviser to McGraw-Edison Co. in employee benefit matters, Mr. John R. Lindquist of the Chicago lawfirm of McDermott, Will & Emery on my left.

On behalf of the council I wish to thank the committee for allowing the council to appear here today on behalf of its members. In accordance with the rules governing the hearings, copies of the council's formal statement together with a summary were filed with the committee last Friday and with the consent of the committee we ask that the council's formal statement and summary be included in the printed record of these hearings.

The CHAIRMAN. It is already here.

Mr. GIESECKE. Thank you very much.

The council opposes the provisions of H.R. 13270 which would provide a special——

The CHAIRMAN. Not only do we have that but we also have a staff summary of your statement.

Mr. GIESECKE. Thank you, Senator.

The council opposes provisions of H.R. 13270 which would provide a special method of taxation of portions of lump-sum distributions made under qualified profit-sharing plans. Other changes contained in H.R. 13270 also would have a bearing on the amount of taxes payable with respect to lump-sum distributions. The next effect of these other changes would be to increase taxes with respect to lump-sum distributions made to some individuals, keep taxes at about the same level for other individuals, and actually result in a net reduction of taxes for still other individuals. However, those other changes are not specifically directed at lump-sum distributions and, therefore, the council's formal statement is directed primarily at the provisions which apply solely to lump-sum distributions.

The three basic grounds on which the council opposes the special provisions of H.R. 13270 which apply to lump-sum distributions are set forth in detail in the council's formal statement. In the time allotted to me, however, I should like to highlight just one of the points made in the council's formal statement—the point that the special method of taxation would introduce incredible complexity in tax administration. The burden of this complexity, of course, would fall upon both the Treasury Department and the taxpaying public.

I have been a certified public accountant for over 40 years and prior to my association with my present employer, was engaged in public accounting. Of necessity, both in my career as an accountant, and as a corporate executive, I have had to be conversant with Federal income tax laws. The change which H.R. 13270 would make has been explained to me, and my experience in accounting tells me that it is going to entail almost endless complexity in tax administration.

In an effort to pin down just how involved it would be, we asked a tax attorney who, incidentally, also is a certified public accountant, to go through the steps which he believed would be necessary in order for a taxpayer to calculate his tax liability initially under the revised method of taxation, and then to calculate, at a later date, whether or not he had overpaid his taxes in the first instance and, therefore, would be entitled to a refund as contemplated by H.R. 13270.

The facts were not "stacked" so as to show complexity that could not exist in an individual taxpayer's situation. On the contrary, they involve what we believe could be a typical situation where a lump-sum distribution under a qualified profit-sharing plan is involved. In brief, they involve a taxpayer who is earning annual compensation of $10,000, is changing jobs, and receives a lump-sum distribution under a qualified profit-sharing plan. His lump-sum distribution totals $35,000, consisting of $5,000 of contributions made on his behalf by his employer before 1970, $5,000 of contributions made by his employer on his behalf in 1970 and thereafter, $5,000 of contributions made by the employee himself, and $20,000 of reinvested earnings and appreciation in the values of investments of the trust fund.

For computation purposes it was assumed the taxpayer filed a joint return with two exemptions for himself and his wife, itemizing his deductions in the amount of $15,000 and had unreimbursed medical expenses for major dental work in the amount of $900 in the year of distribution.

The computations showed that in order to determine his income tax initially and then to use the forward averaging method contemplated by H.R. 13270 to determine his refund, and then to collect his refund, the taxpayer would have to go through a minimum of 102 separate steps. Let me emphasize that those 102 separate steps do not include the steps which are involved for any taxpayer in filling out his income tax return, nor do they include the computations necessary to compute his tax initially assuming that he is going to see whether the general income averaging provisions of H.R. 13270 will produce a lower tax for him than would the special averaging which would be applicable to lump-sum distributions. Neither do the computations include any complications which could very well be involved in recomputing his taxes in each of 4 taxable years after he receives his distribution.

Is such a complex method of taxation warranted? The council believes, especially in light of the estimated revenues involved, that such complications for millions of average taxpayers are not warranted.

Incidentally, Senator, I have here a copy of the computations which show the 102 steps that I was referring to, and which I would be glad to leave with the committee.

The CHAIRMAN. I am not going to put that in the record if it is all the same with you because I think you are right. We have already asked the Treasury how you would go about computing this. They don't know themselves. That is why they think this section should be stricken out of the bill. I don't see any particular point in putting this in. It has got to be deleted unless someone can show us how this can be made to work in some reasonable fashion. I couldn't do it. I don't think anybody else could.

Senator BENNETT. Mr. Chairman, I would suggest the staff might like to have it.

The CHAIRMAN. Then I suggest you make it available to the staff. There is no point in us putting this in the record because it would just be a lot of unnecessary mental gymnastics for someone to try to work all that out. It is too complicated to have any business being law.

Mr. GIESECKE. That is correct.

One additional thought with regard to a change which would require payments of larger taxes initially and then recovery of any excessive taxes through a refund procedure. Who is going to advise an individual taxpayer that he may in fact be entitled to a refund? Who is going to bring such a possibility to his attention after 5 years?

As we see it, in order to enable taxpayers to get the refunds which the situation would entitle them to, one of two things will have to be done. Either the taxpayer assistance program which the Internal Revenue Service now renders to the taxpaying public in preparing their returns will have to be expanded greatly, or, in the alternative, taxpayers will be compelled to seek professional assistance in determining whether or not they are entitled to a refund. We doubt that most taxpayers will think of the possibility themselves and if they do, we doubt

if they will be able to determine for themselves whether a refund is due.

Therefore, even in those cases where the full effect of H.R. 13270 would result in a net reduction of taxes, in many cases that net reduction in taxes would be consumed, insofar as the taxpayer is concerned, by costs of determining whether a refund is due and then collecting the refund.

In the concluding portions of our formal statement, the council has pointed out the principles which it believes should govern in determining how lump sum distributions are going to be taxed. If there is to be a change, the council believes that any change adopted should conform to those principles. The council believes that the present method of taxation of lump sum distributions meets all of the tests set forth in our formal statement and for that reason, as well as the reasons directed against the special method which H.R. 13270 would introduce, urges that this committee retain the present method of taxation of lump sum distributions.

Thank you very much for your consideration.

The CHAIRMAN. Thank you very much, sir.

Senator BENNETT. I think we have pretty well come to an understanding of the attitude on both sides of the table on this.

Mr. GIESECKE. Yes, sir.

Thank you.

(Raymond H. Giesecke's prepared statement follows:)

STATEMENT OF RAYMOND H. GIESECKE, CHAIRMAN OF THE BOARD, COUNCIL OF PROFIT SHARING INDUSTRIES

PURPOSE OF STATEMENT

The Council's statement opposes those portions of H.R. 13270 which would provide a special, revised method of taxation of a portion of lump sum distributions made under qualified profit sharing plans.

The Council is aware that other changes made by H.R. 13270 also would have an indirect effect on taxation of lump sum distributions, but does not direct its opposition to these changes.

The proposed change would affect millions of employees, not just a handful of high income individuals.

The reasons for the Council's opposition are:

I. The change of law is based on a misconception of what profit sharing is and what an employee's interest in profit sharing is.

II. The proposed change is not consistent with some of the underlying premises of H.R. 13270.

III. Modest estimated revenue gains will be offset by increased direct costs of administering the revised method and by indirect effects of the change which could result in an elimination of any revenue gain and might even produce a revenue loss.

I. MISCONCEPTIONS REGARDING PROFIT SHARING

A. An employer's profit sharing contributions are not simply and solely "deferred compensation".

B. An employee's interest in a qualified profit sharing plan is "risk capital".

1. Reasons why employer contributions cannot be taxed at the time made.

2. Reasons why employer contributions should not be taxed as ordinary income when distributed.

II. INCONSISTENCIES OF THE PROPOSED METHOD OF TAXATION WITH THE PREMISES OF H.R. 13270

Inconsistency with the objective of H.R. 13270 that special preferences should be eliminated in order to preserve confidence in the fairness of the self-assessment system of collection of income taxes. H.R. 13270 also seeks to eliminate tax pref-

erences in the Code which grant tax advantages to persons of substantial incomes and which were placed in the Code primarily to aid a limited segment of the economy.

A. Fairness of the proposal and improvement of the tax system.

1. Reasons why the proposed method of taxing parts of lump sum distributions as ordinary income is not fair.

(a) Would provide taxation on the basis of other income and highest tax rates in a single taxable year.

(b) Requires in many cases overpayment of taxes initially and the recoupment of overpayment via a refund.

(c) Is unfair to younger employees as contrasted with older employees.

2. The proposed change will not improve the tax system because of the complications which will be introduced by the special averaging method and the refund possibilities involved.

3. The bulk of the revenue gains envisioned will be paid by persons against whom the revised method of taxation is not directed.

B. The present method of taxation is not an abuse which is availed of by only a handful of high income individuals comprising a limit segment of the economy.

III. THE REVENUE EFFECTS OF THE PROPOSED METHOD

A. Increased costs of administration must be balanced against estimated revenue gains. The complications introduced by the revised method inevitably will require the employment by the Treasury Department of many highly skilled individuals to administer those provisions.

B. Indirect revenue losses coupled with increased administrative costs could eliminate any revenue gain and might result in revenue loss for the following reasons:

1. Profit sharing is successful.

2. The government shares, through increased revenues, in such success.

3. The proposal probably would discourage lump sum distributions with the result that the government would not collect revenues which it now collects when distribution is made in that form.

IV. CONCLUSION

A. H.R. 13270 recognizes much of what the Council contends regarding profit sharing. It also recognizes that employer contributions which are distributed as part of a lump sum payment are "bunched income". The special averaging provision which H.R. 13270 would add does not go far enough in recognizing this point.

B. If any change is to be made it should adhere to the following general principles:

1. It should continue to recognize that a substantial part of an employee's interest in a profit sharing plan is risk capital and should be taxed as such.

2. Any averaging method which is substituted for the long term capital gain method of averaging taxes on bunched income should not be based upon the recipient's income and marginal rates in a single taxable year.

3. Any averaging method should contemplate payment of the taxes due on any distribution once and for all at the time the distribution is made. Refund possibilities should be avoided.

4. Any averaging method should be simple and should not involve the complications which the averaging method contemplated by H.R. 13270 would entail.

STATEMENT OF THE COUNCIL OF PROFIT SHARING INDUSTRIES TO THE SENATE COMMITTEE ON FINANCE IN OPPOSITION TO THOSE PORTIONS OF H.R. 13270 WHICH WOULD CHANGE THE RULES FOR TAXATION OF LUMP SUM DISTRIBUTIONS UNDER QUALIFIED PROFIT SHARING PLANS

PURPOSE

This statement is submitted in opposition to those portions of H.R. 13270 which would change the *method* of taxation of lump sum distributions which are made under qualified profit sharing plans. Other changes contained in H.R. 13270 also would have an effect on the amount of taxes payable by employees who receive lump sum distributions. In brief, the three principal changes which would affect the taxability of lump sum distributions are:

1. *Change of Method of Taxation Specifically Applicable to Lump Sum Distributions.*—The portion of any lump sum distribution which consists of employer contributions would be taxed as ordinary income. In the year of distribution, the amount of tax payable with respect to such ordinary income would be five times the amount of the increase in tax which is attributable to the addition of 25% of such ordinary income to other income.

Five years later, the employee would be entitled to recompute what the total taxes attributable to the ordinary income portion of his lump sum distribution would have been if 20% of the ordinary income portion of his lump sum distribution had been included in his taxable income in the year of distribution and each of the next four succeeding taxable years. If the ordinary income tax which he paid with respect to the lump sum distribution in the year of distribution was greater than he would have paid under the second test, he would be entitled to file a refund claim as though he had paid his "excessive" tax in the fourth taxable year following the year of distribution. This change would apply to that part of any lump sum distribution which consists of employer contributions made after the calendar year 1969. The balance of any lump sum distribution would continue to be taxed as a long term capital gain.

2. *Change in General Income Averaging Provisions.*—Long term capital gains would be included in the definition of "averagable income" for purposes of general income tax averaging. Since portions of lump sum distributions will continue to be treated as long term capital gains, and the balance as ordinary income, this change also would be applicable to lump sum distributions in their entirety.

3. *Elimination of the Alternative Tax on Capital Gains.*—The alternative tax computation now provided for all net long term capital gains would be eliminated. This change would apply to that portion of any lump sum distribution which would continue to be taxed as a long term capital gain as is provided under existing law.

The latter two changes would apply to those portions of lump sum distributions treated as long term capital gains even if the first change were not made.

The Council urges no special treatment of lump sum distributions, either favorable or unfavorable, insofar as any changes generally applicable to capital gains are concerned. However, the first change would single out lump sum distributions and provide a special method of taxing portions of such distributions. Therefore, the main thrust of the Council's statement is directed at the portions of H.R. 13270 which would apply solely to lump sum distributions.

Contrary to any impression that may have been created to the effect that lump sum distributions are a means used by relatively few, highly compensated employees to escape taxation, any proposal affecting lump sum distributions would have far reaching effects. It would not affect just a few highly compensated individuals. For instance, the Council conducted a survey in 1968 among its member companies regarding the use of lump sum distributions as a means of settlement of participants' interests in profit sharing plans. That survey showed that a majority of all distributions made under qualified profit sharing plans are made using this form of payment. Moreover, 90% of the lump sum distributions made involved distributions of less than $30,000.00. Nearly 70% of the distributions fell in the range of from $500.00 to $10,000.00. These results should be considered in light of the fact that there are now approximately 80,000 profit sharing plans in existence. Many of these plans have been established in recent years. For instance, the number of plans has approximately doubled every 4–5 years since 1946. In the year 1968 alone, according to Treasury Department statistics, there was a net addition of some 10,000 net profit sharing plans. In the period from 1964 through 1968 the net number of new profit sharing plans established was 36,119. Those plans covered a total of more than 1½ million employees. In light of the foregoing, it is safe to say that the proposed change in method of taxation would be of far reaching effect and could eventually involve taxpayers numbering in the millions.

The Council opposes those portions of H.R. 13270 which would tax, as ordinary income, a portion of any lump sum distribution made under a profit sharing plan for the following reasons:

I. The Council believes that this change of law is based upon a misconception as to the nature of profit sharing and the nature of an employee's interest under a qualified profit sharing plan.

II. The Council believes that the results which the change in method of taxation would produce are inconsistent with some of the underlying premises of the Tax Reform Bill of 1969.

III. The Council believes that the added costs of administering the revised method of taxation together with other collateral effects which the changed method would produce should be balanced against any estimated revenue gains which would be produced by the change and that when all factors are taken into account, the relatively modest revenue gain now anticipated would be practically eliminated, or might even result in a ne revenue loss.

I. MISCONCEPTIONS REGARDING PROFIT SHARING

The change in the method of taxation of lump sum distributions is based upon the proposition that an employer's contributions under a qualified profit sharing plan are nothing more or less than "deferred compensation". The Council disagrees with this proposition. Perhaps the best way to demonstrate why the Council disagrees with this proposition would be to describe what profit sharing is and what the nature of an employee's interest in a qualified profit sharing plan is.

A. What is Profit Sharing?

Profit sharing is a means of enabling employees to share in the fruits of the companies for which they work. Without profit sharing, millions of employees who now have a stake in the company for which they work would not have such a stake. There are many reasons why they might not have such a stake. For example, inflation and taxes (both federal and local) make the accumulation of a "nest egg" for investment purposes difficult for the vast majority of employees. Moreover, many companies are not publicly owned and traded. Therefore, even if an employee is able to accumulate sufficient funds of his own in order to acquire an ownership interest in the company for which he works, he often is unable to do so for the simple reason that such ownership or part ownership is not for sale.

Through profit sharing an employee has an opportunity to share in one of the benefits of ownership—a chance to share in the same thing in which the investors in a business share—the profits resulting from operations of the business.

The Council believes that its concept of profit sharing fairly describes what profit sharing is. Article II, Section 1 of the Constitution and By Laws of the Council states:

"The Council defines its concept of profit sharing as any procedure under which an employer pays or makes available to regular employees subject to reasonable eligibility rules, *in addition to prevailing rates of pay*, special current or deferred sums based on the profits of the business." [Italic added]

Thus, profit sharing is something extra—something over and above normal compensation. Profit sharing is not a substitute for paying going wages for average performance. It is an "extra" for doing better than average. True, employment is a requirement for participation in a qualified profit sharing plan. To that extent it can be said that an employer's contribution is in consideration of the employee's services. However, since it is something in addition to regular compensation, the Council believes that it is an oversimplification to simply characterize it as "deferred compensation". The objective of profit sharing is not simply to compensate employees. The Declaration of Principles contained in Article III of the Council's Constitution and By Laws set forth the Council's views as to the objectives of profit sharing.[1]

Coupled with the Council's concept of profit sharing as being something in addition to regular compensation, the Council's Declaration of Principles clearly indicates that something other than simply compensation to employees is sought as an objective in establishing a profit sharing plan.

"DECLARATION OF PRINCIPLES

SECTION 1. The Council believes it to be highly important to develop an economy in which there is freedom of opportunity for each to achieve his maximum personal development. The Council holds that profit sharing offers a most significant means of bringing into being such an economy.

SECTION 2. The Council considers well-planned profit sharing to be an effective means of developing group co-operation and efficiency.

SECTION 3. The Council holds that widespread profit sharing will tend to stabilize the economy.

SECTION 4. The Council holds that the true spirit of partnership which sound profit sharing engenders is of paramount importance.

SECTION 5. The Council is dedicated to the purpose of extending soundly-conceived and administered profit sharing in every practical way. At the same time it does not offer profit sharing as a panacea, nor does it minimize the importance of other means of fostering its broad objectives."[1]

B. What is the Nature of an Employee's Interest in a Qualified Profit Sharing Plan?

If an employer's contribution under a qualified profit sharing plan is nothing more or less than a compensating event, that compensating event occurs at the time the employer makes its contribution under the plan. Thereafter, whatever happens to the contribution also happens to the employee. No guarantees are involved. The employer has no beneficial interest whatsoever in the contribution, once it has been made, and neither receives any benefit from, nor bears any burden of, the investment results which apply to the employer's contribution. On the contrary, the results of investment of the employer's contribution, whether good or bad, affect only the employee. Thus, once the contribution is made on behalf of an employee and is invested, it becomes risk capital. In this respect, it is no different than any other investment of risk capital and therefore should be treated no differently than any other risk capital.

Should the employer's contribution, therefore, be taxed to the employee at the time it is made on his behalf? There are at least two reasons why this should not be done. First, at the time the contribution is made it is not at all certain that the employee on whose behalf it is made will eventually receive it. Most plans provide for graduated vesting of employees' interests, including the employer's contributions, over a period of years. Whatever an employee does not receive because of premature separation (for example, on account of resignation) is reallocated among all other participants in the plan. Second, and perhaps of equal importance, because of future investment results an employee may never receive an amount equal to the employer's contribution which is made on his behalf even though, at the time it is made, his interest in that contribution is fully vested and cannot be defeated by his subsequent termination of employmen for any reason.

Since, for the reasons stated, it would be inequitable to exact a tax from the employee with respect to the employer's contribution at the time it is made, should it not be taxed as ordinary income when it is distributed? There are at least two reasons why this should not be done. First, throughout the time that the employer's contribution is held for the employee's benefit it is subject to risk. Second, when the employer's contributions are distributed in the form of a lump sum distribution they represent "bunched income" which may have been accumulated over an employee's working lifetime—perhaps as much as 35 or 40 years. H.R. 13270's answer to this problem would be a form of averaging. However, that averaging would be based on the employee's total ordinary income (including a part of the lump sum distribution) and his highest tax rates in a single taxable year. Unless those factors had remained constant throughout his working lifetime (a most unlikely possibility) this would result in more tax being paid by an employee than he would have paid had the contribution been taxed to him in each year when and as it was made. Clearly demonstrative of the fact that income, and hence marginal tax rates, do not remain the same is the fact that in the period from 1958 to 1967 the number of taxpayers with gross income in the $10,000.00 to $15,000.00 range quadrupled. The number went from about 2½ million such taxpayers to more than 10 million such taxpayers. Those 10 million taxpayers alone comprised about ⅐th of all the taxpayers reporting income on individual returns in 1967.[2]

It has been argued that deferral of taxes on contributions when they are made justifies the imposition of tax on an ordinary income basis when distributions are made. In essence the tax deferral is a "tax subsidy" and therefore one should not complain if one's taxes, as eventually determined, are higher than they might have been if taxes had been payable on employer contributions when and as they were made. This argument also ignores the fact that it is the employee who has borne the risk all along. That the employee would continue to bear all risks is borne out by H.R. 13270 itself. As drafted, H.R. 13270 would tax, as ordinary income, an amount equal to the employer's post-1969 contributions even though through market conditions which could prevail in the future, those contributions

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[1] Article III, Constitution and By Laws of the Council of Profit Sharing Industries.

[2] Source: Preliminary Report, Statistics of Income—1967, Individual Income Tax Returns, U.S. Government Printing Office, Publication No. 198, 1-69.

would be in a loss position. For example, assume that as of December 31, 1969 an employee's account consists of $20,000.00, broken down as follows:

Actual employer contributions up to Dec. 31, 1969	$8,000
Reinvested earnings and appreciation	12,000
Total value	20,000

Suppose that after 1969 the employer's contributions total an additional $10,000.00. However, because of temporary market conditions at the time, when the employee retires and receives a lump sum distribution in 1979, he receives only $15,000.00. Under H.R. 13270, $10,000.00 out of the employee's total distribution of $15,000.00 would be taxed as ordinary income. All the risk of future market performance would have been borne by the employee.

In view of what profit sharing seeks to achieve and the nature of an employee's interest under a profit sharing plan, it is respectfully suggested that it is inaccurate to characterize any part of it simply as "deferred compensation".

II. INCONSISTENCIES OF THE PROPOSED METHOD OF TAXATION WITH THE PREMISES OF H.R. 13270

For the taxable year 1967 over 71 million individual income tax returns were filed. Those returns were prepared and filed under a self-assessment system and produced a total of nearly $63 billion of revenue. That record attests to the willingness of American citizens to be taxed and to their willingness to voluntarily calculate and report their income and to pay the tax liabilities which result therefrom.

The Council agrees completely with the Ways and Means Committee's statement to the effect that:

"Our individual and corporate income taxes, which are the mainstay of our tax system, depend upon self-assessment and the cooperation of taxpayers. The loss of confidence on their part in the fairness of the tax system could result in a breakdown of taxpayer morale and would make it far more difficult to collect the necessary revenues. For this reason alone, the tax system should be improved." [8]

A. Is the Proposed Method of Taxing Lump Sum Distributions Fair?

Conceding, for purposes of argument, that employer contributions are nothing more than deferred compensation, what is "fair" in determining the tax which shall be paid on that deferred compensation on the basis of the employee's income and marginal tax rates in the year of distribution? Is it to be assumed that an individual employee's taxable income and his marginal tax rates will remain the same throughout his entire working lifetime? Only if the latter proves true can it be said that there is no element of unfairness in using his income and marginal rates in a single year, perhaps the year in which he reaches his highest peak of earnings, to determine the tax on employer contributions which may have been made on his behalf over his entire working lifetime.

A further element of "unfairness" in the changed method of taxation of lump sum distributions is the fact that an employee will be compelled to pay a tax in the year in which he receives his distribution and then will be compelled to wait five years to find out whether or not he paid too much tax in the first instance. For employees whose income is drastically reduced following the payment, a refund probably will be payable following the fifth year. In the meantime, of course, the employee involved will have lost completely the use of the excessive tax which he paid in the first instance. In the interim, this money might be put to good use in meeting his retirement needs The new method of taxation would not even allow him interest on the excessive tax which he paid in the first instance and which he must seek by a refund claim five years later.

Is the proposal fair to all employees? Looked at from the standpoint of an employee whose working life is behind him at this time, the proposal seems fair. It is to apply to future employer contributions only. However, looked at from the standpoint of the younger employee who is just joining a qualified plan, the proposal seems most unfair. The taxes which will be payable by him with respect to his employer's contributions may be substantially greater than those payable by his fellow employee who retires in the near future even though they have been treated exactly the same under the plan.

[8] Report of the Committee on Ways and Means, House of Reresentatives, to accompany H.R. 13270, page 9.

B. Will the Revised Method of Taxation Improve the Tax System?

Quite apart from any questions of fairness, the workability of our self-assessment system of tax collection clearly depends upon the capacity of the self-assessor to determine his tax. In this respect, the revised method of taxation will result in incredible complications in determining the amount of tax finally payable with respect to a lump sum distribution. For example, assuming that an employee is going to seek to pay the least amount of tax in the year in which he receives his distribution:

1. For the year of distribution he would have to compute his tax on two alternative bases.

(a) First, he would divide his lump sum disrtibution into the portion which will now be taxed as ordinary income (i.e., post-1969 employer contributions) and the portion which will continue to be taxed as a long term capital gain. With respect to the ordinary income portion, the new special averaging provision will apply. In essence, this new special averaging provision is the same averaging provision which was added to the Code with respect to self-employed individuals as a part of H.R. 10. This provision was added to the law in 1962. To date no form for calculating taxes payable under such special averaging has been published. In calculating the capital gains tax payable on the portion of his lump sum distribution, if his capital gain exceeds $20,000.00 and if he itemizes his deductions, he will have to allocate his deductions between his "preference income" and his other income, as required by Section 302 of the Tax Reform Bill of 1969.

(b) Next, after calculating his taxes as indicated above, he also will have to calculate his taxes on the entire amount of his distribution using the general income averaging provisions of Sections 1301-1305 of the Code, as amended by the Reform Bill. Even after simplifications of general income averaging which H.R. 13270 would provide, the form for calculating taxes under general income tax averaging alone will consist of 22 separate lines.[4]

2. If he paid his tax in the year of distribution on the basis of the special provisions which will now apply to lump sum disrtibutions rather than on the basis of general income averaging, then after five years he will have to recompute what the tax would have been if he had received the ordinary income portion of his lump sum distribution ratably over the year of distribution and the next succeeding four taxable years. This alone will entail recomputation of the tax attributable to such ordinary income in each of four tax returns. Whatever complications already existed in preparing those four returns will be compounded by the addition of 20% of his special ordinary income to his other income in each of those years. If, after all of the foregoing, it develops that he paid too much income tax with respect to his special ordinary income at the time of distribution, he will then be entitled to file a claim for a refund.

Returning to the subject to "fairness", is it fair to require an average employee who receives a lump sum distribution to go through what has been described? Doubtless he will have to employ professional help to calculate his tax liabilities in the first instance, and then to recalculate them in the fifth year following his retirement in order to determine whether or not he is entitled to a refund. Moreover, if it develops that he is entitled to a refund, he no doubt will require assistance in preparing his refund claim. For a lower paid employee whose ultimate tax might actually be reduced below what his tax would be under existing law, the cost of calculating his tax and filing a refund claim, if applicable, probably would exceed the amount of any savings which the net method might produce for him. Suppose that events prove that the employee is entitled to a refund of under $100.00, but that the costs of both determining the amount of that refund and collecting it will exceed $100.00. Will he bother to collect it? If he does not, will not the tax collecting agency have been unjustly enriched since, in fact, he paid more tax than he should have paid? Is this fair?

C. Where do the Burden's Imposed by the Changed Method Fall?

One of the alleged bases of the proposed change in method of taxation is that, since employer contributions under qualified profit sharing plans consist simply of deferred compensation, qualified profit sharing plans are a means whereby highly compensated individuals escape ordinary income taxation on substantial amounts of their income. At the same time, one of the clear objectives of H.R. 13270 is to ease the tax burdens on middle and lower income bracket taxpayers.

[4] Report of the Committee on Ways and Means, page 85.

The Ways and Means Committee Report indicates that the more significant benefits under the existing method of taxation accrue to taxpayers with adjusted gross incomes in excess of $50,000.00.[5] At the same time, of the estimated additional revenue of $70 million per year which would be produced by the proposed change in method of taxation, more than one-half will come from taxpayers whose adjusted gross incomes are less than $50,000.00.[6] In this connection, it is noteworthy that many lower and middle income bracket taxpayers may be in the "over $50,000.00 class" in the year in which they receive their lump sum distributions simply by virtue of the fact that the lump sum distribution is made to them.

On the basis of the latest available published information,[7] in 1962, 54, 484 individual returns were filed showing net long term capital gains arising from lump sum distributions under qualified plans of all types. Of that number, 53,364 returns, or 97.9% of the total, involved returns showing adjusted gross incomes of under $50,000.00. Moreover, 42,082 of those returns, or 81.3% of the total, involved returns showing adjusted gross incomes of less than $25,000.00. The returns showing adjusted gross incomes of less than $50,000.00 involved 81.3% of the total dollar amount of gains so reported. It seems clear that although the objective of H.R. 18270 is to eliminate alleged favorable tax treatment for persons whose adjusted gross income exceed $50,000.00, the major portion of the burden will fall upon persons whose adjusted gross incomes are lower than that figure.

Those who are fortunate enough to have adjusted gross incomes in excess of $50,000.00, exclusive of any long term capital gains resulting from lump sum distributions, no doubt will employ (and probably currently employ) professional assistance in preparing their income tax returns. However, those whose adjusted gross incomes are in the middle and lower brackets frequently do not employ professional assistance in preparing their income tax returns. To the extent that any complications introduced by the revised method of taxation require the employment of professional assistance, added burdens will be imposed upon persons against whom the revised method is not directed.

D. Is the Present Method of Taxation an Abuse?

One of the key objectives of H.R. 18270 is the elimination of tax preferences which enable a relatively few persons with high incomes to escape tax on a large proportion of their incomes. Thus:

"From time to time, since the enactment of the present income tax, over 50 years ago, various tax incentives or preferences have been added to the internal revenue laws. Increasingly, in recent years taxpayers with substantial incomes have found ways of gaining tax advantages from provisions placed in the code primarily to aid some limited segment of the economy."[8]

It is respectfully submitted that distributions from qualified profit sharing plans are not one of the alleged preferences which benefit a relatively few high income individuals. Earlier it was pointed out that qualified profit sharing plans cover millions of employees. These plans have been approved under a provision of the Internal Revenue Code which forbids discrimination in favor of highly compensated individuals, both in the matter of eligibility and the sharing of employer contributions. These provisions were added to the Code 27 years ago to insure that any tax provisions which apply to such plans would not be limited to a handful of individuals.

Moreover, the Code currently limits employer deductions for contributions made under qualified profit sharing plans to an average of 15% of participating pay of employees who are covered on a nondiscriminatory basis. Even if it be assumed that an employer's contributions on behalf of a given employee amount to 15% of his pay in every single year of his employment (a most unlikely possibility) depending upon the employee's terminal pay the *total* of those contributions would amount to from 2½ to 4½ times the employee's annual terminal pay after 30 years of participation. Can the accumulation of such an amount as a "nest egg" to take care of an employee and his spouse for the balance of their lives after retirement, which may be as much as 15–25 years, be characterized as an abuse? In the vast majority of cases it is unlikely that the average employee will receive employer contributions of 15% of pay in each and every year that he participates in a profit sharing plan. For example, a survey by the Council indicates that in

[5] Ways and Means Committee Report, page 154.
[6] See Table 5, Ways and Means Committee Report, page 15.
[7] Source: "Statistics of Income, 1962, Supplemental Report, Sales of Capital Assets Reported on Individual Income Tax Returns," table 8.
[8] Ways and Means Committee Report, page 1.

1968 the average of the percentages of contributions related to participating compensation was 8.6% in the case of the companies responding to the survey. The results break down as follows:

Employer contribution to deferred profit-sharing plan as a percentage of participants' pay

Size of company by number of employees:	
Under 100 employees	10.6
100 to 499 employees	8.8
500 to 999 employees	7.5
1000 to 5000 employees	8.8
Over 5000 employees	7.3
Average of the percentages	8.6

That survey covered 445 plans embracing 1,423,640 employees. The Council has no reason to believe that the results produced are in any way atypical. Of course, if employer contributions on behalf of an employee over his entire working lifetime average less than 10% of his participating pay, the portion of his nest egg at retirement which is attributable to employer contributions will be even smaller. It might amount to less than twice his terminal pay. Whatever else he receives in addition to his employer's contribution will result from his having had his share of employer contributions and his own contributions (if he made any) at risk.

In view of the requirement that the benefits under a qualified profit sharing plan must be nondiscriminatory among employees and in view of the limits on the amounts which may be placed in a qualified plan for employees, can it be said that the method of taxation of lump sum distributions made under such plans gives rise to an abuse or a tax preference available to a limited segment of the economy?

III. THE REVENUE EFFECTS OF THE PROPOSED CHANGE OF METHOD

At the outset it is estimated that the revised method of taxation will produce less than $2½ million of additional revenue in the year 1970. In 1971, it is estimated that $5 million of additional revenue would be produced, and by 1979 it is estimated that $50 million of additional revenue would be produced. It should be noted that in 1971 the estimated increased revenue arising from this single change will comprise only about 1/10 of 1% of the total revenue recoupment contemplated by H.R. 13270 and by 1979 will comprise only 7/10 of 1% of the total revenue recoupment.

While H.R. 13270 is intended to be a reform bill, practical considerations which may outweigh the modest revenue recoupment envisioned by the change which the bill would make in the method of taxation of lump sum distributions cannot be ignored. The increased burdens which would be cast upon the tax collecting agency must be balanced against any estimated revenue gains which otherwise might result from the changed method of taxation. Further, other reasonably predictable revenue reducing effects of the proposed change must also be added to the increased administrative costs. The Council believes that the combination of increased administrative costs plus any collateral revenue reducing results might well eliminate practically all of the estimated revenue gain and, in fact, might lead ultimately to a net revenue loss. In view of the great care otherwise exercised to see that the revenue cutting portions of the bill would be matched by revenue increases produced by the bill, this possibility should not be ignored.

A. Increased Costs of Administration Must be Balanced Against the Estimated Revenue Gain

The complications introduced by the revised method of taxation are almost certain to increase the costs of collection of taxes. The Council believes that the complications introduced by the revised method of taxation inevitably will require the employment of many additional, highly skilled personnel by the Treasury Department in order to administer the revised method of taxation. These additional personnel will be needed to review returns initially filed under the revised method, and thereafter to review all returns involved in determining whether a refund is due. The Council believes that experience would demonstrate that all of the direct costs which would be incurred by the federal government would significantly offset the estimated revenue gains envisioned by the bill.

B. The Indirect Revenue Losses, When Added to the Administrative Costs, Might Well Eliminate any Net Revenue Gain and Could Even Produce a Net Revenue Loss

In addition to the direct costs which must be balanced against the estimated revenue gain, the Council believes that there are at least two reasons why the changed method might eliminate most of the estimated revenue gains and might even produce a net revenue loss.

First, whatever the reason for the change, it would tend to discourage the spread of the principle of profit sharing among employers. To the extent that it does, it will constitute a reversal of long standing Congressional policy. The Council believes that the federal government has long been a silent partner in profit sharing. Why? Because it has been shown that where profit sharing works successfully everybody, including the federal government, benefits.

A study covering 175 companies in a broad spectrum of industry is now complete and will be published next month. The study has been conducted under the auspices of Northwestern University. While the Council has supported the study, it was in no way in a position to control the results of the study. The purpose of the study has been to compare the performance of profit sharing companies with the performance of companies which do not have profit sharing plans. The industry groups covered were: chemicals, drugs, electronics, machinery & metal fabricators, oil-integrated domestic companies, publishing, retail department stores and mail order houses, retail food chains and tobacco (cigarettes). Ten measures of performance were used to compare the profit sharers and non-profit sharers in each industry. The indices were: operating income margin, net income margin, return on operating investments, return on investments, return on common stock equity, earnings per employee, sales, earnings per share, dividends per share and market price per share. The study covered the years 1948 to 1966.

Among the results shown by this study was that the absolute *level* of performance by profit sharing companies was superior in over one-half of the cases studied and inferior in less than one quarter of the cases. Moreover, the *trend* of performance of the profit sharing companies was even more significant in that the margin of superior performance was even greater than when measured on absolute levels. The following is a quotation from the summary and conclusion of that study.

"There are innumerable factors that bear on the operations of a particular business. They all, to a greater or lesser extent, affect its revenues, expenses of asset investment and hence its financial performance. Obviously it would be improper to conclude that the adoption of a profit-sharing plan leads directly to superior financial results. Nevertheless, the strong showing made by profit-sharing companies in this study would indicate that it is an important factor in the final result."

This study confirmed the results of more limited studies confined solely to the retail department store industry and retail food industry conducted under the auspices of the Profit Sharing Research Foundation, Evanston, Illinois, which covered the years 1952 to 1959 and was published in 1960.

Profit sharing works! Because it works, employees, shareholders and the federal government all benefit. To the extent that profit sharing companies are more profitable, employee security is enhanced. To the extent that profit sharing companies are more profitable, investors in those companies benefit through increased values in their investments. To the extent that profit sharing companies are more profitable, the federal government benefits through the increased taxes which result from those increased profits.

Finally, as pointed out earlier in its statement, the Council believes that employees' interests in profit sharing plans are truly risk capital. That capital provides jobs. People who have jobs pay taxes.

While it would be difficult, if not impossible, to measure, the Council believes that whatever Congress does which has a dampening effect on profit sharing also will have an indirect dampening effect on revenues. If the incentives of profit sharing are removed, companies which share profits probably will perform less efficiently. Profits and dividends, and hence income taxes, would be reduced as a result of reduced performance. To the extent that the invested capital furnished by profit sharing is reduced, fewer jobs would be provided. Fewer jobs mean fewer taxpayers and lower revenue collections. Since there are some 80,000 profit sharing plans in existence today, it is not unreasonable to speculate that any dampening effects produced by the change in method of taxation could result,

indirectly, in a reduction of revenues which, alone, exceeds the estimated revenue gains envisioned by H.R. 13270.

Second, estimated revenue gains of necessity must be based upon the assumption that employees will continue to receive lump sum distributions. However, if the taxes payable with respect to lump sum distributions become unduly burdensome, it is likely that this form of distribution will lose its appeal. For many employees, spreading of distributions over their lifetimes could result in either no income taxes being payable with respect to their benefits or lesser taxes being payable than would have been payable under the revised method of taxing lump sum distributions. Revenues derived from distribution of benefits to such individuals would be reduced below those which are derived under the existing method of taxation where lump sum distributions actually are made. Wealthy individuals having outside means will be in a better position to "let it ride" at retirement rather than to receive lump sum distributions than will average employees. Thus, the effect of the revised method of taxation may well be not to produce revenue, but simply to compel employees to change the method of receipt of their benefits. Yet there will be many whose major assets consist of their profit sharing interest. These employees, for other compelling reasons, will continue to want to receive their benefits in a lump sum distribution. It is on such employees that the burden will fall. Others who are more fortunate will seek distribution in a form which will reduce the taxes payable by them below what might have been paid by them under the revised method of taxation.

IV. CONCLUSION

The Council commends the drafters of H.R. 13270 for what is clearly an effort to change the method of taxation of lump sum distributions with a minimum of dislocating and unsettling effects upon millions of employees. The prospective feature of H.R. 13270 bears witness to this. Moreover, in continuing to treat part of any lump sum distribution as a long term capital gain, H.R. 13270 recognizes, in part, what the Council sincerely contends and has long contended—that at least a part of an employee's interest in a profit sharing plan is risk capital and should be treated as such. While H.R. 13270 would change part of a lump sum distribution from a capital gain to ordinary income, it also recognizes, through a special averaging method, that lump sum distributions which represent employer contributions also constitute "bunched income." The bunched income concept, of course, is what underlies the entire concept of treatment of certain types of income as capital gains rather than ordinary income. However, the special averaging provision contained in H.R. 13270 which is designed to recognize the bunched income problem introduces extreme complications of administration as contrasted with the present, relatively simple method of taxation of bunched income received in the form of a lump sum distribution. For these reasons, the Council believes that the present method of taxation of such distributions should be retained.

It remains the duty of Congress, however, to make a final decision. Should that decision be to change the present method of taxation of lump sum distributions to some other averaging method, then for the reasons which have been given above, the Council offers the following principles which it believes should be kept uppermost in mind in formulating any alternative method of taxation:

1. Any change should recognize, as does H.R. 13270, that part of an employee's interest in a profit sharing plan is clearly risk capital and should be taxed as such.
2. Any averaging method which is to apply to the balance of a lump sum distribution which is not treated as a long term capital gain should not be based upon the recipient's income and marginal rates in a single taxable year.
3. Any averaging method which applies to part of a lump sum distribution should contemplate payment of the taxes due on the distributions once and for all at retirement. The possibility of refunds following calculation and payment of taxes should be avoided.
4. Any averaging method should be simple. It should not entail complications such as those which H.R. 13270 would entail.

Since the present method of taxing lump sum distributions meets all of the foregoing tests, it should not be lightly discarded.

The CHAIRMAN. Now, Mr. William Drake and Mr. V. Henry Rothschild II, American Pension Conference.

STATEMENT OF WILLIAM F. DRAKE AND V. HENRY ROTHSCHILD II, OF THE AMERICAN PENSION CONFERENCE

Mr. ROTHSCHILD. Mr. Chairman, my name is V. Henry Rothschild. With me is Mr. William F. Drake. I am appearing on behalf of the American Pension Conference. I am an attorney; a member of the New York Bar. I am a member of the steering committee and also the committee on legislation of the American Pension Conference. The records of the American Pension Conference indicate that our more than 800 members are associated with organizations which oversee the administration of more than 70 percent of all pension and profit-sharing funds in the United States. I am also authorized to state that the position of the American Pension Conference has been endorsed by the Council on Employee Benefits, an organization of 127 businesses, with approximately 7 million employees. With your permission, Mr. Chairman, I would like to file and make part of the record their letter authorizing us to appear on their behalf and to state their position.

(The letter referred to follows:)

COUNCIL ON EMPLOYEE BENEFITS,
September 10, 1969.

V. HENRY ROTHSCHILD 2D,
405 Lexington Avenue,
New York, N.Y.

DEAR MR. ROTHSCHILD: This refers to the statement which you intend to present to the Senate Finance Committee on September 16, 1969 on behalf of the American Pension Conference. As you know, the Council on Employee Benefits is also interested in the impact that the tax reform proposals would have on private pension plans. Members of the Board of Trustees have reviewed this statement.

With the concurrence of the Board of Trustees of CEB and of Roger Vaughan, Secretary of American Pension Conference, I should like to advise you formally that CEB wholeheartedly concurs with the APC statement and would appreciate it if the Senate Finance Committee were to know that CEB, representing 139 major businesses employing over seven million employees, wishes to be associated with those comments. It is our hope that such an arrangement will add further weight to your position. We certainly commend you for your efforts.

Sincerely,

R. A. ALBRIGHT, *President.*

Mr. ROTHSCHILD. Finally, I also am chairman of the New York State Bar Association Committee on Employee Benefits which has filed a report on seven measures included in H.R. 13270. That report sets forth the same position as that of the American Pension Conference.

I want to make one point and one point only. My point is simply that if capital gain rates are increased and ordinary income tax rates are reduced as proposed in the bill, the difference between the capital gains tax on lump sum payments and taxes on ordinary income from a typical annuity is so relatively small as to call for continuation of the simple averaging formula represented by the capital gains treatment. In other words, let's forget about the term "capital gains" and think of an averaging formula which involves taxing 50 percent of lump sum payments at ordinary income rates. There is just not that much difference between this tax and taxes payable on ordinary income basis—generally as a lifetime annuity.

We have prepared tables to show that in the majority of cases the taxes are actually more on a lump sum payment than on an annuity. I am not going to go into those tables here. They show that even going up to a distribution as large as $500,000, the taxes would be relatively the same unless the individual receiving it has substantial outside taxable income.

In conclusion, the bill proposed that the averaging method represented by capital gains treatment be applied to the entire lump sum payment other than that part represented by employer contributions. We respectfully submit that there is no persuasive reason not to apply the same averaging method to that part as well.

Mr. DRAKE. Mr. Chairman, members of the committee, I am William F. Drake, of Peat, Marwick, Mitchell & Co. I am chairman of the committee on legislation of the American Pension Conference. I address myself to lump sum distributions under qualified pension and profit-sharing plans—section 515 of H.R. 13270.

The American Pension Conference believes that the bill in its present form imposes an oppressive burden upon Government and taxpayer alike due to the complex additional administrative functions required. Last night's nationally syndicated column by Sylvia Porter stated, and I quote:

> **Few business or professional men yet grasp what a mathematical horror and additional expense the new tax law might be.**

Now, Mr. Chairman, please understand I don't mean to criticize the entire bill, but the quoted passage seems quite apropos of the provision being discussed.

Senator BENNETT. Why not, Mr. Drake? [Laughter.]

Mr. DRAKE. Touché.

The employer contributions and forfeitures subsequent to January 1, 1970, must be segregated and then allocated to individual employees to whom ordinary income tax rates are to apply. The bill also would require similar segregation and allocations of earnings on these funds to individual employees to whom capital gains tax rates may apply.

Those of us who deal with pension plans recognize that no employer contributions are allocated to specific employees covered by most quali-

fied pension plans and public pension plans, too. The exception is primarily in the area of certain types of insured plans for small employers. Generally, company contributions are held on an unallocated basis, with sufficient funds accumulated in a combined pool to pay the required disbursements as they fall due.

The requirement to allocate employer contributions among individual employees would result in a major retooling of, and increase in the administrative expenses of, most qualified pension plans.

As has been demonstrated by my colleague, Mr. Rothschild, the end results simply do not justify this additional expense.

Pension plans are rarely static. Each plan change in the area of benefits generally requires additional employer contributions and, with respect to such changes subsequent to January 1, 1970, would result in additional complications in the administrative aspects of pension plans.

Further complications involve the application of income averaging provisions which, in certain circumstances, apply retrospectively and in others are applied prospectively. This ultimately requires a retired employee to recompute his tax for 5 prior years to determine if he is entitled to a refund.

This will be a unique experience for the vast majority of retired employees and one well beyond their personal capacity to cope with.

Previous witnesses today have quite adequately and most accurately described the almost unlimited number of tax computations to be required of a retired employee which would ultimately result in a refund of a tax overpayment. This would be the unhappy lot of most low and average income bracket taxpayers.

Mr. Chairman, these are American citizens who have always paid their taxes on a simplified form. How in Heaven's name can they be expected to personally prepare the tremendously complicated tax returns this bill would require, if, indeed, such a tax return form can be designed? And most taxpayers who receive lump sum distributions will, in fact, have overpaid their taxes because their income in the year of separation from service is bound to be higher than in the following 4 years.

It seems to us that claims for refunds, which are basic to the averaging theory in the bill, must be considered largely illusory. The retired employees must not only maintain completed and accurate records which, historically, they haven't done, but will find it necessary to retain competent tax consultants at heavy expense.

Lump-sum payments, particularly under profit-sharing plans, and well administered pension plans, too, have always been recognized as providing a useful and desirable function for the retired. Therefore, it is recommended that in the interests of a simple fair method of solving the "bunch income" problem upon receipts of a lump sum in one taxable year, that the present method of tax treatment be retained.

Thank you.

The CHAIRMAN. May I just say this. Mr. Drake, and Mr. Rothschild, what we are seeing here is one good reason why you shouldn't have two Houses of Congress with a closed rule, just one. Do you understand what I am talking about?

Mr. DRAKE. Yes, sir.

The CHAIRMAN. Because when this bill was passed in the House of Representatives, there was a great hue and cry about tax reform and the fact that 154 millionaires got away with a lot of money without paying any taxes. The House was asked: "Do you approve of that?" Well, of course, we don't approve of that. I am against that. I think everybody is against it. We all think if a man made a million dollars in a year he should have paid some taxes. But having been told that and given that image, then someone charges down the way and here is some fellow who has worked his lifetime out to accumulate a little something and he gets his pension plan retirement. So they foul up his pension plan for him to where he can't figure what he owes to begin with.

Then the thing is sent to us and we are told we must pass this before we can consider any other revenue bill.

Well, now, I don't think anybody can sustain the case for doing what the House did about your lump-sum pension settlements if they have to debate that item alone. But if the House is told that you have to vote it all up or down, either take it all or leave it, then maybe you have to vote it, "yes." But I am sure you will find a lot of support for your position both in this committee and, if need be, on the floor of the Senate because it sounds to me as though the Treasury should have taken the same attitude towards this item as they did towards the other items of deferred payment. That ought to be studied and they ought to try to work up some reasonably simple plan that people could understand if they are going to change it.

I think you made a very fine statement and——

Mr. DRAKE. I think you have, too, just now, Mr. Chairman.

The CHAIRMAN. You can be assured that your position will be carefully considered by this committee.

Senator BENNETT. No questions.

Senator MILLER. I would just like to ask whether or not you would favor leaving the lump-sum distributions alone but at the same time treat the capital gains as a limited tax preference and also put them in the allocation of deductions approach which the Treasury has recommended.

Mr. ROTHSCHILD. Senator, if this averaging method is used and if they are treated as capital gains I think they should receive the same treatment as other capital gains. In other words, whatever the tax preferences are, or allocation of deductions rules are, they should apply similarly.

Senator MILLER. You are saying if other capital gains receive that treatment, these should, too. But——

Mr. ROTHSCHILD. On the other hand, sir, if I may say it, our point is the term "capital gains" is, in a way, a misnomer. This is only an averaging method. That is the way we think of it. The term "capital gains" has become sort of, particularly at this hearing, during the course of this morning, a sort of a term of disrepute. This is not, should not, be thought of as capital gains. This is an averaging method—50 percent of the total of a man's money being taxed as ordinary income.

Senator MILLER. Do you support the inclusion of capital gains in the limit on tax preference treatment and also for purposes of allocation of distributions?

Mr. ROTHSCHILD. We have not specifically considered that point at the American Pension Conference. However, my own personal view is that, if they are treated as capital gains, they should have the same treatment as other capital gains, whatever that treatment is.

Senator MILLER. Thank you.

Mr. ROTHSCHILD. Did I answer your question satisfactorily, sir?

Senator MILLER. I think you answered it as honestly and as factually as you are in a position to answer it. Thank you.

(Prepared statement of William F. Drake and V. Henry Rothschild II, follows:)

STATEMENTS OF WILLIAM F. DRAKE AND V. HENRY ROTHSCHILD II, AMERICAN PENSION CONFERENCE

SUMMARY OF PRINCIPAL POINTS

1. The Tax Reform Bill, as passed by the House of Representatives (H.R. 13270), proposes to tax benefits under qualified retirement plans accrued after December 31, 1969 attributable to amounts contributed by the employer 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). 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, for each year during such five-year period, on 20% of the distribution, the employee would be entitled to a refund.

2. The five-year carry-forward formula with the proposed procedure for refund claims would involve administrative complexities and heavy burdens on Government and taxpayers alike, with a special burden on retired employees who have not customarily retained tax consultants. Particularly if the 25% ceiling on the tax on capital gain is to be removed and taxes on earned income are to be reduced, as proposed in the Bill, the disparity between the rate of capital gains tax on lump sum payments 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 warrant continuation of the present simple method of taxing the entire lump sum payment in excess of employee contributions at capital gains rates.

3. It is accordingly recommended, in the interests of a simple, fair method of solving the bunched-income problem upon receipt of a lump sum in one taxable year, that the present method of capital gains treatment be retained.

September 8, 1969

STATEMENT CONCERNING TAX REFORM BILL PROPOSALS RELATING TO INCOME TAX TREATMENT OF LUMP SUM PAYMENTS FROM PENSION AND OTHER QUALIFIED PLANS

SUMMARY OF PROPOSED CHANGES

Under present law, if an employee (other than a self-employed individual) receives his total accrued benefits from a qualified plan in a distribution within one taxable year on account of separation from service or death, the amount of the distribution in excess of employee contributions is taxed as a capital gain, rather than ordinary income. Section 515 of H.R. 13270 (the Bill) would limit this capital gains treatment to the amount of the total distribution in excess of employer contributions made during plan years beginning after 1969. Thus amounts attributable to employer contributions made during plan years beginning after 1969 would be treated as ordinary income, taxable at regular income tax rates.

The Bill provides for a special five-year "forward" averaging of the amounts to be treated as ordinary income, provided the employee participated in the plan for at least five years. Under this averaging method (which under present law applies to lump sum distributions to self-employed individuals), the employee would compute the increase in tax as a result of including 20% of the ordinary income amount of the distribution in his gross income for the taxable year of distribution, and then multiply the increase in tax by five to determine the amount of tax on the ordinary income portion.

The Bill further provides that an employee may recompute the tax paid on the ordinary income part of the distribution at the end of the five taxable years by

including 20% of the ordinary income amount in gross income for each of the five years and determining if the tax he would have paid had he received the amount ratably over the five years is less than the tax he had actually paid under the five-year forward averaging rule. If the recomputed tax is less, the employee would be entitled to a refund. If the employee dies within the four-year period beginning on the last day of the taxable year of the distribution, the employee's estate would be entitled to a refund if the tax paid by the employee exceeded five times the average of the increase in tax which would result from the inclusion of 20% of the ordinary income portion in the gross income of the employee for each of the taxable years the decedent lived in the five-year period (excluding the year of his death).

The amount of the distribution treated as a capital gain would be eligible for averaging under the provisions of the Bill (§ 311) permitting capital gains to be included in income averaging. However, if the employee chooses the benefit of income averaging, the Bill provides that the five-year carry-forward averaging provision for the ordinary income portion of the lump sum distribution would not be available to him.

REASONS GIVEN FOR THE PROPOSED CHANGE

The House Ways and Means Committee gave the following reasons for the 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.

2. 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. The more significant benefits from capital gains treatment of substantial amounts go to those with adjusted gross income of over $500,000.

CONCLUSIONS OF THE AMERICAN PENSION CONFERENCE

1. The five-year carry-forward formula with the proposed procedure for refund claims would involve administrative complexities and heavy burdens on Government and taxpayers alike, with a special burden on retired employees who have not customarily retained tax consultants.

Rules and procedure would have to be developed for determining the portion of a lump sum distribution attributable to employer contributions for plan years beginning after 1969. The allocation of a distribution into portions representing employer contributions, forfeitures and investment earnings would add administrative burdens and costs to Government and employers. Such allocation would be particularly burdensome and expensive in the case of the typical aggregate funded pension plan in which individual determinations are rarely made or records kept of the amount of employer contributions (including forfeitures) or investment earnings which could be considered attributable to specific individuals. Ultimately the added administrative costs of preparing and maintaining such records would be reflected in the amount of the employees' benefits.

Computation of the amount of tax on the lump sum distribution would be extremely difficult for most employees, requiring the assistance of tax advisors. In most cases, employees would be over-paying the amount of tax ultimately due under the special refund limitation. The over-payment would be due to the fact that the employee's gross income for the taxable year of distribution would be increased by one-half of the portion of the distribution attributable to income and appreciation, putting him in a higher tax bracket than he would be in the years after distribution. Thus most employees would be faced with the complex, burdensome task of making the refund computation five years later if they want to receive a refund of the overpayment.

2. We do not favor the substitution of the five-year carry-forward averaging rules with the procedure for refund claims as a substitute for capital gains treatment in alleviating the bunched-income problem of a lump sum distribution, for the following reasons:

(a) Particularly if the 25% ceiling on the tax on capital gains is to be removed and taxes on earned income are to be reduced, as proposed in the Bill, the disparity between the rate of capital gains tax on lump sum payments 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 warrant the continuation of the present, simple method of taxing the entire lump sum payment in excess of employee contributions at capital gain rates.

(b) Capital gains treatment, under the proposed new capital gain rules of the Bill, provides a workable, equitable solution to the bunched-income problem caused by receipt of the entire amount attributable to employer contributions in one taxable year.

It is acordingly recommended, in the interests of a simple, fair method of solving the bunched-income upon receipt of a lump sum in one taxable year, that the present method of capital gains treatment be retained.

Attachment

Comparison Under H.R. 13270 of Capital Gains Tax Treatment of Lump Sum Distribution With Tax Treatment of Annuity Payments

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 I). The annuity payments are based on a 5% annual interest rate.

Taxes shown asume 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 employe'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

Senator BENNETT (presiding). The chairman has left us.

This concludes today's list of witnesses. We will meet at 10 o'clock tomorrow morning. Thank you very much.

(There follows written testimony received by the committee expressing an interest in the subject of lump sum distributions from pension and profit sharing plans:)

CORPORATE FIDUCIARIES ASSOCIATION OF CHICAGO,
Chicago, Ill., September 30, 1969.

Hon. RUSSELL B. LONG,
Chairman, Committee on Finance,
U.S. Senate, Washington, D.C.

DEAR SENATOR LONG: This written statement is submitted by the Corporate Fiduciaries Association of Chicago in lieu of a personal appearance. The Association represents all the major banking institutions in metropolitan Chicago which have trust powers. These banks are corporate trustee or agent for hundreds of thousands of employees and dependents who as beneficiaries under profit sharing plans would be adversely affected by the proposed change in the tax treatment of lump sum distributions.

We conservatively estimate that 85% of the profit sharing plans which we service provide for a lump sum benefit. In order for a profit sharing plan to qualify, it cannot by definition discriminate in favor of highly paid personnel so that many average employees have a major stake in this proposed change. At a time when Congress is showing great concern over the financial needs of older citizens, it is hard to believe that it would enact a law which would discourage the establishment of profit sharing plans and deprive millions of people from sharing in the prosperity of the companies for which they work. In many cases, these funds are their only form of savings for retirement. Certainly the restrictive legislation would impair the growth of existing funds and remove the incentive for the establishment of new ones.

Very truly yours,

VAN R. GATHANY, *President.*

DALLAS, TEX.,
September 23, 1969.

Senator RALPH YARBOROUGH,
Federal Office Building,
Austin, Tex.

DEAR SENATOR YARBOROUGH: It is my understanding that the Tax Reform Act of 1969, which has passed the House of Representatives, would eliminate the capital gains treatment on lump sum distributions from pension and profit sharing plans.

I am sure you can see what a hardship this would impose on those of us who have attempted to provide for our retirement income. Such a change in the tax laws would be discriminatory against those of us who are trying not to be dependent on others after we retire. I would hope that the Senate would be able to eliminate this provision from this act.

Sincerely,

E. F. AYMOND, Jr.

AMFAC, INC.,
Honolulu, Hawaii, August 12, 1969.

Hon. HIRAM L. FONG,
U.S. Senator,
New Senate Office Building,
Washington, D.C.

DEAR HIRAM: Thank you for your response to Don Nicholson's cable message regarding the proposed changes in the Internal Revenue Code as they relate to distributions from the profit sharing funds.

Our profit sharing plan at Amfac is an integral part of our retirement benefit program and the more than 2,500 members of our plans look to these benefits at the time they retire from employment. This is generally true, also, for the almost 40,000 employees who are members of other profit sharing plans in Hawaii. The concern regarding these amendments is therefore a very understandable one.

Two of our principal objections to the measure were eliminated in the committee's reconsideration when they decided to tax profit sharing fund earnings as capital gains and deferred the unrealized appreciation on employer securities to the time of sale rather than the time of distribution.

Taxing employer contributions as ordinary income even with the five year averaging clause, however, will have a significant effect in the future of reducing the retirement income of our employees. If anything like the present code treatment of five year income averaging is employed this will be virtually meaningless in reducing the impact of the tax on the retiring employee. "Five year averaging" has the sound of being a fair and equitable approach but unfortunately it has almost no practical effect. Further, of all the Internal Revenue Code provisions it is one of the most complicated in its application even for the experts in the field of taxation. Certainly it would be beyond the ability to cope for the ordinary person. One of our nation's unique strengths has been our ability to rely on the American taxpayer for his voluntary computation and payment of his taxes. The proposed amendments would be just one more compelling reason for him to throw up his hands in absolute frustration. Our recommendation would be to continue the present tax treatment of profit sharing distributions.

If you feel you can concur with these thoughts I would be most grateful if you would forward this letter to Senator Russell Long.

My thanks and Aloha.

Sincerely,

H. C. EICHELBERGER,
Chairman of the Board.

MILICI ADVERTISING AGENCY, INC.,
Honolulu, Hawaii, August 5, 1969.

Hon. HIRAM FONG,
U.S. Senate,
Washington, D.C.

DEAR SENATOR FONG: I am writing to ask you to vote against the "Tax Reform Bill" (I do not have the bill's number as of this writing). It is our understanding that the House Ways and Means Committee has included in its "Tax Reform Bill" a basic change in the taxability of lump sum distributions in profit sharing or pension plans. We understand the proposal would break the lump sum distribution into two parts.

A. That part which represented the investment growth over the years would continue to be taxed on a capital gains basis.

B. The balance (essentially the employer's contributions) would be taxed as ordinary income, possibly with a provision that it could be spread over a number of tax years.

We believe the principle points are these:

1. Capital gain treatment of lump sum distributions is a highly important factor of qualified plans, which in turn have been tremendously beneficial for a great many people of all income levels and for the economy as a whole.

Emasculating this key provision would tend to discourage further plans and could lead to the termination or diminution of existing plans.

2. Capital gain treatment has been counted on over the years by enormous numbers of participants in these plans, again of all income levels. The proposed change would upset their planning for their retirement and would in many cases force a reduction of retirement income.

3. Capital gain treatment is available and can be highly advantageous to *all participants*, from those of very modest means to the highest income people. Because of the 25% ceiling, higher income people may seem to have a greater relative tax advantage. This may not be true when the tax advantage is considered in relation to an individual's total financial situation. The tax advantage is more important to people of modest income because the distribution from a plan represents a much greater part of their total income or estate.

In short, the proposed change would hurt all participants, including the great majority of modest means.

4. The proposed change would penalize unreasonably those participants who are terminated before retirement or who enter a plan at an older age—since there would be fewer years to build up the investment growth on their shares.

5. The proposed change would add significantly to the computation and record keeping burden for such plans.

I hope you will give serious consideration before voting and that you will vote against the provisions in this bill.

Best personal regards,

FRANK VALENTI,
Executive Vice President.

(Whereupon, at 3:40 p.m., the committee was adjourned until Wednesday, September 17, 1969, at 10 a.m.)

TAX REFORM ACT OF 1969

WEDNESDAY, SEPTEMBER 17, 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 Russell B. Long (chairman), presiding.

Present: Senators Long (presiding), Anderson, Gore, Talmadge, Byrd of Virginia, Williams, Bennett, Curtis, Miller, Jordan, and Fannin.

Also present: Tom Vail, chief counsel.

The CHAIRMAN. Mr. Rockefeller, will you please come forward? You are one of Mr. Javits' constituents and I am sure he would be willing to let you testify first. We are pleased to have you and we are very proud of the work you have done in many different areas—health, research, a great many others—through the Rockefeller Foundations. May I say I am well aware of the way the Rockefeller Foundation has been handled under your leadership. We hope you will continue that fine work and that nothing in this bill will prevent you from continuing.

STATEMENT OF JOHN D. ROCKEFELLER III, OF NEW YORK CITY

Mr. ROCKEFELLER. Thank you, Mr. Chairman, members of the committee, I have a number of affiliations with philanthropic organizations but I appear here today as an individual, as a citizen concerned with the future of philanthropy in the United States. I appreciate the opportunity to testify because I am deeply troubled by the consequences of some of the provisions of the bill before you as they affect philanthropy.

I am particularly troubled because I think philanthropy is so important to the solution of two massive overriding problems which face our society today, problems of a magnitude and difficulty such as we have never before had to deal with.

The first is coping with poverty, racial conflict, the urban crisis, population growth, widespread unrest. The second is meeting the rapidly approaching financial crisis of our privately supported nonprofit institutions: hospitals, colleges, libraries, museums. The deficit gap of these institutions is getting larger and larger with no visible prospect of new sources of funds other than Government. In both of these areas of mounting concern I believe that private initiative has a tremendously important role to play. Today as I see it, philanthropy,

whether individual or institutionalized, provides the channel through which private initiative can be most effectively expressed with regard to social problems. Our pluralistic system is almost unique in the world. Instead of all social problems falling to the Government, our system makes it possible for private citizens and private organizations to help solve them. With foresight and wisdom Congress historically created the conditions for such a system and has consistently maintained them over the years.

Now, at the very time that the challenges confronting our society are greater than ever before, when the role of philanthropy is potentially more important than ever before, the Congress is contemplating a reversal of this fundamental policy. The bill now before you would upset the delicate balance of our pluralistic system which has encouraged private initiative to help in such a meaningful and constructive way in coping with society's problems. The net effect of the bill is nothing short of revolutionary in its impact on the role of philanthropy. It would start a trend away from pluralism and private initiative at the time of the greatest need and opportunity.

Philanthropy has been my life's work. Based on my experiences and assessment of the current situation, Mr. Chairman, I would like respectfully to put before you my views on what I believe should be the four overriding——

The CHAIRMAN. Mr. Rockefeller, if I might interrupt you for just a moment. While you have been testifying, your Senator, who I am sure is very much interested in your testimony, has arrived in the room and I would like to ask Senator Javits to sit with the committee and if he is so disposed I will invite him to take his turn and I will offer you, Senator, one of our Democratic seats. Then you will be more available to the television cameras than if you take one of the junior Republican seats. Go ahead, Mr. Rockefeller.

Mr. ROCKEFELLER. Based on my experience and assessment of the current situation, I would like to respectfully put before you my views as to what I believe should be the four overriding objectives in your deliberations.

First, abuses in philanthropy must be eliminated. In my opinion the great majority of the persons in philanthropy are honest and are committed to public service rather than personal gain. They are more eager than anyone else to have abuses stopped because the wrongdoing of the few tends to impugn all. We need wise measures that can be effectively and justly applied.

I applaud a number of measures in the bill relating to foundations which move forthrightly in this direction. I believe even more can be done. The idea of a user fee to pay for complete audits by the Internal Revenue Service is excellent. Could not the fee be shared with the States to further support the broad-ranging powers of the attorney general in assuring that philanthropy lives up to its obligations?

My second belief as to objectives is that philanthropy must be maintained and strengthened rather than cut back. We need more resources than ever before. Even with present inducements and incentives for charitable giving the flow of funds is critically short. This situation would be seriously aggravated if steps were now to be taken to reduce

the incentives. But this is precisely the impact of a number of the provisions in the bill before you.

I strongly believe that every individual above the poverty level should pay taxes but this need not be done in a way that forces such drastic cuts in the incentives for charitable giving.

The third objective, Mr. Chairman, is that philanthropy must be venturesome. In my judgment, a foundation that never makes mistakes is not worth very much because this is a sure sign it never attempts to deal with the really tough problems. It must pioneer new fields, take calculated risks, identify new needs. These are the historic functions philanthropy has performed best in our pluralistic society.

However, the bill before you contains language restricting program activities that would almost guarantee that donors and foundations would be supercautious in their giving, afraid to engage in anything but the safest and surest of activities. I am advised that the language of the existing law is adequate in prohibiting political activity by philanthropy. The real need is to enforce the present law more vigorously.

The fourth objective is to forge a more effective sense of partnership between philanthropy and Government. Because of the complexity and magnitude of so many of our national problems, Government and philanthropy have worked together more and more in recent years. The activities of one supplement the other, or there may be joint funding of a project. The result is a good deal of creative interaction between Government and philanthropy and a variety of approaches to problem-solving rather than one monolithic approach. Any partnership must be built upon trust and confidence but the present bill militates against this. Under it there would soon be increasing isolation, one from the other, rather than partnership.

In conclusion, Mr. Chairman, may I say that I am concerned that you may feel my testimony is unresponsive to the specific and immediate problems with which your committee is faced and the pressures that are upon you. I debated long and hard as to what form my testimony should take. I finally decided that, based on my experience, I owed it to you as well as to myself, to speak out frankly, taking the long look ahead.

To me, this bill before you raises certain questions that are fundamental to our society. How are we going to meet the almost overwhelming problems that face us today? Does Government really want to take them on singlehanded? What is to happen to our private institutions which play such an important role in our society? Does Government really want to take them over, with all that that implies, or to at least pay out vastly increased sums for their support?

What about the character of our society itself and the role of the individual in it? Have we reached the point where we feel that initiative and decisionmaking should pass mainly to Government?

If the bill before you should be passed substantially as it stands, we would be taking the first major step away from pluralism and toward a monolithic society. I do not believe that that is what the Congress wants or any of us want. And I do not believe that this approach is necessary to meet the problems with which your committee is faced.

Personally, I have great confidence in the future of our country and

our society. I believe we can accomplish almost anything to which we set ourselves. The pluralistic approach has brought us to where we are, to our position of world leadership.

I have no question that as a result of the lessons learned from these hearings and with the elimination of abuses, there can be close and effective cooperation between Government and the private sector to the advantage of all concerned. And in this framework I believe our overriding social problems can be met and our private institutions saved.

The CHAIRMAN. Thank you very much for your statement, Mr. Rockefeller. I believe it might be just as well for us to make a matter of public record something which is known to you and known to me. I think it speaks with credit to you and I do not think it reflects anything that has to do with discredit to me. That is the fact that at least a year ago you came to me and discussed the foundation problem and the very problems you are discussing here and in fairness to you and me, I think your views have been somewhat modified and so have mine since we first discussed this matter. I am not concerned about taxing or doing anything to correct the activity of the Rockefeller Foundation, but I am concerned about more than 20,000 other foundations that I do not think have the same credentials that yours has. You had some doubt that the Federal Government ought to interfere in this matter at all. I believe that since that time we agree that neither you or I knew what these other 20,000 foundations were doing and I think even to this very day, even though both of us have tried to find out, I do not think either of us know about these other foundations.

You are nodding your head and that means you have spent as much time in the witness chair as some of the other witnesses.

Mr. ROCKEFELLER. That is right.

The CHAIRMAN. You and I tried to find out what they try to do with all this money and what is this thing all about. Has your foundation been audited?

Mr. ROCKEFELLER. Well, we have an audit that we commission ourselves. You mean Internal Revenue Service?

The CHAIRMAN. No. I mean has anybody audited you——

Mr. ROCKEFELLER. We do it ourselves. We retain a firm of certified public accountants.

The CHAIRMAN. The answer to the question is "Yes," but it is my understanding that with regard to more than 20,000 foundations that are not known such as yours is, that less than 5 percent and perhaps less than 2 percent of them have even been audited by their own auditors so that nobody knows what they are doing with their money. Now, furthermore, some of us have reason to believe that some of the things they are doing were things never intended by Congress. For example, we never intended that the existence of a foundation should be something to permit a man to avoid his tax liabilities to this Government.

I was concerned a while back that someone told a member of this committee that a certain oilman paid no taxes and I undertook to find out why. It turned out that every time he owes something to the Government he just takes some of his oil company stock and puts it into his foundation. He still owns the stock and I do not know whether he does anything for charity or education. I am not trying to put that at your doorstep. All I am saying is that there are some things that have

happened that do not seem right to some of us and we think they ought to pay taxes.

Now, you made a statement here that you think that philanthropy should volunteer venture capital for attacking problems. I think that is right. It also occurs to me that philanthropy should advance debenture capital for attacking problems. For example, there are a lot of situations in which people would like to help find outstanding people of all races to start new businesses, to improve their communities, not through a grant, but through some loan capital on reasonable terms where it is a good proposition and they think they can make it pay off. It occurs to me that you can cut with two edges, that you can loan money in ways that you would make money and that those people in turn would also be doing good work with that kind of capital. Are you doing anything of that sort in the Rockefeller Foundation?

Mr. ROCKEFELLER. We are not. Other foundations I know have.

The CHAIRMAN. I would hope you would look into it and I would hope that others would.

Now, there is this question. It was raised by Senator Talmadge previously in questioning other witnesses. Should a foundation be entitled to immortality?

Now, the question comes to me that if it is to be entitled to immortality it ought to earn immortality by the work it does. I see you are nodding your head, that you agree. If the foundation does such fine works that it deserves it, fine. I am sure you realize that if we placed taxes on foundations as some suggest we should, that would keep money from going into foundations that is presently going there and you have so suggested by your testimony.

Now, if by keeping the money from going into those foundations we caused it to be donated directly to the universities or directly to the charities or directly to the worthwhile undertakings which these foundations seek to support rather than to go into foundations, can you say that a billion dollars of revenue would go directly to the churches, charitable organizations, rather than the foundations? Can you say we would have done something bad by achieving that result?

Mr. ROCKEFELLER. I think the individual donor should have the choice, that his decision should not be prejudiced one way or the other. I am all for the full support of the museums, universities, hospitals. I think that is tremendously important. My only concern is that the way the bill is written it is prejudicial to the foundation.

The CHAIRMAN. I see. If I understand your position, let us take a situation. Here is a worthy young child who will not have the opportunity to go to college, but you and I agree he should. Now, one could make a grant that would result in this child receiving an education in this generation or he could put this money in a foundation with the result that the foundation would earn money on its investment and over a period of time it would be able to perhaps start out making, say, 6 percent of that amount of money available to that youngster. It would not put him through school at all but down through the years it would perhaps eventually achieve some good, but that would follow in future generations, not this one.

Now, do I understand your argument to be that he ought to have that choice to put his money in a way that it would eventually do that same amount of good even though it will not achieve it today?

Mr. ROCKEFELLER. I see your point. On the other hand, I happen to be interested in the population field and specifically in an organization known as the Population Council.

The CHAIRMAN. I am well aware of that and I applaud you for doing it.

Mr. ROCKEFELLER. Thank you. Under this provision that we are discussing people giving to the Council would be penalized so to speak. So that while your child would be getting an extra benefit, an extra push in this direction, organizations like the Population Council, which I believe are pretty basic to our efforts today, are put in a secondary category. My feeling is that it is difficult to legislate on a matter like this, that certainly we should do everything to encourage large sums going to the institutions I am referring to and to the child that you are referring to. But I question if we can wisely decide that certain institutions which in my judgment are doing equally important work should be put in the class B category.

The CHAIRMAN. May I say, Mr. Rockefeller, I think on every point that I have been able to persuade you I am right, I agree with you, and on every point that you have been able to persuade me you have been right.

Mr. SCRIVENER. May I just say something. My name is Robert Scrivener. I am an associate of Mr. Rockefeller. If I understand your question, I think I might be helpful. As I understood it, you were concerned about the possibility of grants being made directly to schools, churches, hospitals, et cetera, instead of through foundations and it occurred to me in that context one might consider the creation of the National Merit Scholarship Fund. This was done by the Ford Foundation and it spawned an awful lot more charitable money, large contributions by major business corporations and the whole testing procedure, et cetera. So, what I am saying is that there is more that happens when the money goes from the donor to the foundation than simply if the money were going from the donor directly to the scholarship fund or to the Council or so on.

The same thing, I think, characterizes Mr. Rockefeller's description of the Population Council. It would be literally impossible for a single donor to make grants in the population field which would have had the same effectiveness as the grants by the council. The Population Council has done a job, so to speak, with the charitable money that could not have been done if an individual had done it directly.

The CHAIRMAN. In some respects you can have the total inaction, people putting money there and it doing no good for anybody. Now, at this very moment if I could find the time, I would seek to find out who from my part of the country have money sitting there in foundations. If they do not do anything with that money, I am in favor of taxing them. If they keep it there for their own advantages, then I am in favor of taxing the eyeballs off of them.

So, it gets down to about the same thing you are talking about here. If the foundations will do the job we would like them to do, and I think yours is, then they should be given favorable tax treatment. If they are not going to do that job and they are going to do it for other purposes, then it is my feeling that they ought to be taxed like everybody else.

I see your head nodding. Does that mean you agree?

Mr. ROCKEFELLER. That payout idea is in the direction I am talking about, to require annually that the total income——

The CHAIRMAN. It seems to me that this idea—if you want immortality you ought to earn it. Even a blind hog ought to find an acorn once in a while and if you take your foundation money and all the things you have done with it, after 20 years or 50 years you have yet to do a single worthwhile thing, then it seems to me you ought to be required to go out of existence, phase out.

Mr. ROCKEFELLER. I did not mean to be speaking just for the Rockefeller Foundation. I meant to speak for what I believe to be the great majority of foundations.

The CHAIRMAN. You set that in motion.

Mr. ROCKEFELLER. I agree with you that there are some that are doing wrong but I think the great majority are in the right direction.

The CHAIRMAN. Well, if you find out what you are trying to find out and I find out what I am trying to find out, then we will find out whether a majority are moving in the right direction.

Thank you very much.

Senator ANDERSON. Mr. Rockefeller, I remember in 1919 the great help to the International Health Board the Rockefeller Foundation did for our State. I have not forgotten that. I appreciated it very much then and I appreciate it now.

The CHAIRMAN. I want to recognize the new member of our committee whom I am sure will make a great member and will be of great service to this Nation, Senator Hansen.

Senator, will you stand up?

Senator HANSEN. Thank you, Mr. Chairman. [Applause.]

The CHAIRMAN. Senator Hansen is a great Senator from Wyoming, and I know he is going to make a great contribution to this committee.

Senator John Williams?

Senator WILLIAMS. Mr. Chairman, first, I want to join in extending a welcome to Senator Hansen to this committee and agree with you that he will make a great addition to our body.

Mr. Rockefeller, I was well pleased with your statement here and glad that you openly recognize that there has been some abuse in this area and that it is the abuses which we need to correct without at the same time destroying the principle of philanthropy itself, and on that point we are in complete agreement.

Now, one question. I would like to ask. Some criticism has been made of the fact that in certain instances foundations have been putting public officials on their payroll in some capacity. Do you see any useful purpose or need of a foundation having on its payroll members of the legislative, the executive or the judicial branch? As a matter of policy, don't you think it would be better if they were excluded completely from that category, from paid positions?

Mr. ROCKEFELLER. I agree with you entirely.

Senator WILLIAMS. That they should be excluded. Now, a question has been raised as to their future employment after they leave public office. I realize you do not want to bar a public official from earning a living but since there is a possibility of some questionable conflict, would you think it would be advisable to have a waiting period of—

some suggested, I think I suggested 2 years; maybe that is too long. One year or something. So that there would be no connection, no possible thoughts of a connection where it could reflect either on the foundation or the public official if we had a separation period between them. What would be your opinion on that?

Mr. ROCKEFELLER. Sir, I see your point. My concern is that, with philanthropy and Government working ever more closely together because of the nature of the problems with which we are dealing today, a Government official may bring into the philanthropy picture a knowledge and a background to make that partnership a much more effective and meaningful relationship. I would therefore be somewhat concerned about any absolute prohibition for any appreciable period. On the other hand, I recognize what you have in mind.

Senator WILLIAMS. Well, there are some of our Federal agencies that do work very closely with foundations and philanthropy as you know, by matching grants, and so forth, avoid any possible conflict would you—do you see any handicap if we had a 1-year separation period because that man certainly would not lose and forget his knowledge of operations after that 1 year. If he did, he did not know much to start with. That would save the separation—I think you realize the point we are trying to correct, potential abuse, not that it has been general.

Mr. ROCKEFELLER. Would it be possible to differentiate between different categories or different positions in Government? You could thus deal with positions in Government that had been particularly sensitive in relation to foundations and maybe put a time period there, leaving open the relationship in general. Most of the transfers, I would think, would not have been the kind of implication that you are thinking of. I am wondering if there might be a compromise.

Senator WILLIAMS. Perhaps it could. But I—to be specific, we as members of the committees in this Congress are going to be dealing with legislative matters which are of tremendous importance to the foundations, as you well recognize. If perchance, one of us separated from Government and immediately went with a foundation, there would be a question raised in the minds of a lot of people as to whether there had been an improper relationship between this public official and the foundation. The same thing would be true of members of the White House staff who are recommending legislative matters. In order to avoid the criticism and put the foundation in perhaps what would be an unjustifiable position of being criticized, would it not be better for all concerned if we had a separation period where they could not raise this question of conflict?

Mr. ROCKEFELLER. Your point being there might be a point of——

Senator WILLIAMS. It could be a question in the minds of the people even though it were not true. For example, right now we as members of the committee are going to be voting on the question of whether the foundations will be taxed. If so, to what extent? And just to put it to a personal proposition, questions could be raised as to an improper relationship and we have to avoid that question of impropriety in order to maintain the dignity of these philanthropies. I am just wondering if there could not be some separation period because we have had instances of public officials leaving, as you well know, without getting

personal, going on the immediate payroll of foundations under circumstances which the administrator of the foundation himself said was subject to criticism and he would not do it again but somebody else may do it later and to avoid that. Would it not be well while we are correcting this to remove the temptation for both?

Mr. ROCKEFELLER. I see your point, sir, and I am sympathetic. I am just wondering if there could be a compromise by selecting certain areas that are sensitive, rather than make the rule so sweeping. There are many fine people in Government who, when they leave, could be a tremendous strength in the foundation picture.

Senator WILLIAMS. If you have any ideas how we can define those areas I would appreciate hearing them because I am very much interested in this point and at the same time, I do not want to disrupt the proper work of your organizations.

Mr. ROCKEFELLER. We will give it thought, sir.

Senator BENNETT. Mr. Chairman, I have no questions of Mr. Rockefeller. I have had the privilege of a private discussion with him of these problems. I think if all of the foundations fit into the pattern that the Rockefellers have set, we would not be arguing the question today.

That is all, Mr. Chairman.

Mr. ROCKEFELLER. Thank you, sir.

Senator JORDAN. No questions.

Senator ANDERSON (now presiding). Thank you very much, Mr. Rockefeller, for appearing here today.

(John D. Rockefeller 3d's prepared statement follows:)

STATEMENT OF JOHN D. ROCKEFELLER 3D

Mr. Chairman and members of the Committee. My name is John D. Rockefeller 3rd. I have a number of affiliations with philanthropic organizations, but I appear here today to testify as an individual, as a citizen concerned with the future of philanthropy in the United States.

My whole adult life has been spent in one way or another in the field of philanthropy. This experience has always been rewarding, and often exciting because of the opportunity for public service. In this respect, I think of the Rockefeller Foundation which has helped eliminate such diseases as yellow fever and hookworm, and has been instrumental in producing the so-called miracle strains of rice and wheat. I think of the Population Council which in 17 years has grown to be an important international force in the population field. I think of Colonial Williamsburg which has so effectively brought to life our colonial heritage. Particularly satisfying to me in serving important social needs are Lincoln Center in New York and the Rockefeller Public Service Awards program.

With this background I was happy to testify before the House Ways and Means Committee because I fully believed in the Committee's objectives, namely to make our tax structure more equitable and to stop any improper conduct in philanthropy.

I am appreciative of the opportunity now of testifying before this Committee because I am deeply troubled by the consequences of some of the provisions of the bill before you as they affect philanthropy.

I am troubled because I see philanthropy as so important in relation to two broad areas of major concern in our society. The first is the massive social problems we face today, problems which have reached a magnitude and difficulty such as we have never before had to deal with: poverty, racial conflict, the urban crisis, population growth, widespread unrest. Obviously, government has the major responsibility, but we need every resource we can find in every element of our society if we are to meet these problems.

The second area of concern relates to our privately supported, non-profit institutions—hospitals, colleges, libraries, and museums—which are approaching a crisis situation. The deficit gap is getting larger and larger with no visible

prospect of new sources of funds other than government. The New York Public Library is a good example. Like so many public institutions, it depends heavily on private support. Three years ago its deficit was $800,000; two years ago, $1.7 million; last year, $2.4 million with its income from contributions remaining at approximately the $1 million level in spite of strenuous efforts to increase it. By using its dwindling reserves, full service has been maintained, but the library's future is at stake, not to mention the needs of its many users, particularly the students.

In both these areas of concern I believe that private initiative has a tremendously important role to play. Today, as I see it, philanthropy in all its forms, whether individual or institutionalized, provides the channel through which private initiative can be most effectively expressed in regard to social problems. Obviously government is increasingly important in relation to such problems. Philanthropy in fact is not keeping pace in financial terms. However, it continues to have a unique and essential contributi n to make.

As we look at our country's position of leadership in the world today, perhaps we do not fully appreciate and understand the extent to which private philanthropy has been a factor. Our pluralistic system, in which philanthropy is a major element, is almost unique in the world. Instead of all social problems falling to the government, our system makes it possible for private citizens and private organizations to help solve them. With foresight and wisdom, the Congress historically created the conditions for such a system and has consistently maintained them over the years.

Now, at the very time that the challenges confronting our society are greater than ever before, when the role of philanthropy is potentially more important than ever before, the Congress is contemplating a reversal of fundamental policy. The bill now before you would upset the delicate balance of our pluralistic system which has encouraged private initiative to help in such a meaningful and constructive way in coping with society's problems. The net effect of the bill is nothing short of revolutionary in its impact on the role of philanthropy. The basic philosophy of the House bill appears to be that our traditional tax incentives for charitable contributions are in fact loopholes and therefore abuses. A number of the provisions would drastically curtail the availability of funds for philanthropic purposes. Others would force what is left of philanthropy into only the most tried and proven of program activities. This bill would start a trend away from pluralism and private initiative at the time of greatest need and opportunity.

Although I may disagree strongly with the bill produced by the Ways and Means Committee as it affects philanthropy, I do understand and respect the concerns which motivated its members. The Committee was disturbed about reports that many wealthy people were paying no taxes. It was increasingly apprehensive about abuses by foundations brought to its attention. It was worried about apparent political overtones of some foundation programs. It saw foundations as being somewhat arrogant and uncooperative. And finally, the Committee was unhappy that foundations did not seem responsive in their testimony to the problems which were disturbing to the Committee.

The same sense of frustration and concern over these and other issues is shared by many of us in the field of philanthropy. We recognize that some foundations have been created primarily as tax dodges, that some are partly or wholly self-serving, that some are guilty of self-dealing. We realize that too few foundations produce adequate annual reports; that too many individual donors and foundations appear to have a relaxed attitude instead of a sense of urgency about helping to meet today's needs and opportunities. It often seems that many in the private sector expect to ride out the storm of the youth revolution, the civil rights conflict, the crisis of the inner cities, with only minor discomforts.

Philanthropy has been my life's work. Based on my experience and assessment of the current situation, Mr. Chairman, I would like respectfully to put before you my views on what I believe should be the four overriding objectives in your deliberations. And under each I would like to comment briefly on relevant aspects of the bill.

First, abuses in philanthropy must be eliminated. In my opinion, the great majority of persons in philanthropy are honest and are committed to public service rather than personal gain. They are more eager than anyone else to have abuses stopped because the wrongdoings of the few tend to impugn all. We need wise measures that can be effectively and justly applied.

I applaud a number of measures in the bill relating to foundations which move forthrightly in this direction, such as the improved requirements for public disclosure, the principles of a minimum annual payout and of a stock ownership limitation, strictures against self-dealing. Another very useful step is the authorizing of the Internal Revenue Service to make information available to the attorneys general of the 50 states who have such an important role to play at the local level. I believe that even more can be done. The idea of an annual or user fee to pay for complete audits by the Internal Revenue Service is an excellent one. Could not the fee be shared with the states to further support the broad-ranging powers of the attorneys general in assuring that philanthropy lives up to its obligations?

The second objective is that philanthropy must be maintained and strengthened, rather than cut back. We need more resources than ever before. Again, I would mention the financial crisis of thousands of non-profit public service institutions which depend heavily on private giving. Even with present inducements and incentives for charitable giving, the flow of funds is critically short. This situation would be seriously aggravated if steps are taken now to reduce the incentives. But this is precisely the impact of a number of provisions in the bill before you. These include:

Imposing a tax on foundations: This is a dangerous precedent. Its effect would be to tax the recipients of charitable giving—churches, colleges, hospitals, libraries, and other charities.

Taxing the capital gain on gifts of appreciated stock to foundations: This provision would constitute a major deterrent to the creation of new foundations and the growth of existing ones.

Requiring the untaxed appreciation on all gifts of property to charity to be included in tax preference income: This would again be a disincentive to charitable giving, depending on the donor's other tax preference income.

Requiring a donor to allocate his deductions between taxable income and tax preference income: The incentive for charitable giving would be reduced through the elimination of a portion of the charitable deduction.

Eliminating the unlimited charitable deduction: This would primarily affect large givers whose contributions often are essential to major capital campaigns and to the development of venturesome, imaginative approaches to social problems.

Mr. Chairman, I strongly believe that every individual above the poverty level should pay taxes, but this need not be done in a way that forces such drastic cuts in charitable giving.

The third objective is that philanthropy must be venturesome. In my judgment a foundation that never makes mistakes is not worth very much, for this is a sure sign that it never attempts to deal with the really tough problems. Philanthropy must provide the venture capital for attacking such problems. It must pioneer new fields, take calculated risks, identify new needs. These are the historic functions philanthropy has performed best in our pluralistic system. It must perform them more vigorously now than ever before.

However, the bill before you contains language restricting program activities that would almost guarantee that donors and foundations would be supercautious in their giving, afraid to engage in anything but the safest and surest of activities. No one would question that tax privileges must be entirely dissociated from partisan activity. But the bill before you would preclude any "attempt to influence legislation through an attempt to affect the opinion of the general public or any segment thereof . . . other than through making available the results of non-partisan analysis or research." It will be very difficult to determine objectively what is non-partisan analysis and what is not. And virtually every important problem challenging the interest of philanthropy today eventually involves the government and the legislative process. Furthermore, inordinately harsh penalties are proposed.

I am advised that the language of the existing law is adequate in prohibiting political activity by philanthropy. The real need is to enforce the present law more vigorously, and for this purpose I would support measures to strengthen the machinery in the Internal Revenue Service and in the attorney general's office in the states.

The fourth objective is to forge a more effective sense of partnership between philanthropy and government. I place a great premium on this because in a way it is the sum of all the objectives. Because of the complexity and magnitude

of so many of our national problems, government and philanthropy have worked together more and more in recent years. The activities of one supplement the other, or there may be joint funding of a project. The result is a good deal of creative interaction between government and philanthropy, and a variety of approaches to problem-solving rather than one monolithic approach.

Any partnership must be built upon trust and confidence, but the present bill militates against this. It would prohibit "any attempt to influence legislation through private communication with any member or employee of a legislative body or any other person who may participate in the forming of legislation." Again, Mr. Chairman, with government activity and legislation so pervasive in respect to our social problems today, this measure would cut off much of the fruitful communication that now takes place between government and philanthropy. They would soon be in increasing isolation from one another rather than in partnership.

Philanthropy is a valuable resource to government because of its ability to do what government cannot do or is not ready to do, its ability to supplement government efforts, its ability to move quickly and to take risks. To me, it would be tragic and self-defeating to cut back this resource.

In conclusion, may I say that I am concerned that you may feel that my testimony is unresponsive to the specific and immediate problems with which your committee is faced and the pressures that are upon you. I debated long and hard as to what form my testimony should take. I finally decided that, based on my own experience, I owed it to you as well as to myself to speak out frankly, taking the long look ahead.

To me, the bill before you raises certain questions that are fundamental to our society.

How are we going to meet the almost overwhelming problems that face us today? Does government really want to take them on single-handed?

What is to happen to our private institutions which play such an important role in our society? Does government really want to take them over with all that that implies, or to at least pay out vastly increased sums for their support?

What about the character of our society itself and the role of the individual in it? Have we reached the point where we feel that the initiative and decision-making should pass mainly to government?

If the bill before you should be passed substantially as it stands, we would be taking the first major step away from pluralism and toward a monolithic society. I do not believe this is what the Congress wants or any of us want. And I do not believe that this approach is necessary to meet the problems with which your Committee is faced.

Personally I have great confidence in the future of our country and our society. I believe we can accomplish almost anything that we set ourselves to. The pluralistic approach has brought us to where we are today, to our position of world leadership. I have no question that as a result of the lessons learned from these hearings and with the elimination of abuses there can be close and effective cooperation between government and the private sector to the advantage of all concerned. In this framework I believe our overriding social problems can be met and our private institutions saved.

Senator ANDERSON. Senator Javits, we are very happy to welcome you.

STATEMENT OF HON. JACOB K. JAVITS, U.S. SENATOR FROM THE STATE OF NEW YORK

Senator JAVITS. Thank you very much.

Mr. Chairman, I have an extended statement because the nucleus of almost everything with which the tax reform bill deals has considerable impact on my State of New York and to be very specific, New York City. Hence, the need for my examination and comments in a more detailed way even than my time here would allow, made the statement much more extended than is normal for me and than I would wish. So, I ask unanimous consent that my whole statement may

be incorporated in the record and I will attempt within the 10 minutes allotted to highlight portions of it for the committee.

Senator ANDERSON. Your statement will be printed in the record.

Senator JAVITS. I understand also your committee has given today to philanthropies, I hope the committee will allow me to comment on other matters briefly because this is my only chance to appear and I do have quite a field to cover.

First, Mr. Chairman, I have two principal purposes in testifying. One, to offer specific amendments to correct the inequities in the tax reform bill or to offer other tax reform measures which should be included. I will undertake to include in the printed report the detailed amendments implementing the recommendations which I shall make.

Secondly, the purpose of my testimony is to consider the propriety of the economic effects of the bill in view of the current inflationary situation, to consider the revenue effects of the bill, given the choice of reducing revenue by cutting taxes or by being able to meet more adequately the acceptable demands on the Treasury for desirable appropriation. Mr. Chairman, my view on that may be summarized as follows:

I support those reform provisions which provide for a minimum income tax through tax limitations on tax preferences and allocation of deductions. I support the removal of the poorest taxpayers whose incomes are below the poverty level from the tax rolls. I support the reduction of oil depletion allowances and intangible drilling costs and I support the provisions which will prohibit the tax avoidance through the improper use of tax provisions affecting foundations.

I also support the administration recommendations on increasing the minimum standard deductions as they affect taxpayers in the middle income level.

The reason I say the latter, which is somewhat inconsistent with my general position that this should be a tax reform, not a tax reduction bill, is simply on the grounds of practicality. I would not have included tax reductions in this bill. The House has done it. The administration has not fully supported these reductions but has nevertheless provided intermediate rate reductions so there is no point to mounting an opposition against what seems to be a willingness to yield some grounds to the House at this stage on that point. I have adopted for myself and will vote that way, the recommendations made by the administration on the doctrine of diminimis rather than any other doctrine. I do not believe, therefore, that the 2-percent tax reduction for corporations is in order for the same reason I have just stated.

Mr. Chairman, I have already offered a bill, S. 1069, which provides for specific tax exemptions for the handicapped. I think it is an element of tax reform where there is great inconsistency with respect to the blind and aged and others who are completely handicapped. I will at the earliest possible moment also offer amendments to include certain revisions relating to philanthropy and foundations (I think Mr. Rockefeller's testimony was very eloquent on that); certain provisions with respect to the proposed changes in the tax treatment of small business; the elimination of the repeal of tax exemptions on municipal bonds; certain other amendments regarding real estate, especially as it affects housing, pollution control equipment, incentives

for banks to participate in redevelopment and other socially desirable projects; and new reporting requirements under the jurisdiction of the Secretary of the Treasury.

Senator CURTIS. May I ask a question on procedure? Does this constitute a list of amendments that you propose to offer to the bill before us?

Senator JAVITS. Yes, and I will send them to the committee first, Senator. I have already offered an amendment relating to the phaseout of the investment tax credit rather than its immediate repeal, coupled with the inauguration of revised depreciation mechanisms to provide incentives to industry to invest in productive equipment. I think it is an infinitely sounder way to approach the problem which American business and the Government face.

Senator ANDERSON. What about savings bonds?

Senator JAVITS. The Federal savings bonds? No, I am not dealing with that subject. I know it requires attention and I hope the committee will give that a very careful look. I might say it is a little personal because I found in my vault going back 20 years bonds for my children which have long since matured and the interest rate, of course, being paid on them today is probably close to half of the going interest rate.

Now, to hasten on, Mr. Chairman, I have already expressed myself as to my feeling that we should make this a tax reform rather than a tax reduction bill, and I would like to perhaps be of some aid to the committee in that regard by asking unanimous consent to have printed as part of my statement an analysis which I have made of individual income tax paid as a percentage of adjusted gross income for people in the $7,000 to $15,000 income category. I am sure these figures are not unfamiliar with the committee. There is a remarkable stability of tax rates, aside from the recent surtax, from the years 1964 to 1969. In my judgment this has considerable bearing upon the case of whether we ought to make a heavy individual Federal income tax reduction. In these times of such serious financial stringency, it seems to me, the case is very clearly marked out. For example, in the $15,000 income category, based on standard deduction returns, the rate was 15.5 percent in 1964 and in 1969 it is 15.9 percent (the percentages are even lower for those who itemize). So, it is practically stable and I think that has a very material effect on what we ought to do about this particular matter.

Now, Mr. Chairman, I would like to, because it is the day for philanthropies, make a suggestion or two with respect to philanthropies in the little time I have remaining. I heard the previous discussion with Mr. Rockefeller concerning accumulations. I think that the way in which that problem can be dealt with which would satisfy the view that there should not be an accumulation of income or contributed resources by foundations. We should apply the same rule to the foundations that is applied to corporations in connection with the accumulation of earnings which are not paid out in dividends or which are set up for unreasonable reserves, et cetera. There is no reason in the world why any foundation should not pay a heavy penalty tax—as the members of the committee have indicated—if it demonstrates on an individual record that it is simply not doing what it ought to do with the

money which the Government has allowed it to keep. That, it seems to me, would be very much in accord with Mr. Rockefeller's views and also be in accord with the highest interests of public policy.

The other thing which is very deeply concerning to the foundations, universities, colleges, is the treatment of gifts of appreciated property. I am told by the great recipients of these charitable deductions that they would much rather have a 30-percent limitation for those contributions than to be deprived of the benefit of the contribution of appreciated property. In many cases, involving many of the greatest and most extensive philanthrophies, for example, the Federation of Jewish Philanthropies in New York which runs a $100 million plus fundraising drive successfully every year, the appreciated property gift represents a very material percentage, anywhere between 30 and 60 percent, of all the benefactions received. This is a very serious problem for the foundation.

Senator GORE. Mr. Chairman—before you leave, I have a question on the so-called charitable giving. I say "so-called" because now charity is a profitable undertaking to many people. Would you agree with that?

Senator JAVITS. I do with many severe reservations.

Senator GORE. Do you think then we should put quotations marks around the word "charity"?

Senator JAVITS. Well, I think rather, Senator Gore, that we should make such tax reforms as will remove the quotation marks by requring, for example, that where there is a tax benefit in giving appreciated property over and above what would be the tax benefit if the property were sold, that that part of the tax benefit should be payable by the donor. That results in taking away the quotation marks.

Secondly, I do thoroughly agree that we ought to have stringent regulations as to accumulations by charitable trusts or foundations and nonuse of their resources for the purposes for which they are organized and for which they get their tax exemption. Again, in an effort to remove quotation marks.

Senator ANDERSON. The first time I encountered this was the Philadelphia case. You are familiar with it?

Senator JAVITS. No, I am not.

Senator ANDERSON. Do you object to that?

Senator JAVITS. I did not quite get that.

Senator ANDERSON. Do you object to that?

Senator JAVITS. What are the facts of the case?

Senator ANDERSON. They have a matter of a member of a religious order who gave all of her money to charity.

Senator JAVITS. Well, I certainly do not object to any citizen giving all of her money to charity. I do think there is a case for the minimum income tax and for the repeal of that section of the law which exempts all income from taxation where there has been a record of charitable giving over a period of years.

Senator GORE. Senator Javits, I think Senator Anderson was referring to the unlimited charitable deductions.

Senator JAVITS. Yes. I understood that and I say I do not agree with that. I think that the time has come to impose a minimum income tax

on every citizen of some kind even though that citizen chooses to give all of his or her income to charity.

My reason for that is precisely the same as the desirability of imposing a tax on those who are at very low income levels. I think there is a certain sharing of responsibility upon which the people of our Nation insist and while I am sure they feel much more kindly to people who do not pay taxes because they give everything away to charity than they do to people who give everything up for tax avoidance, I think there is a case for minimum income tax. An element of that case is that we give wide discretion to the giver in respect to charity.

Senator GORE. I wish to explore a bit further with you the desirability of, for want of a better way to describe it, taking the profit out of charity. The profit motive is wonderful, but I do not like to see it confused with charity. It is very appealing to the beneficiaries of the present so-called philanthropy, the present law. I can understand why they would like to continue to be the beneficiaries of this law. But I am pleased to hear you say that you would be agreeable to amending the law so that it is not possible for one to wrap the flag and the Good Samaritan role around himself and claim to be a great philanthropist when actually he is motivated for profit for himself. Do you agree with that?

Senator JAVITS. I thoroughly agree with that and all I am trying to testify to—I would not dream of testifying before this committee in the sense of things that can be taken up in debate—is that we have such a concentration of foundations, charitable giving, and these problems that I felt it was my duty to get the facts, which I have, and have been very painstaking about it, and second, to communicate to the committee that degree of opinion which resides in those who give and those who receive because we have such a heavy concentration of both.

Senator GORE. I wish to compliment you. Your testimony has been informed and constructive.

Senator JAVITS. You are very kind. If I may hasten and finish. I come now to the provision of the ownership of not more than 20 percent of the business. I wish to acquaint the committee with very deep problems in that. There are some foundations which have done extraordinary work. One example is the so-called Hecksher Foundation, which was owned for 30 to 40 years the total stock of a business which consists of interests in real estate. This is a very unique thing which is not easy to sell. Indeed the Hecksher Foundation when it first came into being, had nothing except equities in property which were then worthless because it was the time of the great depression and by the painstaking work of the trustees, that foundation is now worth a $100 million and is doing fantastic things in the area of aid to children health care, and so on. It is just an example.

Therefore, I would hope that the committee will give consideration to two ways of dealing with that problem. One way will be for cases where you do not have a very long-term ownership—I suggest 10 years—to put the burden of proof upon the foundation that such ownership is essential to its exempt foundation purposes and that it should be permitted to retain such ownership. Where there is own-

ership for more than 10 years or whatever other period the committee might think is a desirable cutting off point, then the burden would shift to the Government so that the Government if it desires divestiture, will be required to show that the retention of this interest is not desirable from the point of view of the exempt purposes of the foundation.

Now, this is a suggestion as to a way in which that particular problem might be handled.

I also would like to underline what this committee has already heard a great deal about, respecting the very strict definition which the House bill makes respecting a philanthropic organization having anything to do with a public question. As I read it, it would prevent a philanthropic organization, let us say like a day-care center, from testifying before the committee of which I am the ranking member, Labor and Public Welfare Committee, to give us the benefit of its expertise in carrying on its own activity. If the House language prevails, then that organization would be unable to appear before us. Hundreds of such organizations have appeared to give us the benefit of their experience. Now, it is inconceivable to me that we would want to deprive ourselves of the kind of expertise which is represented by these worthwhile organizations. Again let us always be wary of the legislative trap of legislating to catch the 2 to 5 percent who are rascals and thereby destroy the effectiveness of the 95 percent who are not.

Finally, Mr. Chairman, I favor very strongly the elimination of the repeal of the tax exemption on municipal securities. I mention this because it is so critical to my own city, New York City, which has such very serious financial problems, as I think do most of the cities of the country. I am very glad to see that the administration has also made the same recommendation.

With respect of the real estate depreciation I urge the committee to have a very great care for housing for low-income and moderate-income families. There are many programs of which we are very proud in the 1968 act. We believe, and my presentation shows this, that the House provisions do tend to defeat these provisions by hampering investment in low- and moderate-income housing by making it less attractive to the individual entrepreneur whom we desperately wish to attract.

I point out that the House provision repecting rehabilitation of housing is very liberal in that regard. We should provide the same treatment for new construction where it reaches the same groups in the community, to wit, the low-income and middle-income people.

One last thing, Mr. Chairman, and that is, I hope the committee would call for two new types of information to be included as a regular part of the Secretary of the Treasury's annual report. One would be an estimate of the losses in revenues which result from income presently excluded from tax under the Internal Revenue Code. This, I think, is a very useful public document to keep us constantly alert to what exemptions continue even after the tax reform bill. And the other would be an estimate of how much the Government subsidizes housing, agriculture, natural resources, et cetera, through the income

tax law as compared to the direct expenditures for those purposes through the Federal budget. These facts and figures we understand are available to the Secretary of the Treasury and we think they are very illuminating for the country. Such a report would represent an excellent opportunity for the individual citizen as well as the Congress to be better informed in this area.

Finally, Mr. Chairman, I ask unanimous consent to include in my testimony such exhibits that are pertinent thereto.

Senator ANDERSON. That shall be done.

Senator CURTIS. I will not go into detail on the many things you have mentioned. I am interested in many of those areas. Our witness is a very experienced parliamentarian and legislator and I would like to ask his views on this.

Do you think we can do all these things by October 31 and do a good job in every field? This bill is very far reaching. The impact of what we do with reference to foundations and gifts is going to affect our society for a long time to come. It seems to me that this committee needs to be relieved by the Senate from the obligation to complete this work by October 31.

Senator JAVITS. Senator Curtis, I will answer your question with the same candor—you and I have known each other a long time—with which you asked it. I think it could be done. I doubt it will be done because we are many men of many strong and pronounced opinions. I hope we will, however, pass a tax reform bill that will have enough in it to justify the work and be worthy of being called a tax reform bill. As the committee considers this bill I hope it will hold those items which turn out to be so deeply locked in combat that you simply cannot settle them within the time limit for future action. I believe that such items will be not enough to destroy the character of the bill as a tax reform bill, but I do not believe that the matter ought to be passed over in toto with simply the repeal of the investment tax credit and whatever terms that implies.

Now, for example, when you sit down, I am sure—you are an experienced man just as I am—with something that has a lot of detail and a lot of individual items, you always pick out the items that are relatively easy or agreed on and lay those aside and do them first and then you get to the tough ones and you always find—it is always a surprise—how few of the tough ones are left. We do it in committees all the time. But even if there are an appreciable number I still do not believe—this is simply my judgment for which you asked—that it will be enough to change the character of this bill, to emasculate it so it is not even worth passing as a tax reform bill. I think you have enough things in this to make it worthwhile to take those up that are reasonably susceptible of fairly quick agreement and pass a tax reform bill. For example, I think there is a universal feeling of deep outrage in the country that we do not have a minimum tax. I think there are some very glaring abuses with accumulations in foundations, self-dealing in foundations, making a profit out of the giving, which have outraged the country. I think those can be dealt with. I think the idea of taking the people under the poverty level which, let us say for argu-

ment, is $4,000 off the tax rolls is again a pretty generally agreed upon proposition. So, I hope that the committee will wrap up the thing that can be agreed to fairly readily in a bill and that we will pass it this year and reserve, and we will all have to understand that, the really tough nuts.

Senator CURTIS. I appreciate your comments that some of this ought to be resolved to a later time. The committee is faced with this problem. These matters are very far-reaching and try as we might, we cannot master all the assembled facts that we ought to have to do justice.

Some one has said there are about 22,000 foundations. No one, even those who have crusaded against foundations for a quarter of a century, has even touched more than about 500 of them and in those cases they picked out bits and parcels that maybe did not give the full picture of even the foundation that was under discussion. We have a very difficult job.

Senator JAVITS. Senator Curtis, I agree. I do think there are a few things even in the foundation and philanthropy field which will justify the name of tax reform and which we can within reason agree to. That is all I say.

Senator CURTIS. Are you recommending divestiture provisions of the foundation?

Senator JAVITS. I recommend with respect to the ownership of business interests, a divestiture provision which will be based upon a presumption, in favor of the Government which can be rebutted for assets which are held under a certain number of years. I suggest 10. Thereafter, there is a shift of the presumption to the foundation so that the Government would have to prove its case for divestiture. In my judgment this is a fairer procedure than the mandatory divestiture which is contained in the House bill.

Senator CURTIS. That is all the time I will take.

Senator BENNETT. I have no question.

Senator MILLER. Would you favor changing the House divestiture provisions to permit less than 50 percent of the control of the business to remain in the hands of the foundation?

Senator JAVITS. Where the foundation could prove that it is a desirable and essential thing for the exempt purposes of the foundation. I use my words very carefully—for the exempt purposes of the foundation. There are assets which are so difficult to dispose of, there are assets which are so desirable in terms of the economy of retaining them as to disposing of them, that many foundations could bear that burden, but I would put them to their proof. I put the burden on them and I do suggest the possibility of some kind of a grandfather clause at which point the burden would shift.

Senator MILLER. The problem I have with that is that while you and I might be able to agree on something of that nature, you throw the enforcement of this in the hands of the typical revenue agent and I can see a horrible administrative nightmare in trying to meet the test of unreasonable accumulation which we are all familiar with and whether this fits with the purposes of foundations and I think what

the House was trying to do was to try to avoid all of that administrative burden by setting up some guidelines. My difficulty is that I think the guidelines are too severe. And you have already pointed out that the 5-percent payout is too severe. But it seems to me that we might try to resolve the administrative problem and the abuses by working out some kind of a tradeoff so that if a foundation wants to hang on to control, 51 percent of the stock of a business, then it is going to have to live with the 5-percent payout. But on the other hand, if it is willing to release a certain amount of the ownership so that it is not the 51-percent owner, it is only a 49-percent or at least less than 50-percent owner, then it can meet a less severe test than the 5-percent payout.

Senator JAVITS. I do not find myself hostile to that, Senator Miller. It is somewhat different from the proposition which I had in mind which was the economy or lack of economy of the actual disposition. In other words, I think that kind of a Hobson's choice perhaps is not unreasonable. But I do not think it ought to be coupled with a mandatory divestiture where the foundation can prove that this would really be uneconomic.

Senator BENNETT. Will the Senator yield to me?

Senator MILLER. Yes.

Senator BENNETT. The Senator may remember that when the Secretary of the Treasury testified on this point he indicated that one of the purposes of their recommendation for a 2-percent fee was to make it possible for all decisions affecting four lations to be brought to Washington rather than be made in the fi' by the agents. This might eliminate the fear that you have that the different agents would take different positions.

Senator MILLER. That would help, but even so you end up with a Washington office with a good many people in it and you are going to get into the same problem of controversy over whether something is reasonable or unreasonable or whether something is in fact in accord with the purposes of charity or is not and what is the balance. What I am suggesting is that perhaps we can avoid a lot of that by liberalizing this stock ownership limitation on the part of foundations on the one hand and also avoiding the arbitrary 5-percent payout on the other hand, which has been called to my attention on several occasions to be completely unrealistic.

Senator JAVITS. It is. As I said a minute ago you could give such an option to the foundation to thereby get itself out of the category of having to litigate, and so forth, but I do not think you ought to deny them the option to litigate and stand their ground if they feel they can prove their case, that it is truly uneconomic to require divestiture. I said a minute ago I did not entirely disagree. I think many foundations may say, look, if we can hang on to 40, 45 percent of this company and thereby make easy our administration, and so forth, sure, we do not like it, but we will do it because it is better than litigating with the Government, but other foundations really may find that they cannot go through the divestiture without very major sacrifice and they may stand their ground and I say give them their chance.

Senator MILLER. In the case of those that are willing to divest so they are not in the position of holding 55 percent, what would be the standard that we might devise in lieu of that 5-percent arbitrary payout provision? For example, it has been suggested that a payout equivalent to the Dow Jones stock average payout during a year would be one test. Well, if this is a test that we could adopt, I do not know whether it is the best, but what are we going to use in lieu of the 5 percent?

Senator JAVITS. I find great difficulty in a mandatory payout percentage. I would much rather have the opportunity to go after a foundation on its annual report on the grounds that it is accumulating unreasonably and leave the guidelines to rules and regulations, rather than to have a fixed percentage in the law.

Senator MILLER. Well, understand I do not think I am talking quite about the foundation accumulations. I am talking about its investment. You may have a foundation that pays out all of the income it receives but it is investing in the type of equities which pay out 1 percent a year.

Now, then, you have a position set forth in the House bill and the Treasury to some extent saying, Well, charity is not deriving adequate benefit from that. Have them put it in bonds and pay out 5 percent.

Senator JAVITS. In other words, you want a mandatory payout of the capital resources, if income is not a given percentage of the capital resources.

Senator MILLER. Well, I do not want the 5 percent because I think that is unrealistic and arbitrary, but on the other hand, what kind of a standard might we devise? It has been suggested that they put their investments in equities that will pay out to the foundation an amount equivalent to the Dow Jones stock payout for a year.

Senator JAVITS. It is kind of a going percentage.

Senator MILLER. That is right.

Senator JAVITS. All pay out and equivalent.

Senator MILLER. That is right. You are much more equivalent with these averages than I am that is why I would——

Senator JAVITS. I would not give you that precise a reaction to that proposition now. My fundamental feeling was that it should be left to a definition more in principle, that is, a definition against the improper and unreasonable accumulations which occur either by accumulating income or not realizing income and I think that such a definition coupled with a guideline of the Internal Revenue Service which might change—it may be the Dow Jones average or average rate of interest for Government bonds or some other standards which they would be subject to change from time to time—is better than a specified percentage or formula in the law.

Senator MILLER. Thank you.

Senator ANDERSON. Senator Jordan?

Senator JORDAN. No questions.

Senator ANDERSON. Senator Fannin?

Senator FANNIN. No questions.

(Senator Jacob K. Javits prepared statement follows:)

STATEMENT OF HON. JACOB K. JAVITS, A U.S. SENATOR FROM THE STATE OF NEW YORK

Before appearing before the Finance Committee today, I have made a careful study of the House-passed tax bill, which represents an enormous effort by the House in an area where reform is long overdue. I also have reviewed the Administration's proposed changes as so ably presented by the Secretary of the Treasury David Kennedy and Assistant Secretary for Tax Policy Edwin S. Cohen, and I find much wisdom in many of the suggestions made by the Administration. I have had numerous conversations with tax experts, business leaders and philanthropic leaders and I have been impressed by my voluminous constituent mail and by the lively tax debate raging in the press.

In my testimony today, I have two principal purposes:

I. To offer specific amendments to correct inequities in the tax reform bill (H.R. 13270) or to offer other tax reform measures which should be included; and

II. To consider the propriety of the economic effects of the bill in view of the current inflationary situation and to consider the revenue effects of the bill, given the choice of reducing revenue by cutting taxes or by being able to meet more adequately the acceptable demands on the Treasury for desirable appropriations.

At the outset, we must remember that the most important thrust of the bill we are considering is its reform provisions. I am convinced that the citizens of our nation will support legislation which makes a serious attempt to tackle the abuses of our present tax system—even if this legislation does not make any changes in the tax rate structure. Most Americans, I am sure, concur with Justice Holmes when he said that taxes are the way in which one buys civilization. Right now the American people are demanding justice within our tax system by means of the tax reform bill—even more than they are demanding lower federal tax rates—and it is this equity of treatment that we should work towards.

I, therefore, fully support those reform provisions of the bill which would (1) provide for a minimum income tax through limitations on tax preferences and allocation of deductions, (2) remove 5,000,000 of our poorest taxpayers, whose incomes are below the poverty level, from the tax rolls, (3) reduce oil depletion allowances and intangible drilling costs, and (4) prohibit tax avoidance through the improper use of tax provisions affecting foundations. I also support the Administration's recommendations on increasing the minimum standard deduction.

However, in working toward the equity of tax reform, we must be exceedingly careful that we do not throw out the baby with the bath water. It is in this respect that I am seriously concerned about certain of the proposals contained in H.R. 13270 and also about certain reforms that are omitted both from this bill and the Administration's proposals.

I.—SPECIFIC AMENDMENTS TO H.R. 13270

At the earliest possible opportunity, I will offer amendments to this bill or co-sponsor amendments by some of my Senate colleagues in the areas of particular concern to me. Those amendments will include proposals on: (1) special tax exemptions for the handicapped; (2) revisions relating to philanthropy and foundations; (3) revision of the proposed changes in the tax treatment of small business; (4) repeal of the investment credit; (5) elimination of the repeal of tax exemption of municipal bonds; (6) treatment of capital gains; (7) those sections dealing with real estate depreciation as it affects housing, in particular the recapture provisions; (8) accelerated amortization of pollution control equipment; (9) oil depletion allowances and intangible drilling costs; (10) incentives

for banks to participate in redevelopment and other socially desirable projects; (11) the establishment of new reporting requirements under the jurisdiction of the Secretary of the Treasury.

Equitable treatment of the taxpayer is therefore my principal concern for appearing today.

II. ECONOMIC & REVENUE EFFECTS OF H.R. 13270

It is of the highest importance that this Committee and the Senate carefully examine the economic effects and revenue effects of this legislation. The Chairman of the Federal Reserve Board last week eloquently stated a fact that has become apparent to us all. Chairman Martin said that our economy is going through a "very, very difficult and unpredictable period"—referring to the surprisingly stubborn inflationary forces plaguing our economy and our pocketbooks. In an effort to dampen these forces our authorities have adopted highly restrictive monetary and fiscal policies—and it appears that the upward thrust of the inflationary spiral has been dampened. It is in the interest of every citizen of this nation that the tax bill passed by this Congress not upset the economic applecart just at the time when our hard anti-inflationary labors are beginning to bear fruit.

To illustrate what I mean, the magnitude of the change in purchasing power which the bill contemplates would add two percent to total personal consumption expenditures. Some $7.3-billion more (in addition to those amounts made available by the expiration of the surtax) would flow to the consumer market. Generally speaking, these sums would accrue to those income groups which spend, rather than save, their income. In other words, most of the $7.3-billion to which I refer would show up as additional consumer demand. Would this not just add additional fuel to the inflationary fires burning a hole in all our pockets? I ask what benefit the average taxpayer would receive if an additional 3 percent tax rate reduction would almost certainly guarantee that he would continue to lose 6 percent a year on the value of his dollar because of inflation. I also ask how would this help our elderly living on fixed pensions.

Would it not be the wise course to accept the smaller tax rate reductions as proposed by the Administration—reductions that still would average in excess of 6 percent for the taxpayer in the $7,000-to-$15,000 income class and in excess of 10 percent for those in the $3,000-to-$7,000 class—if this would help insure that the purchasing power of our dollar does not continue to erode at a 6 percent rate per year?

I have asked the Internal Revenue Service to prepare a table outlining the income tax paid by the average family with two children over the past five years. This table clearly indicates that federal tax levels—even with the surtax—have remained at fairly constant levels over this period. The table shows that the federal income-tax burden of our middle income families is at exactly the same level it was in 1964. In my opinion, these figures—which I ask unanimous consent to insert in the record—clearly show that higher federal income taxes are not an important contributing factor to the so-called "tax revolt." One must look elsewhere, and I strongly suspect the principal culprit would be found in the inflationary spiral—and in local taxes.

It is for these reasons that I also support the Administration's proposals as they relate to raising the present standard deduction of 10 percent with a $1,000 ceiling to 12 percent with a $1,400 ceiling, instead of 15 percent with a $2,000 ceiling as proposed by the House-passed bill.

INCOME TAX AS A PERCENT OF ADJUSTED GROSS INCOME

[Individual income tax returns]

	1964		1965		1966		1967		1968		1969	
	Standard deduction returns	Itemized deduction returns	Standard deduction returns	Itemized deduction returns	Standard deduction returns	Itemized deduction returns	Standard deduction returns	Itemized deduction returns	Standard deduction returns	Itemized deduction returns	Standard deduction returns	Itemized deduction returns
$7,000	9.5	8.0	8.6	7.3	8.6	7.3	8.6	7.3	9.3	7.7	9.5	8.0
$8,000	10.5	8.9	9.7	8.1	9.7	8.1	9.7	8.1	10.4	8.7	10.6	8.9
$9,000	11.	9.7	10.5	9.0	10.5	9.0	10.5	9.0	11.3	9.6	11.5	9.9
$10,000	12.1	10.6	11.1	9.8	11.1	9.8	11.1	9.8	12.0	10.6	12.3	10.8
$11,000	12.7	11.1	11.9	10.4	11.9	10.4	11.9	10.4	12.7	11.1	13.0	11.4
$12,000	13.5	11.6	12.6	10.8	12.6	10.8	12.6	10.8	13.5	11.6	13.9	11.9
$13,000	14.3	12.3	13.3	11.5	13.3	11.5	13.3	11.5	14.3	12.4	14.7	12.6
$14,000	14.9	12.9	13.9	12.0	13.9	12.0	13.9	12.0	15.0	12.9	15.3	13.2
$15,000	15.5	13.3	14.5	12.4	14.5	12.4	14.5	12.4	15.6	13.4	15.9	13.7

The story of the corporations over the same period is quite different. Between 1965 and 1969, corporate tax liability has increased 38.8% while corporate profits after taxes increased 11.6%. To put this 11.6% gain in profits in better perspective, personal consumption expenditures (the money that is available to individuals for spending after taxes) increased 30.9% over the same period. The undistributed profits of corporations were running at a lower level in 1969 than they were in 1966. The money needed to finance expansion plans came increasingly from borrowings—which means upward pressure on interest rates—and the excess of investment over gross retained earnings rose to $38.1-billion in 1969. This excess was only $23,400,000 in 1965.

This does not present a very encouraging picture. For this reason I introduced an amendment last Friday providing for a two year phase-out of the investment credit and requesting prompt Administration action on instituting permanent investment incentives in the form of revised depreciation schedules. If the Administration does act promptly and institutes revised depreciation schedules, I would see no need for a 2 percent tax reduction for corporations.

The overall revenue effect of the bill is another item which concerns me. In discussing this effect, we must consider not only the $2.4-billion revenue loss which the House bill is expected to bring, but also the estimated $9-billion which the government will lose when the tax surcharge expires. This reduction in revenues would not only put a crimp in Federal spending programs, it would also affect substantially the amount of investment money which could go into such important areas as housing mortgages.

We have heard a lot in recent weeks about the "peace dividend," and the long range "fiscal dividend" which we can expect over the coming decade. Despite the controversy over the amount of the dividend, one point remains clear: the claims upon the Federal budget in the foreseeable future will be immense. A comprehensive welfare plan, revenue sharing, aid to urban mass transit and the expansion of existing social programs are all activities which people generally agree should be undertaken by the Federal government in the near future. Add to this the claims made by our national security needs, and one can see that revenue cuts cannot be made without considering our long-range national goals.

This tax-cut proposal, moreover, comes at a time when responsible economists are urging that we maintain substantial budget surpluses in order to keep interest rates down and release investment money for housing mortgages. Last year, Congress solemnly declared a ten-year national housing goal of 25,000,000 new units. But this goal can only be met if the resources exist to finance this gigantic construction project. If mortgage brokers—especially those who deal in FHA and VA financing—must compete with the Federal government and with cash-starved businesses for investment funds, then I predict we may never see the end of exorbitantly high interest rates.

I therefore recommend that we accept the changes in the tax-rate schedules for individuals as recommended by the Administration. By doing so, a great deal will have been gained since in my judgment, the changes proposed in the House bill (1) are inflationary, (2) will put additional upward pressure on interest rates, (3) will make it more difficult for the federal government and private investors to fund important social programs, and (4) will not produce the budget surpluses sufficient to release investment funds into the mortgage market and thus prevent us from meeting our national housing goals.

Mr. Chairman, I now return to a more complete discussion of the specific areas of amendment of the tax reform bill that are of particular concern to me.

(1) Special tax exemptions for the handicapped

Legislation is already on the floor of the Senate (S–1069) and the House (H.R. 424) which would give cognizance to the special needs of our handicapped citizens. H.R. 424 was introduced by the distinguished chairman of the House Ways and Means Committee as the companion bill to S–1069 which I introduced in the Senate.

This legislation would provide the disabled an income-tax deduction of up to $600 to cover transportation to and from work and would also allow the disabled the same additional $600 income-tax deduction now given to the blind.

It is estimated that some 300,000 disabled persons would qualify under this legislation, at a maximum cost to the Government of about $130 each, or $40,-000,000 per year. This cost seems small when we consider the average cost of from $480 to $545 per year to rehabilitate a disabled person. What we will be doing through this measure is helping these people to help themselves and en-

abling them to achieve some personal independence from institutions, from overburdened families, and from local and state governments.

Our handicapped citizens are capable of being productive workers, contributing to the nation's economy instead of being dependent upon it. But their disabilities impose upon them additional expenses in pursuit of their livelihoods which are not otherwise tax deductible. Such expenses include special orthopedic devices; extra travel costs because they are unable to utilize routine methods of transportation; expensive additions to office, shop or home to facilities their movements; special prosthetic devices; higher insurance costs; and the costs of hiring help to perform simple tasks which the nonhandicapped perform for themselves. In addition, rapidly rising costs are particularly burdensome to the handicapped—for example, the prices of some special orthopedic shoes required by the disabled have doubled in the past year.

Under this bill, the disabled taxpayer, in order to qualify for the additional $600 exemption, must suffer from a loss of one or more extremities or 40% or more loss of ability as defined under the Schedule for Rating Disabilities of the Veterans Administration. In addition, both the blind and the disabled would qualify for the tax deduction of up to $600 for expenses of going to and from work.

Hundreds of thousands of Americans have endeavored valiantly to transform their physical handicaps from stumbling blocks to building blocks. They wish to use their crutches to move on, not to lean on. This legislation will help them to do just that. It is as practical in economic terms as it is humanitarian. It is, in effect, a practical bill to benefit those who have no alternative than to be practical.

(2) *Philanthropy and foundations*

In view of the growing role of government, I believe that it is essential to the pluralism of our society that the activities of private philanthropies be proportionately increased—not decreased as the House bill and to a lesser extent the Administration's proposals would do. Basically, I see in many of the features of both measures a two-pronged attack on the viability of our private philanthropies. First, charitable giving is likely to be seriously restricted and secondly, our philanthropic institutions are likely to be so curtailed in their activities and have their resources affected in such a manner that they will not function with the flexibility and innovativeness that we should have a right to expect.

(a) *Philanthropic giving.*—The problems of our philanthropic institutions cannot be properly considered without also considering the means by which these institutions receive their major source of revenue—through the charitable concern of our citizens. We have heard considerable talk in the last several years about how a very few of our higher-income taxpayers have dramatically reduced their federal income-tax liability—despite their substantial incomes—by use of certain provisions of our Internal Revenue Code respecting charitable contributions. I am not in favor of abusing the intent of these provisions to the extent that a taxpayer's obligation to his government is unfairly reduced. However, it is also an indisputable fact that philanthropic activities have been the source of considerable good and insuring the access of worthy foundations to funds of individual donors is in the interest of us all.

President Nixon, in announcing the start of the national fund raising campaign for the United Community Chests, was very careful to stress the importance of philanthropic activity, characterizing it as a sacred American tradition of private initiative. Enough has already been said about the need for and the desirability of private philanthropic activities. Therefore, I wish to direct my attention to certain of the specific provisions of the House bill which in my judgment will unwisely stifle this individual initiative. In all fairness to the great effort of the House, I also believe that the House bill has done much to correct abuse and provide greater incentives to some taxpayers to support philanthropic activities.

I agree wholeheartedly with the principle of increasing the size of the charitable deduction limitation from the present 30% to the proposed 50% of adjusted gross income and support this provision of the House bill. However, in my opinion, this increase to 50% in the charitable deduction would not result in the very large contributions being made today to educational institutions, hospitals, etc.

We must, therefore, make certain that the provisions which encourage the very large contributions which are being made today are not written out of our tax

laws. The only alternative to the anticipated reduced services from such institutions would be government intervention—this is a step which I hope we would all wish to avoid. I therefore recommend that we continue the unlimited charitable deduction so long as we properly circumscribe it with minimum income tax provisions such as I proposed in my tax reform bill, S. 1522.

I am also concerned about the proposed treatment of gifts of appreciated property. This represents not only a major source of the very large contributions but also is one of the major inducements for gifts of valuable works of art and literature to our libraries, universities, and museums. Frequently, these provisions are the very reason why such works become available to the public rather than remaining in private collections where they can be enjoyed by only a few. In the case of fungible appreciate property, such as securities, having a readily determinable market value, it may be possible to sell a portion to generate sufficient funds to satisfy the additional tax burdens imposed by the House bill. But how does one sell a corner of a painting or a few pages from a rare book? For these reasons, I will support the Administration proposal to continue the charitable deduction for appreciated property subject to the 30% limitation as an acceptable compromise.

In my judgment, the provisions of the House bill respecting charitable income trusts and remainder trusts, and gifts of partial interests to charity, are unnecessarily severe. These provisions offset what are in most instances substantial benefits to charity without providing a commensurate return. I believe that the Administration does not go far enough in reducing the severity of the House provisions and I ask this Committee to reject both the House position and the Administration's proposal and retain the current tax treatment of these items.

Since the provisions of the House bill and the Administration proposals will have impact on gift and estate taxes, in addition to affecting the income tax treatment of many charitable dispositions, I urge the Committee to give careful consideration to the effective dates of these provisions. In my judgment, we should allow at least one full tax year to elapse before such provisions become effective.

(*b*) *Philanthropic institutions.*—I find serious problems with the proposed treatment of foundations by the House bill. Many of these problems are only partially corrected by the Administration proposals. First, I can support the Administration's proposed reduction in the House proposed tax on foundation investment income from 7½% to 2%. It is estimated that at 2% the amount of tax will approximate the additional administrative costs in policing foundation activities, and this is acceptable as a compromise. However, I would much prefer to see some upper limit placed on the amount of this "user fee." I might add parenthetically that a very good case can be made to eliminate such a tax altogether and I would not be adverse to such a decision if the Senate made that choice.

I believe that our first duty in accomplishing tax reform with respect to foundations is not to curtail drastically the activities of the great bulk of these institutions which are functioning as we would wish merely because of the sins of a few. Our first duty is rather to sharpen our understanding of the abuses we are trying to correct. In this regard, I have grave reservations about the broad provisions of the House bill which go far beyond the principle that philanthropic institutions should not operate principally as vehicles for tax avoidance.

For example, many foundations own more than 20% of several businesses. In some cases where the amount of the business owned represents control and the balance is widely held, there is no alternative but total divestiture since there is virtually no market where control is not being sold. However, there must be some flexibility in this regard. I will, therefore, be offering in the immediate future an amendment to H.R. 13270 which would basically provide that where a foundation owns effective control of a business, there would be a rebuttable presumption that the needs of the business take precedence over the exempt purposes of the foundation. If a foundation has owned effective control of a business for ten years or more, then there would be a rebuttable presumption that the needs of the business do not take precedence over the exempt purposes of the foundation. Where a business is owned for 25 years or more the latter presumption would be conclusive.

The position of the House bill regarding the current distribution of income is, in my judgment, too inflexible. The House itself recognizes this since they allow the accumulation of income with advance permission, and also there is a perma-

nent exemption for those foundations which are prohibited from distributing income by a charter which cannot be judicially changed. I believe an approach similar to that provided by Sec. 531 of the Code is appropriate here. My amendment also will provid . 'hat accumulations up to a certain amount or percentage of assets would be more or less automatic. Accumulations in excess of such amount or percentage would be subject to tax only if found to be unreasonable in light of the charitable purpose for which they were accumulated. I would retain the House provisions with respect to unamendable charter documents.

While I support in principle the provisions which would limit activities which are political in nature on the part of foundations, again in my judgment, the House bill will deprive us of much needed and valuable information and services. We must be certain that our foundations can properly investigate and report on problems which confront our society and which may presently be or which may become the subject of legislation.

For example, legislation which would prevent a philanthropic organization from giving to a congressional committee the benefit of its expertise on a child daycare center, or in conducting a recreation center for the aged on the grounds that it will have some influence on the decision of any governmental body, is carrying regulation too far. We must have a more carefully worded provision consistent with our true intent—the prevention of so-called lobbying and the furtherance of special interests.

I am greatly troubled by the definitions of private foundation and private operating foundation contained in the House bill. My amendment will also provide for a new category, the public service foundation and will greatly broaden the House definitions to among other things include a longer base period to account for year to year variations.

More information is needed concerning philanthropic activities before we can be prepared to offer conclusive solutions. Some foundations have abused their privilege, and this cannot be permitted. However, the sweeping comprehensive measures contained in the House-passed bill take too much for granted the good that the great bulk of our foundations provide.

Perhaps the most important part of the House bill is the increased reporting requirements. We need greater knowledge in order to approach this important area with intelligence. I would hope that the Committee in considering these areas will recognize how little we know, and will not adopt positions which, with a broader perspective, we will later regret. The amendment I intend to present in the very near future attempts to balance needed reforms while maintaining the philanthropic activities which have been such a source of innovation, pluralism, freedom and creativity in American society.

(3) Tax treatment of small business

Small businesses represent in terms of numbers approximately 95% of all the businesses in this country. I need not remind the Committee of Congress' concern over the years for the small businessman and for the development of healthy small businesses. One measure of the House bill will have severe impact upon small business. As ranking Minority member of the Select Committee on Small Business, I feel that I must bring this matter to your attention and ask that you restore the benefits of the multiple surtax exemption to small business.

The House Ways and Means Committee in adopting this measure noted that the multiple surtax exemption was designed to aid small business but that large organizations had been deriving substantial, unintended benefits, and therefore recommended its elimination. It is inconceivable to me that we would want to injure small business because of an abuse of a small-business provision by big business. I believe that this Committee can and should devise a means whereby the benefits of the multiple surtax exemption can be retained by small business without, at the same time, permitting big business to abuse those benefits.

I am also saddened that of all the recommendations regarding Subchapter S corporations proposed by the Treasury last April that the only thing to appear in the House bill was the provision dealing with retirement plans. I concur fully with the recommendation of the Administration that this measure be deleted and that the entire area of the taxation of the small business coropration receive separate attention.

(4) Repeal of the investment credit

I have previously mentioned that last Friday I introduced an amendment calling for a two year phase-out in the investment credit in order to provide a

transition period during which permanent investment incentives in the form of revised depreciation schedules are phased in. I will not dwell on this matter at greater length now since I am aware that this Committee is not hearing testimony on the investment credit at this time. Suffice it to say that in the long run, I do not believe that we can afford to operate our economy without some sort of major equipment incentives—the soundest of which are modernized depreciation schedules. The level of business investment is closely tied with those social and national goals which we—liberals and conservatives alike—can agree upon: increased production; an improved competitive position in the world economy; increased purchasing power; and a full level of employment.

(5) *Elimination of the repeal to tax exemptions of municipal bonds*

The financial health of our states and municipalities are of vital concern to me, and I cannot support those provisiones of H.R. 13270 as they relate to federal taxation of interest paid on municipal bonds. The Administration has now indicated that it plans to recommend to the Congress different proposals than those contained in H.R. 13270 at an early date. I feel that it is particularly important that any tax changes in this area be consistent with the revenue sharing proposals that this Congress will be considering in the near future.

The facts are incontrovertible—many of our state and local governments, and particularly our cities, are caught in a financial crisis. These governments have traditionally relied on rather limited tax bases and these bases are now, in many cases, taxed as heavily as prudence will allow. In addition, when we consider the total tax burden placed upon our citizens, the component which represents state and local taxation is rising far faster than all others.

In light of the prevailing conditions, I do not consider it wise to entertain measures which are likely to impose greater burdens on these governments without careful study as to the consequences. As a case in point, we already have witnessed the almost complete deterioration of the municipal bond market as a result of the proposed imposition of a tax on the presently exempt interest on the obligation of state and local governments. Simultaneous with this deterioration has been an increase of approximately 36% in the market rate of return on such investments. Ultimately this must be translated into higher interest costs to these governments with resultant higher taxes.

Now is not the time to remove the tax exemption of interest on state and municipal bonds. Until such time as alternative means of Federal support have been enacted and are available to states and localities, this important means of raising capital should not be made exorbitantly expensive—and, thereby, unavailable—to them. The inevitable result would be a contraction of action at the state and local level in dealing with important community and social problems and an increasing burden on the Federal government to devise and operate such programs.

(6) *Treatment of capital gains*

The changes proposed in H.R. 13270 are too drastic and would seriously impede investment and the flow of investment capital in our economic enterprises. They also probably would have adverse revenue effects by slowing the capital gains turnover of stock issues. On the other hand, the limited changes proposed by the Administration in the treatment of capital gains provide meaningful reform by providing that unusually large capital gains will be taxed at higher rates while at the same time capital gains which are not excessive in relation to a taxpayer's usual income continue to be taxed at present rates. Similar treatment is also accorded corporate capital gains. This reform will not seriously affect the important revenue flows accruing to the Federal government from stock market activity and will not drastically change the rules of the game for the more than 26,000,000 U.S. investors in stocks and bonds.

(7) *Real estate depreciation*

Section 521 of the House-passed tax reform bill would amend those provisions of the Internal Revenue Code dealing with real estate depreciation in several ways: it reduces real estate depreciation except as to new residential housing; it provides that accelerated depreciation taken in excess of allowable straight-line depreciation is to be recaptured as ordinary income; and it recommends a new section under which rehabilitation expenditures of low-cost rental housing are to be permitted to be written off over 60 months.

The House Ways and Means Committee noted in its report that existing law provides a real estate "tax shelter" which often bears little relation to true economic loss. The report states: "The present treatment creates a tax environment favorable to frequent turnover which tends to discourage long-range 'stewardship' and adequate maintenance; it also encourages thin equities and unsound financial structures which could topple if the market for real estate and rental housing weakened."

The Ways and Means Committee concluded, "The present tax treatment of real estate does not efficiently stimulate investment in low- and middle-income housing."

Mr. Chairman, unquestionably, tax reform in this vital area is needed, but the elimination of present tax incentives, which the Ways and Means Committee describes as "inefficient,"—without the enactment of alternative incentives for increasing the supply of housing for low- and moderate-income persons—would have the most serious possible effect on this sector of the economy.

The fast "write-off" for rehabilitation of older rental housing represents an improvement over existing law and I support this provision, but it alone will not provide the necessary alternative incentives to housing.

Section 521 of the bill—in particular that portion of it dealing with present recapture provisions—could have a disastrous effect on the achievement of the national housing goals as articulated in the Housing Act of 1968. The 1968 Act was premised upon a major contribution by private capital to the achievement of adequate rental housing. Yet, the proposed tax reform contained in the House bill will significantly reduce yields and the profitability of investment in real estate and will thereby drive private equity capital away from residential rental construction and into other areas where the yields are competitive and more attractive. In other words, at a time when we must promote new investment in housing, this bill would provide a disincentive to such financial commitments.

It may be expected that Federal programs to involve private investors in low- and moderate-income housing will be particularly hard-hit. It should be emphasized that the 1968 Housing Act contained several programs which were based upon such a heavy involvement by the private sector—the homeownership program (section 235), rental assistance program (section 236) and the National Corporation for Housing Partnerships. Investment in low- and moderate-income housing is more risky and less profitable, and under these new programs tax benefits provide the main source of yield on private investment. Inevitably, then, if this section of the tax reform bill is enacted in its present form, there will be a fall-off in the production of housing for low- and moderate income families at the very same time that the Congress has established greatly increased production of such housing as a national goal.

Mr. Chairman, at the present time, inflation and increasing interest rates have hit the housing market particularly hard. Investment capital is increasingly difficult to find. Nevertheless, the need for rental housing, particularly in our major cities, has never been greater. Vacancy rates are below one percent in New York and Chicago; rents are spiraling upward and production is not adequate to meet the demand. In these circumstances, we should be considering new incentives, not eliminating them.

In light of this situation, I recommend that this committee consider, and I am prepared to support, an additional provision in this bill whch would offer a specific incentive to investment in housing for low and moderate-income persons. I do not recommend any changes in the bill's provisions with regard to depreciation—that is, accelerated depreciation would be permitted for new residential housing and straight line depreciation for used buildings. However, in the specific case of low and moderate income housing projects, which have been constructed or rehabilitated with public assistance, which are sold or transferred to a nonprofit or tenant group, or to a cooperative, which will operate the project as low-cost rental housing—there would be no recapture of the depreciation previously taken. In effect, the gain or income recognized in such dispositions would not include depreciation. Such a provision should also distinguish between short-term and long-term investors—favoring the latter.

Such a provision would be an important incentive to private investment capital in the sector in which it is most needed—that is, housing for persons of low or moderate-income. By reducing the tax on the disposition of such projects, this provision would lower the debt-service requirements of the subsequent owning group or cooperative and would thereby permit it to set and

maintain low rents. Lest it be thought that such a provision would afford too great a possibility of abuse, it should be noted that the limited number of prospective buyers in such dispositions would restrict the potential gain which might be achieved by a taxpayer.

Moreover, any abuses could be met by increasing the burden on the individual taxpayer, rather than on the housing industry as a whole. Thus, the preferences which an individual taxpayer might obtain under such a provision should be subject to the limited tax preference which is contained in this bill.

Mr. Chairman, it is critical that the interests of tax reform and the production of housing for persons of low and moderate income be harmonized. I believe that it is incumbent upon this Committee and the Senate to insure that the tax reform bill will be enacted with this objective in mind.

(8) *Accelerated Depreciation of Pollution-Control Equipment*

I basically support the concept of Section 704 of H.R. 13270, a section which would accelerate the amortization of pollution control facilities. The question of pollution of our environment has become one of the major issues of the day, and this problem must be attacked by every resource available—including the use of our tax laws.

I would suggest, however, Mr. Chairman, that the law that allows for the amortization of pollution control facilities should be made consistent with the aims and procedural design of other existing federal laws in this field—particularly with the Clean Air Act, as amended, and the Federal Water Pollution Control Act, as amended.

These laws have established procedures which emphasize the States' responsibility in setting the standards and enforcement regulations to combat pollution. It is the procedures and standards established pursuant to these Acts that should determine whether a pollution facility should be "certified" for an accelerated depreciation. In addition, the effect of these laws, which have had initial success, would be seriously delayed if there were a requirement that new minimum standards be developed by the Federal government as a basis for "certification."

(9) *Oil Depletion Allowance and Intangible Drilling Costs*

I have long been on record that we can not achieve satisfactory tax reform in this area without first making adjustments in the magnitude of these tax advantages. Let me emphasize from the very beginning that I am not in favor of eliminating these advantages altogether but rather, I feel that they should be reduced somewhat. I do not believe that the oil and gas industries should be allowed to retain their present tax advantages at a time when all other taxpayers are being asked to carry such a heavy burden. These industries should share in this burden-carrying by assuming a somewhat heavier burden themselves.

The history of the oil depletion allowance dates back to 1926 and has remained at 27.5% of the gross income from the property since that date (subject of course to a maximum limit of 50% of the taxable income from the property). The tax rates in 1926 were substantially lower than today with the result that this allowance now provides far greater tax inducements. An argument can therefore be made in favor of reducing this allowance substantially below the 20% level. However, I am not in favor of reducing the oil depletion below 20% because I believe that these industries, which are vital to our national defense, need an incentive if their continued viability is to be insured.

While I agree with and will support the House bill on the reduction of the allowance, I must concur with the Administration with respect to the elimination of the allowance for foreign deposits. In my judgment, this would needlessly increase the foreign tax burdens of American business without substantially increasing federal tax revenue.

I do not believe that the House bill or the Administration proposals adequately deal with intangible costs. These costs often represent a greater tax preference than the depletion allowance and should be subject to reasonable limitations. I will therefore introduce an amendment to HR 13270 which will over a five year period limit the deductibility of these costs to 50% of actual expenditures.

(10) Redevelopment and social incentives for banks

The tax code as it relates to financial institutions should provide for two things: (1) the ability to weather both good times and bad; and (2) incentives for activity in socially desirable areas which might be underfunded if these incentives did not exist.

For these reasons, I strongly urge the Committee to leave in effect the bad-debt provisions of financial institutions as they presently stand. I support the very imaginative proposals of the Treasury Department as they relate to the granting of a special deduction to encourage financial institutions to make loans in certain socially desirable areas such as residential housing, student loans, and SBA guaranteed loans, et cetera. The proposals of Mr. Preston Martin of the Federal Home Loan Bank, for tax deductions of 5 and 10 percent respectively of the income derived from loans in housing and other areas and inner city projects are also very commendable.

While in concept the limitation of bad debt reserves to actual experience is very appealing, we should not lose sight of the reasons why it has in the past been deemed desirable to permit such reserves in excess of experience. Reserves limited to experience are no doubt sufficient in rather stable times. However our concern for a sound banking industry has taught us to allow prudently for those times when conditions are not stable. I would submit that we may even now be on the verge of such times if we are unable to bring inflation within reasonable limits and interest rates remain at such high levels. In addition government has been making every effort, and the banking industry is responding, to encourage more receptivity to socially desirable projects such as increased loans within the inner city. I would hope that maintaining reserves at present levels would serve as encouragement to increase activity in such areas.

This brings me to my second recommendation in the financial institutions field: incentives for certain kinds of investment. Mr. Martin on Monday very correctly pointed out that there is no incentive in our tax code for financial institutions to invest directly in inner city projects. The same could be said of the loans of which Assistant Secretary Cohen spoke. Partly because of market factors and partly because of anticipated risk, many loans in inner-city areas carry an interest rate which makes the enterprise or borrower hard-pressed to make a reasonable return. Nevertheless, this country is committed to promoting private activity in funding urban renewal, in housing construction, in education and in other kinds of socially oriented activities. This is not only proper but it is often the more efficient alternative. I realize that the kinds of loans which would qualify for the 5 and 10 percent deductions would have to be carefully defined, in order to prevent abuse. However, I believe that this is mainly a problem of administration and careful drafting of the code, and I look forward to Assistant Secretary Cohen's more detailed statement.

(11) New reporting requirements

I will offer a bill in the near future which would call for two new types of information to be provided as a regular part of the Secretary of the Treasury's annual report:

1. Estimates of the losses in revenues resulting from income presently excluded from tax under the Internal Revenue Code, from deductions allowed under the Code, from the deferral of the imposition of the taxes imposed by the Code and other such special tax provisions of the Code and other laws as the Secretary of the Treasury considers appropriate.
2. Estimates of how much the government subsidizes such areas as housing, agriculture, and natural resources through the income-tax laws as compared to direct expenditures though the Federal budget.

This phenomenon—known as the tax expenditure budget—gives rise to claims upon Federal resources just as real as the claims made by direct budgetary outlays. Publication of the first type of information is therefore needed to make the public aware of the cost to the Treasury of tax preferences. In this way, the public can intelligently call the attention of the Congress to take appropriate action where needed.

The second type of information would be extremely valuable to Congress, and to the Executive Branch, by permitting a clearer insight into the allocation of public resources. The Treasury made a first attempt in this direction when Secretary Barr provided some of this data in his testimony before the Joint Economic Committee on January 17, 1969. The Treasury is to be commended for this, and my bill would ensure that such information will be made a regular part of its annual report.

Senator BENNETT. Mr. Chairman, the next witness is Dr. Ernest L. Wilkinson, president of the Brigham Young University, in the State

of Utah, and as he comes to the witness table, I would like to claim the privilege of introducing him.

He appears today as president of the American Association of Independent College and University Presidents. While this association is less than 2 years old, it already includes 317 presidents of the private universities and colleges located in 46 States and the District of Columbia. Their names are attached to the statement that Dr. Wilkinson will file with the committee. Since these are all private universities and colleges, it is axiomatic that they are all dependent to a greater or lesser degree on charitable contributions.

He will appear as president of the Brigham Young University and since this school is in my State, he and I can boast about it a little bit. In terms of full-time students it is the largest private university in the United States. It has a campus enrollment of 25,000 full-time students who come from every State in the Union and 70 foreign countries and so far there has not been a single student compus disturbance. With that kind of a record I am sure the committee will be very much interested in hearing the testimony of Dr. Wilkinson.

STATEMENT OF DR. ERNEST L. WILKINSON, PRESIDENT, BRIGHAM YOUNG UNIVERSITY, ON BEHALF OF THE AMERICAN ASSOCIATION OF INDEPENDENT COLLEGE AND UNIVERSITY PRESIDENTS

Dr. WILKINSON. Mr. Chairman, gentlemen of the committee, in my limited time I will try first to say something about the contribution of these private universities which I represent and second, how they would be seriously impaired and injured if the bill in its present form should be enacted. The contribution to our society of private institutions of higher learning is tremendous. Time only permits me to indicate that eight of the 16 members of this committee were educated at private institutions, that 73 of the 100 Members of Congress were educated in private institutions.

Senator BENNETT. Shall we say Members of the Senate?

Dr. WILKINSON. I meant Members of the Senate and I appreciate the correction because I know there is quite a difference. [Laughter.]

Senator CURTIS. Does that figure come from the private institutions or from the Senate itself?

Dr. WILKINSON. From the Senate itself.

Senator CURTIS. I see. I did not know whether the private institutions agreed to it or not.

Dr. WILKINSON. Senator Curtis, may I say my background is a lawyer, and as a lawyer whenever I went into court I wanted to know who the jury was, so when I came here I wanted to know who the jury was and, therefore, I counted and found out that 73 of the Senators were from private institutions.

Senator GORE. Do you think this is what is wrong with us?

Dr. WILKINSON. I think that is mainly what is good with you.

Now, as stated in the introductory article of the current edition of "Who's Who in America," private liberal arts colleges have been the basis and the backbone of higher education in America. Because of their many contributions, and I do not have time to give them here, Congress in the first Income Tax Act of 1913 gave favorable treatment

to colleges and universities. The purpose was no mere gesture of generosity on the part of Congress. The object was to provide the greatest amount of public benefit at the lowest amount of cost to the Government. Senator Hollis, in charge of the bill, explained the deduction to the Senate in these words: "For every dollar that a man contributes for these public charities, education, scientific, or otherwise, the public gets 100 percent. It is all devoted to that purpose. If it were the Federal Government or local governments and the taxes were imposed for the amount they would only get the percentage, 5 percent, 10 percent, 20 percent, or 40 percent, as the case might be.

Ever since the enactment of the first income tax law in 1913, during the 51-year history of the code, Congress has always enlarged and never restricted the charitable deduction for universities and colleges although the same arguments now made have been previously made to prior Congresses.

The House-passed bill, on the other hand, would almost destroy the present tax incentives and this at a time of very serious and critical financial crisis for private colleges and universities. The private institutions today outnumber public institutions by 1,409 private to 821 public. But one by one the private universities are closing shop. The president of the Carnegie Foundation, who we hope is wrong, has predicted the end of all but a few private colleges in the very near future, but if the new tax bill that comes from the House should be enacted in its present state, he would probably be right.

Fortune magazine and U.S. News & World Report both have noted that many private colleges will be forced into mergers or go under public control if they are to survive. Already colleges of considerable size such as Houston, Buffalo, Kansas City, Temple, and Pittsburgh have gone from private control to public control. This has happened also to scores of smaller institutions.

Allen Cartter, chancellor of New York University, after a study he made, said that each new institution taken over by the State raised the tax burden by a factor of 10 to 20 times the amount of contributions that might have been necessary to keep the college as a viable, independent institution. The University of Buffalo now costs the State of New York $45 million. Cartter states that a contribution of from $3 to $4 million would have let it continue as an independent university.

In 1965 and 1966 private gifts accounted for 58 percent of all capital funds received by private schools. This constituted 80 percent of the total private gifts to higher education, showing that the public recognizes that private institutions rather than public schools should be the object of their bounty. Private schools situated in the 16 States represented by the members of this finance committee received gifts of $200 million in 1965 and 1966. Yet the report of the House committee on this bill estimates that the increase in taxation as a result of the changes in the bill affecting charitable contributions will be only $5 million in 1970, $20 million in 1974.

Now, if nothing else does, I submit that this shows how penny wise and pound foolish this bill actually is. May I point out here that the new massive programs of Federal aid have been of little help to private institutions on the whole. In a recent year six universities received 57 percent and 20 universities received 80 percent of all Federal aid to

higher education. Only 10 percent of research funds and 12 percent of fellowships were shared by 600 public and 1,400 private colleges and universities.

I now would like to discuss the bill itself. It is so complex, as Senator Curtis has mentioned, that our attorneys told me it should be entitled, and I quote, "The Lawyers and Accountants Pensions and Annuity Bill of 1969." And I knew why when I saw their fee for analyzing what the bill is. [Laughter.]

Dr. WILKINSON. I want to say that what this country needs is a simplified tax bill, not one that is more complicated, more difficult to understand, and breeds more litigation. All I can do in my limited time is to indicate the major changes required if most of our private universities are to survive and, as Senator Bennett has indicated, I speak for 371 of them.

The present bill introduces two new concepts. One, a concept of tax preference, and, two, an allocation of deductions. The new concept of tax preferences includes five items of income not now taxed at all, municipal bond interest, accelerated depreciation, cash on hand, hobby farming, and appreciated value of property. As to all five of these, the new bill provides that to the extent the total of these items exceeds the other gross income of the taxpayer, then one-half of the excess over the tax of the gross income is also taxed.

May I point out as to the first four of these items the taxpayer does enjoy a realizable benefit and there may be therefore a rational basis for taxing them. The same, however, is not true of the appreciated value of property given to charity. In order for a taxpayer to get a deduction for such a charitable gift, he must give away his profit to charitable organizations of the type authorized by Congress, and even then he can obtain a deduction only up to 30 percent of his gross income. This item of appreciated value of property given to charity is therefore totally unlike the other four items and consequently should not be classified as a tax preference at all.

The second concept provides that allocable expenses be apportioned between the traditional taxable income and the new tax preference income. That which is allocable to the tax preference income cannot be deducted as an expense at all. The net effect of this is further to reduce the tax benefit of the charitable contribution. The result is that gifts to charity are penalized in two ways, both coming and going. They are like the drug addict. He suffers when he starts taking the drug and when he gets off it.

The accounting result of these two new concepts being imposed on top of our already complicated tax system is that the accountant who makes up the tax income of a taxpayer who has made a charitable contribution or a charitable deduction often has to make 30 computations to come up with the answers to the taxpayer's tax. These computations are submitted with my statement. Summarily stated and by way of example may I merely state that if we take the case of a man with $250,000 taxable income who gives $75,000 of appreciated property, he would under the present law save $51,000 in taxes. Under the proposed law his tax savings would be $287. A lousy $287 for a magnificent gift of $75,000. Yet in both cases he has given away property worth $75,000. Our position therefore is that gifts of appreciated

property should not be included as a part of tax preference income and no charitable contribution, cash or appreciated property, should be required to be allocated. This position was supported by the Secretary of the Treasury in his testimony before this committee. My second point is that the increase in limits on charitable contributions deductions from 30 to 50 percent is virtually meaningless to higher education because gifts of appreciated property are still held at a 30-percent limitation.

During the last 3 years, for instance, at Brigham Young University the largest single cash gift was $10,000, while during the same period we received 35 gifts of property having a value of more than $100,000.

If contributions to educational institutions are to be encouraged, the limit should be increased to 50 percent of all gifts.

Next, one of the most pernicious features of the present bill is that it applies retroactively to all existing irrevocable trusts and estates which have been created under the present law. Suppose, for instance, the late Senator Dirksen established by his will a life retention trust for his widow with the remainder to charity. Under existing law this would be partially tax exempt. Under the proposed law, this would all be taxable and no one could now find the Senator to change it. It should not take effect until December 31, 1970, as recommended by the Assistant Secretary of the Treasury.

Next, may I just say a word as to gifts of remainder interest. In our overall fundraising program at Brigham Young University the most popular gift is a gift of property in which the donor reserves the income for himself for life. At his death the entire corpus of the property vests in the university. A charitable deduction for this gift is not permitted under the present bill. It permits only two types of gifts of future interests (1) annuities and (2) unitrusts. We strongly recommend that the bill be changed so as to allow the continued use of straight life income retention trust as a third type of deferred gift. The only abuses that existed in the trust that we have recommended is where the donor remains the trustee. This can be cured by requiring the university or a bank or a trust company to be the trustee.

Finally, may I say a word as to so-called bargain sales. They are virtually eliminated by the requirement that the donor sell or allocate his cost base between the amount he receives from the sale and the gift. Yet the donor parts with property in both cases. The abuses under the present law could be stopped by simply denying deduction as to any amount which would have resulted in ordinary income had the property been sold.

In conclusion, may I say we agree with the previous witnesses that every loophole which enables the donor to make a profit by reason of having made a gift should be plugged. Conversely, however, we feel that in every case where the donor parts with more than he enjoys by way of a tax deduction, he should be encouraged to do so, for to the extent he gives to authorized charities, charities authorized by the Congress, the Government will be saved that expense.

Our tax experts have told us that the present bill hits private universities particularly hard because, first, appreciated property gifts are penalized at least two ways and sometimes up to four.

Second, future interest gifts are penalized at least three ways.

Three, gifts in trust are penalized at least four ways, and we submit that for the small amount of additional income contemplated under the House bill, it is not worth the price it exacts.

Senator GORE. Doctor, I believe you were in the room and heard Senator Javits' testimony.

Dr. WILKINSON. I heard most of it. I couldn't hear all of it.

Senator GORE. Do you insist that the law should make it possible for one to profit personally from what has been described as a charitable gift?

Dr. WILKINSON. Senator, in my concluding summary, I said that we do not—that we agree that one should not be permitted to profit by his gift, that is, over and above the credit that he gets for his charitable contribution.

Senator GORE. I apologize to you. I was conferring with an aide when you concluded.

Dr. WILKINSON. I agree with that. We don't think there should be a profit over and above the charitable contribution he gets.

Senator GORE. I realize that is possible and the practice is engaged in under present law.

Dr. WILKINSON. We think that is one of the abuses that should be cured. But we don't think the baby ought to be thrown out with the bath.

Senator GORE. Well, I don't think we are talking about a baby here. This is a rather mature loophole.

Thank you very much.

Dr. WILKINSON. I agree with closing that loophole.

Senator BENNETT. Mr. Chairman, I am delighted to be here and hear Dr. Wilkinson's testimony. I think he has been a very excellent and a very vigorous witness and I am sure the information he has given us will be of value to the committee.

I have no questions.

Senator MILLER. Doctor, you cited an example of a $250,000 income taxpayer giving a $75,000 piece of property which represented appreciated property. If the only thing that was retained in the House bill was the inclusion of that appreciated property in the limit on tax preferences and if there were no other limited tax preferences in the case you cite, there would be no tax problem, would there?

Dr. WILKINSON. I am not sure, Senator, that I understand that question. You say if the only thing left in the House bill—you mean that if we left the House bill as it is so that he could not——

Senator MILLER. No. If we deleted from the House bill everything on this point except the inclusion of appreciated property in the limit on tax performances, there would be no problem in that case, would there?

Dr. WILKINSON. Oh, yes, I think there would be. In fact, the thing we object to most is the inclusion in the bill under the tax preference of this appreciated property because 80 percent of all gifts that I know of at the present time are appreciated propery. And if you classify that as a tax preference, subject to the penalties of the House bill, then all the incentive for giving them is lost.

Senator MILLER. Well, perhaps you don't understand the example because the example you gave is $250,000 of taxable income.

Dr. WILKINSON. That is right.

Senator MILLER. And only $75,000 of limited tax preference.

Dr. WILKINSON. That is right.

Senator MILLER. And in that case, under the House bill there would not be any tax effect. It is not until the limited tax preferences get up over 50 percent of the total income that there is a tax effect.

Dr. WILKINSON. May I have my tax expert answer that?

Mr. HARDY. Senator Miller, in the example we assumed he already had $50,000 also of tax preference income at the time he started to make the gift. In the complete report we covered this in detail showing that he had $250,000 of taxable income, $250,000 of tax preference income, and then made a gift of $75,000 of fully appreciated property.

Senator MILLER. Well, nobody is going to argue with that example, although I would suggest to you that that would be a most rare example. I have discussed this with a good many people and in hardly any case have I found a situation where they were particularly concerned about the limit on tax preferences because most of their givers who give appreciated property don't run into the amount of the limit on tax preferences when you get into a tax problem. Maybe a few but very few.

Now, however, when you get into the other aspects of the House-passed bill, that is the problem. But I think following on what Senator Gore's problem is, which is a problem for all of us, if you are going to plug the loophole which you advocate plugging, that is what the limit on tax preferences is all about. I can understand the situation where somebody with not too much taxable income during the year might desire to give a farm which has appreciated a great deal but if you have an odd case like that, I would think that could be readily satisfied by having him give half the farm in one year and half the farm in the next year.

What I am getting at is that while you advocate plugging the loophole, I don't know how you are going to do it unless you use the limit on tax preferences approach, but I can well understand how some of the other provisions of the House bill in addition to that cause your basic problem.

Dr. WILKINSON. That is right, because they are all interrelated and you have to read the entire bill in order to get the connotation.

Now, the example we give in the full statement with respect to this tax situation of which I informed you showed that 30 computations are made. In our statement, we have given all smaller gifts also. In other words, my full statement gives the computations showing what the tax would be. I admit that may not be the normal case but we know in our university of situations of this kind where somebody is very much injured, in fact, almost prohibited, because of the lack of incentive if this bill is passed as it now is.

When I said, "plugging the loophole" and when I agreed with Senator Gore that I didn't think anybody should profit by this, I meant I did not think that anyone should make, because of his charitable contributions, a profit over and above the deduction that he would get in the charitable contribution.

Unfortunately, under the present law they sometimes make money by doing it in addition to the contributions they give. We do not think they should be permited to do that.

Senator MILLER. Well, I appreciate your response and I know it would be almost impossible for you to get this data for the committee, but if you have some basis for rebutting my observation that the number of people who would be adversely affected by the limit on tax preferences treatment alone is very small, if not almost nonexistent, I would like to have it.

With respect to the other areas of the tax bill, that is something else. But take, for example, a typical person out in my State with $50,000 of salary and he gives some securities which have appreciated $20,000. He has no problem because his limit on tax preferences are $20,000.

Now, of course, if he has long term capital gain and percentage depletion and a lot of other—some tax-exempt municipal bond interest for example—certainly then he gets into that example, but I suggest to you that example is a very remote one, and we have a problem with respect to the attitude of the general public about some people having a large amount of income and paying little or no tax, and that is what the limit on tax preferences is designed to accomplish.

But when you get into some of these other areas that you are objecting to, I think I read you loud and clear, but I don't like to use an example such as you gave to tear down that limit on tax preferences approach because I don't think that you are going to have much problem with the limit on tax preferences if that is all there is in here.

Dr. WILKINSON. Had I more time, I would give some other illustrations which are given in my full statement. That I admit may be one of the unusual cases, yet we know at our own university of cases of that kind. I wish it were possible for me and I had the resources to find out the answer to your question. The Treasury hasn't answered it. To that extent, to the extent that we can find it out, we will let you know.

Senator MILLER. Thank you very much.

Senator ANDERSON. Senator Jordan?

Senator JORDAN. No questions. A very good statement.

Senator FANNIN. Dr. Wilkinson, I certainly commend you for a very forthright statement, your recognition that we do have problems, we do have loopholes, and that you are concerned about many of our schools that have been vitally affected, private schools, by inflation. They are in need of additional gifts rather than to curtail them.

I am wondering if we are not really defeating our purposes as far as revenue is concerned if we do not have the gifts, do not have the revenue tuition. Then, of course, we have the schools drop by the wayside. I don't know just how many of our private schools of higher education have dropped by the wayside in the last 10 years but I understand that we have been going in inverse ratio. We have been dropping rather than adding, especially in some of the Eastern States where we have had a large proportion of the students in private schools, a larger proportion than in public schools. So that is of great concern to me.

But I am wondering what your thoughts are as far as the actual savings that—as far as the Federal Government is concerned if we are picking up the tab at many institutions on tuition, loans, funding, one way or the other, what effect you think this would have in that regard.

Dr. WILKINSON. The House committee in its report, Senator, estimates that if these charitable deduction provisions are included, that

they would get for the current year $5 million more in income and by 1974, $20 million more in income.

Now, we submit that that is a pretty small figure to justify these drastic changes in the law. As I pointed out, the States represented by this committee, have obtained $200 million last year in charitable gifts to public and private institutions and if you are going to destroy the incentive for that $200 million for even the 16 States represented by this committee in order to get $5 million this year and $20 million in 1974, we say it is not worth the price.

Senator FANNIN. I agree. Thank you.

Senator ANDERSON. Senator Byrd?

Senator BYRD. Thank you, Mr. Chairman. Dr. Wilkinson, if the Congress were to enact legislation which would be crippling to the private colleges, that would increase the burden, I would assume, on the State-supported, tax-supported institutions.

Dr. WILKINSON. No question about it.

Senator BYRD. So in attempting to plug loopholes which I think we should attempt to plug, we want to be careful that we don't do it in such a way that it will eliminate contributions to the independent colleges which in turn, if that is done, would react to the disadvantage of the taxpayers everywhere.

Dr. WILKINSON. I agree thoroughly, Senator.

Senator BYRD. Thank you. Thank you, Mr. Chairman.

Senator ANDERSON. Senator Hansen?

Senator HANSEN. I have no questions. I want to compliment Dr. Wilkinson on a very fine presentation.

Senator GORE. Doctor, I hesitate to ask for another brief turn to interrogate you, but you are an important witness. You represent a very important and valuable segment of our society.

A great many references have been made to appreciated property. Perhaps it might be well for the record and for us to understand that we are also talking about depreciated properties.

An example, for instance, would be the gift of a very valuable building that has been fully depreciated. Another example would be a so-called charitable gift of a white elephant, an old dilapidated but fully depreciated building. We are speaking of depreciated values and appreciated values and of property which may have an estimated value in excess of its real value.

I was glad that you and I reached an agreement that the tax law should remove the profit from charity.

Now, there is another fundamental question that I would like to have your views on and that is this.

To the extent that the tax law permits an individual to make a gift for a private purpose and subtract the value of that gift from his otherwise taxable income on which he would pay taxes to the U.S. Government, the law to that extent permits the substitution of an individual's judgment as to what would be a good purpose for the judgment of society itself exercised through its democratic governmental process.

Dr. WILKINSON. That is right, Senator, and I think that that is inherent in our democratic process and should prevail. As a matter of fact, this country has come into its greatness just because of voluntary giving of that particular kind. I remember that Woodrow Wilson at

one time said that the thing that had made this country great was what it had done, not under compulsion of law, but voluntarily, and I submit, therefore, that these individuals ought to have the right to choose their particular charity.

Now, if the charities, however, as defined by Congress, if some of them are improper, then let's have a redefinition of the charities that Congress will permit to be given to. But as long as we are within the orbit of the definition already given by Congress, then I submit that the individual ought to have his choice as to those to whom he will give.

Senator GORE. Then you think he should have complete choice as to whether he contributes to his Government by way of taxes or whether he contributes to a charity of his own choosing?

Dr. WILKINSON. Except where he makes a profit by it and you and I agreed on that.

Senator GORE. Leaving the profit out of it, you still would allow him to substitute private charity of his own choosing for 100 percent of his tax liability otherwise?

Dr. WILKINSON. Otherwise, I think, Senator, we are going way, way down the road to a welfare state and I am in favor of that voluntary choice. In other words, I do not think that Washington or the 50 States of the Union themselves should have any better judgment on some of those things than the individual who has made the money.

Senator GORE. Well, this is——

Dr. WILKINSON. He is limited, of course. Let's note this, that under the present bill he is limited to 30 percent. Under the new bill he would get 50 percent if it were cash. Under the new bill he could not give more than 30 percent if it were appreciated property. He would still have the limit of 30 percent.

Senator GORE. Well, you and I are in an area in which we would disagree. Democracy is not a perfect science and in the short run may not be the best form of government. However, I believe it was Mr. Churchill who said it was the best that anyone had ever tried.

Dr. WILKINSON. I think he said it was the worst in the world but the best the world had ever discovered.

Senator GORE. I am not sure either one of us is quoting him verbatim.

I will not trespass upon the time of the committee. You have been a very helpful witness. I would like to say I would disagree with you in your last comment. True, democracy may not be the most efficient form of government for a particular purpose in the short run, but let us remember that while Mussolini made the trains run on time, he ran Italy over the precipice.

Senator BENNETT. Mr. Chairman, will the Senator yield?

Senator GORE. I have finished.

Senator BENNETT. Does the Senator from Tennessee say that the Federal Government should dictate the extent to which a man may support his church?

Senator GORE. I said there should be a limit to this.

Senator BENNETT. Well, there is a limit of 30 percent.

Senator GORE. But the question I was posing to the distinguished witness was, to what extent he would permit it. He agreed he would go to 100 percent.

Dr. WILKINSON. I meant 100 percent of the present percentage permitted by statute—100 percent of that.

Senator GORE. I see. That helps a little bit.

Dr. WILKINSON. I don't think you and I are very far apart.

Senator BENNETT. On the basis of the separation of church and state which is one of the basic principles of our democracy, the individual should be allowed to decide to which church he wishes to give his support, personal and financial, and then if you go that far, I think the majority of these independently financed universities which Dr. Wilkinson represents are church-supported. Certainly, that is true of Brigham Young University.

So you have that aspect and that same aspect runs through most charities. And I think we have touched a fundamental nerve here when we assume that limitations should be placed on a man's right to choose the cause he will support and that the overpowering power of the Federal Government should move in and say you can't support this one, but you can support this one.

I think that is very serious.

Senator GORE. Senator, you are not referring to anything unprecedented. The law now provides purposes for which tax deductions can be taken and for which it cannot. And there are limits and there ought to be limits as to the purposes for which a tax deduction will be permitted. It is not new in our jurisprudence to have——

Senator BENNETT. But they are limits of definition. They are not limits imposed on individual institutions within the definition.

Senator GORE. Well, I didn't mention that at all. That was not even the subject of our conversation, was it, Doctor?

Dr. WILKINSON. I didn't understand it. May I say, Senator Gore, so that you will understand my viewpoint further, and I am speaking only for my own university now, we agree thoroughly that unrelated business income should be taxed. May I say the church which operates my university has always paid taxes on unrelated business income even before it was required by law, and I think they should be taxed.

Senator GORE. Thank you.

The CHAIRMAN. Let me say, Dr. Wilkinson, I didn't get into the very end of this exchange and I am glad I didn't because I might have dealt myself a hand and I might have regretted it. But I see you have some interesting reports and I will promise to study them.

Senator ANDERSON. And a good football team. Just ease up a little bit.

The Chairman. The full statement will be placed in the record.

(Dr. Ernest L. Wilkinson's prepared statement follows:)

STATEMENT OF DR. ERNEST L. WILKINSON, PRESIDENT, BRIGHAM YOUNG UNIVERSITY, ON BEHALF OF AMERICAN ASSOCIATION OF INDEPENDENT COLLEGE AND UNIVERSITY PRESIDENTS

SUMMARY

I appear on behalf of the American Association of Independent College and University Presidents. I also appear on behalf of Brigham Young University. Although my university is a large one with 25,000 full time students, most of the member institutions of the Association are smaller independent colleges and universities.

CONTRIBUTION OF PRIVATE INSTITUTIONS TO THE NATION MEASURED BY GRADUATES

The contribution to our society of private institutions of higher learning is tremendous. Time only permits a very few examples:

1. In the decade from 1956 through 1965, 45% of all doctorate degrees awarded were conferred by private institutions.

2. In a recent ranking by the American Council on Education private institutions lead state institutions in quality of graduate faculties in engineering, humanities, social sciences, biological sciences and physical sciences.

3. Our faculty members have won 29 of the last 41 Nobel Prizes awarded to Americans for scientific research.

4. At the undergraduate level, students from private institutions won approximately half of all Rhodes Scholarships.

5. My own university has produced 50 college presidents.

6. Eight of the 16 members on this Committee attended private institutions for undergraduate or graduate education or both. Five of the 8 Senators on this Committee attended sectarian schools and 3 attended nonsectarian schools. Seventy-three of the 100 present members of the Senate attended private institutions of higher education. Thirty-five attended nonsectarian schools; 35 attended sectarian universities; 3 attended private schools the religious affiliation or lack of affiliation of which could not be determined by us.

CONTRIBUTIONS OF PRIVATE COLLEGES AND UNIVERSITIES TO THE NATION MEASURED BY THE ROLE THEY HAVE PLAYED IN OUR DUAL SYSTEM OF HIGHER EDUCATION

As stated in the introductory article to the current edition of "Who's Who in America":

Private liberal arts colleges have been the basis and the backbone of higher education in America. It is these institutions that have pioneered and made possible the vast and effective structure of tax-supported education. Private junior colleges showed the way to our burgeoning system of public junior colleges; private preparatory schools have pioneered much that is now incorporated in our comprehensive system of public secondary education. In the case of all three groups, from an enrollment standpoint, the off-spring dwarfs the parent.

The Danforth Foundation Report of 1966, recognized by all educators as an authoritative study, lists these distinctive assets of private institutions:

(1) freedom to experiment and serve special purposes, academic and social;
(2) responsiveness to able leadership;
(3) a good record of preparation for graduate and professional study;
(4) concern for progress of individual students;
(5) close student-faculty relationships;
(6) the espousal of human values.

CONGRESSIONAL PURPOSE IN PROVIDING AND EXPANDING THE DEDUCTIONS AVAILABLE FOR CHARITABLE CONTRIBUTIONS

Since the first income tax law was passed in 1918 Congress has at succeeding sessions constantly expanded and liberalized the tax treatment for charitable contributions for higher education. Congressional history states that the reason for this liberalization has been the fact that increases in costs and inflation have put private institutions in a financial squeeze. Congress has also recognized that it is cheaper to encourage direct assistance by charitable giving than it would be to provide tax dollars to higher education. Higher education has been favored over many other charities in the tax laws.

In summary, Congress during the 51 year history of the Internal Revenue Code has always enlarged, never restricted, the charitable deduction, although the same arguments now made have previously been made to Congress. The alternative method would be for government, through the imposition of taxes, to fund these institutions itself.

PRESENT CRITICAL NEED FOR SPECIAL TAX TREATMENT FOR CHARITABLE GIFTS IN VIEW OF THE CURRENT FINANCIAL CRISIS OF PRIVATE COLLEGES AND UNIVERSITIES

Private institutions of higher education outnumber public institutions by 1,409 to 821. Although 63% of the institutions are privately controlled and in 1900 70% of college enrollment was in private institutions, today only approximately 30% of the students attend private institutions while 70% attend public institutions. This trend is due to the increase in higher cost of education and to the heavy tax structure, which has cut down on the amount of money available for charity. Private institutions however still educate more students than

they did in the past and enrollment at them is increasing in number although the percentage of the total enrollment is smaller. To further discourage their growth these taxes would be disastrous.

The president of the Carnegie Foundation, with whom we disagree, has predicted the end of all but a few private colleges in the near future. But without more tax considerations and a more generous share of contributions many institutions will not survive. *Fortune Magazine* and *U.S. News and World Report* have both noted that private four-year institutions are piling up big deficits and that many private colleges will be either forced into mergers or will go under the public umbrella if they are to survive.

Already colleges of considerable size, such as Houston, Buffalo, Kansas City, Temple and Pittsburgh have gone from private to public control. This has happened to many smaller institutions. Allan Cartter, chancellor of New York University, states that each new institution taken over by the state raises the tax burden by a factor of 10 to 20 times the amount of contributions that might have been necessary to keep the college as a viable independent institution. The University of Buffalo now costs the State of New York $45,000,000. Cartter states that a contribution of $3,000,000 to $4,000,000 would have let it continue as an independent university.

Current expenditures of private institutions constitute 43% of current expenditures of all institutions of higher learning.

Capital receipts fell $300,000,000 short of capital expenditures for private institutions during the period 1965–66. Private gifts made up most of this deficit. In fact private gifts accounted for 58% of all capital funds received by private schools.

Private schools of higher education received approximately 80% of total private gifts to higher education, while public institutions received the rest. If gifts to the capital account of private institutions equaled the capital account gifts to public institutions as a percentage, private schools would have experienced an $800,000,000 capital account deficit. Private gifts also constitute 10% of the current revenues of private institutions. The conversion of a private institution to a public institution would place an even heavier burden on state government which now provides over 40% now received by public institutions of higher education. The present tax bill would add a considerable load to the states if the states ended up taking over the private institutions.

Private schools situated in states represented by the members of this Finance Committee received gifts of $200,000,000 in 1965–66.

The new massive programs of federal aid have been of little help to private institutions on the whole. In a recent year six universities received 57% and 20 universities received nearly 80% of all federal aid to higher education. Only 10% of research funds and 12% of fellowships were shared by 600 public and 1,400 private colleges and universities.

There are grave constitutional questions inherent in a program of direct federal aid to private parochial institutions managed or controlled by religious bodies. Several institutions, including my own, do not accept federal aid. The only source of their survival is the philanthropy of the American people.

COMPLEXITY OF THE BILL

The Bill is so complex our own attorneys told us it should be entitled "The Lawyers and Accountants Pension and Annuity Bill of 1969." I knew why as soon as I saw their fee statements. Even so, they are very unsure of many of their conclusions. This Committee should be in no hurry and should take ample time in drafting the Bill to make it less complex wherever possible. What this country needs is a simplified tax bill, rather than one more complicated and more difficult to understand.

ANALYSIS OF BILL INCLUDING THE RECOMMENDED CHANGES THAT ARE NEEDED IF PRIVATE UNIVERSITIES ARE TO BE ENCOURAGED AND IN FACT SURVIVE

1. *Limitation on tax preferences and allocation of deductions.*—The Administration has recommended eliminating the appreciation portion of a charitable contribution of appreciated property from the limitation on tax preferences. It has also recommended eliminating the charitable contribution deduction as an allocable expense. If these two changes are not made the government will be forced into providing for the health, education and welfare of this nation, with-

out significant help from the private sector. The bulk of all gifts received by universities are in appreciated property. The bulk of these gifts are made in large amounts by substantial contributors. The combined effect of the limitation on tax preferences and allocation of deductions will so critically penalize the giver that substantial gifts will no longer be made. These type of gifts constitute between 60% and 80% of all gifts made to private education.

2. *Increase in limit on charitable contributions.*—The increase in the limit on charitable contribution deductions from 30% to 50% is virtually meaningless to higher education because gifts of appreciated property are still held to the 30% limitation. Since the bulk of gifts, in dollar amount, are in large substantial donations of appreciated property, the donors of such gifts will not additionally give cash to take advantage of the extra 20% limit. The limit should be increased to 50% for gifts of appreciated property.

3. *Gifts of appreciated property.*—Appreciated property is hit again under the Bill (Section 170(e) of the Code) because the donor must either take a deduction only equal to his tax basis or if he elects to take a contribution deduction equal to the value of the appreciated property he must recognize as income and pay tax upon the appreciation portion of the gift. The only instance in which this is not the case under the Bill is if he makes a present gift of the appreciated property and any portion of the property given is not "ordinary income" property. A donor is penalized by being forced to make this undesirable election if (a) the property given is in future interest form, e.g. he reserves the income for his life but gives the entire property at his death to charity; or (b) he makes a gift of tangible personal property (valuable books, art objects, etc.); or (c) the property or any part of it is ordinary income property. Many properties are mixed. Even stocks or bonds if sold can result in the realization of ordinary income if there are accrued but unpaid dividends or interest. About $10,000,000 has been given to my university in a form that would cause this election. We have established an excellent deferred giving program that would no longer be possible under the Bill.

4. *Set aside trusts.*—Section 642(c) of the Code as amended by the Bill would disallow an income tax deduction to nonexempt trusts or estates which set aside all or a portion of their income for charity. Thousands of such trusts for the benefit of universities exist today. The trust instruments were created under present law which allows these trusts and estates to avoid paying tax on the capital gains realized upon sale of trust assets. The instruments cannot now be changed. Prudent trustees must sell assets from time to time. If the assets in these trusts are sold under the proposed Bill capital gains taxes will have to be paid thereby reducing the ultimate amount going to charity. This is most unfair. At my own university we hold about $10,000,000 of property in such trusts. Present law should not be changed.

5. *Present gifts of fractional interests.*—In a further effort to impose penalties upon the creation of future interest gifts the Bill goes too far and in fact prevents the present gift of a fractional undivided interest in a property. Sections 201(a)(3) of the Bill adding paragraph (a) to Section 170(b), Section 201(b)(1) of the Bill adding subparagraph (H) to Section 170(b)(1) of the Code and Section 201(c)(4) of the Bill all use the phrase "entire interest" which causes this problem, e.g. a man has not given his entire interest if he gives a fractional interest only. All three provisions should be reepaled not only to allow present gifts of fractional interest but also to alow creation of future interest gifts without penalty.

6. *Split interest trusts—Income tax deductions.*—Section 201(e) adding subsection (H) to Section 170 coupled with the provisions of new Section 664(d) of the Code will deny deductions for gifts to trusts unless the trust either agrees to pay a sum certain or a fixed percentage of net fair market value of trust assets based on annual redetermination of the fair market value. Many universities, including my own, hold millions of dollars of property in trust. To meet the requirements of these sections could be disastrous to the universities. In order to meet the guaranteed payout, assets would have to be sold. A prolonged period of declining yield could eliminate the corpus altogether. Annual value determinations are very costly and would reduce the amount going to the universities. They are also very uncertain. These determinations could lead to extensive litigation. If property appreciates in value, the fixed percentage payout could force additional sales of property to meet the payout. The Bill goes too far. The alleged abuses it sought to cure were investment policies that would

favor the donor and the fear that the universities would ultimately receive less than the value utilized in determining the donor's deduction. The solution is to simply require the gifts to be made to an independent trustee or to the university itself as trustee or co-trustee. The independent trustee's fiduciary duty would require it to consider the interest of both donor and donee. If the university itself were trustee or co-trustee, its own self-interest would insure an investment policy that would not favor the donor. The above Bill provisions should be deleted.

7. *Split interest—Estate and gift tax deductions.*—Section 201(H) of the Bill amends subsection (e) of Section 2055 and subsection (c) of Section 2522 in a manner parallel to the amendments discussed under paragraph 6 above so that gift tax and estate tax deductions are disallowed on the same conditions that income tax deductions are disallowed. We make the same recommendations as we did in paragraph 6.

8. *Pooled split interest trusts.*—The proposed charitable remainder annuity trust and the charitable remainder unitrust requirements coupled with the present "set-aside" provisions will effectively eliminate the pooling of trust funds. Hundreds of universities now have existing pooled reserved lifetime income charitable remainder trusts as receptacles for charitable contributions. The suggested changes made in paragraphs 4, 6 and 7 above must be made in order for these pooled fund trusts to continue as effective receptacles to receive charitable contributions.

9. *Reserved legal life estate to donor.*—Section 201(a)(3) adds a new subsection 8 to Section 170(b). This subsection 8 appears to treat only the subject of disallowance of a deduciton for mere use of property. The first sentence, however, is susceptible of an interpretation that no deductions would be allowed for the gift of a remainder interest following the creation of a legal life estate unless the grantor is assured of payments in the same manner as if the conveyance were made to a charitable remainder annuity trust or a charitable remainder unitrust. If this is a correct interpretation, it will probably mean an end to the creation of legal life estates with gifts of the remainder interest to charity. Accordingly, we think the subsection 8 should be amended to clarify the fact that it only applies to the mere use of propery by the donee.

10. *Bargain sales.*—"Bargain sales" to universities would no longer be advantageous from a tax standpoint by reason of new proposed subsection (b) of Section 1011 of the Code, which is added by Section 201(d) of the Bill. This subsection would require the donor-seller to allocate his cost basis in the property "sold" between what he receives on the sale and what the university receives from the gift. The Bill goes too far. The only possible abuse in the event of a bargain sale is when the tax savings resulting from the gift to the donor-seller plus the amount he receives exceed the fair market value of the gift. This will only occur if he gives ordinary income property. The simple solution is to merely disallow a portion of the charitable contribution deduction to the extent that the doror made a "profit" by giving "ordinary income" property.

11. *Gifts of income interests.*—Section 201(g) of the Bill repeals Section 673(b) of the Code. Section 201(a) amends Section 170(b)(1)(H). These sections will prevent the possibility of any future gifts of income to universities. The Administration believes the Bill is unduly stringent in only permitting deductions for the value of a charitable income interest when such income is taxable to the grantor under other rules. We agree. W think the solution for all gifts of income should be the disallowance of a portion of the deduction to the extent that the donor "makes a profit" from the gift. We also think the trustee should be an independent trustee or else the university itself should be a trustee or co-trustee.

12. *Information returns—publicity.*—We vigorously oppose the requirement of filing information returns which Section 101(d) requires. Subsection (e) also provides for publicity of the information. These provisions apply not only to colleges and universities but to the churches that support many of these institutions. This will prove extremely burdensome and costly to the universities and churches with no offsetting revenue to the government because colleges and churches are tax exempt. The donors must file their own returns and so there are no aspects of evasion involved. The magnitude of information required will be extremely costly and should not be required.

13. *Taxation of passive income from controlled corporations.*—Section 121(b) of the Bill amending Section 512(b) of the Code by adding paragraph 15 thereto will tax the passive income received from corporations which are controlled by

exempt organizations. The apparent abuse was the belief that proceeds of unrelated trades and businesses conducted by such corporations were being siphoned off in the form of unreasonable rents, interest, etc. so that the corporation conducting the unrelated trade or business would pay no tax. Speaking solely for my own university and the church which largely supports it, we do not believe unrelated trades or businesses should be exempt. My own church has followed this policy on a voluntary basis for a long time. There is no good reason, however, for the taxation of passive income such as rent and interest if the amounts paid are reasonable. The courts and the Internal Revenue Service have coped with reasonable rent problems very successfully. The solution should be based on fact determination and not absolute blind confiscatory fiat as is done under Section 121(b) of the Bill which should be repealed.

Statement

My name is Ernest L. Wilkinson. I appear before you on behalf of the American Association of Independent College and University Presidents, an organization of which I am President. The Association is only about two years old, but our membership presently includes 371 presidents of private universities and colleges and I expect that our membership will be over 400 before the year is over. A list of these universities and colleges which are situated all over the country is attached to this statement.* The list is necessarily incomplete since new members join every day. I also appear here on behalf of Brigham Young University, of which I am honored to be President and which in terms of full-time students, is now the largest private university in the United States. We have a campus enrollment of over 25,000 full-time students who come from every state of the Union and nearly 70 foreign countries. Approximately one-half of our enrollment comes from states represented on this Committee. We have not had, and do not intend to have, any student disturbances. Our students come to study and not to riot. We also serve more than 100,000 other students in extension courses, education weeks, etc., off campus.

CONTRIBUTIONS OF PRIVATE COLLEGES AND UNIVERSITIES TO THE NATION MEASURED BY GRADUATES

The contribution to our society of private institutions of higher learning has been and still is tremendous. Time does not permit me to fully brief this, so I will have to content myself with a very few examples:

1. ". . . in the decade 1955–56 through 1964–65 private institutions conferred approximately 45 per cent of all doctorates awarded . . ."

2. ". . . In a recent American Council on Education evaluation of the quality of graduate faculties, three of the five 'leading universities' in engineering were private, as were four of the six in humanities, six of the nine in the social sciences, five of the nine in the biological sciences, and seven of the nine in the physical sciences."

3. ". . . their faculty members have won 29 of the last 41 Nobel prizes awarded to Americans for scientific research."

4. "At the undergraduate level, students from private institutions have won approximately half of all Rhodes Scholarships awarded."[1]

5. Taking as an example only the University of which I am President, and which 25 years ago was a relatively small institution, having only approximately 1,100 students, we have produced 50 college presidents including presidents of the three largest universities in Utah and of such other universities as the University of Oregon, University of Minnesota, San Jose State College, and Chancellor of the University of California at Los Angeles.

6. If any proof were needed as to the contributions of private colleges and universities, may I say that a study of both undergraduate and graduate schools chosen for attendance by members of this Committee, shows that private institutions were selected by 8 of the 16 members of the Committee. Five of the 8 attended sectarian schools and 3 attended nonsectarian schools. Out of the entire Senate, 73 of the 100 members chose private schools for undergraduate or graduate education, and in some cases, for both types of education. Of the 73 Senators who

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*The membership referred to was made a part of the official files of the Committee.

[1] William G. Bowen, "Some Reasons for the Public Interest in the Private Universities," *The Education Digest*, December 1968.

have attended private institutions of higher learning, 35 attended nonsectarian schools and 35 attended sectarian universities. Three Senators attended schools, the sectarian or nonsectarian affiliation of which we could not determine. Thus, the ratio of attendance by members of the Senate is 73 to 27 per cent in favor of private institutions. This indicates that these private colleges and universities do produce leaders.

CONTRIBUTIONS OF PRIVATE COLLEGES AND UNIVERSITIES TO THE NATION MEASURED BY THE ROLE THEY HAVE PLAYED IN OUR DUAL SYSTEM OF HIGHER EDUCATION

It has been universally recognized that the private institutions have contributed and still contribute to our dual system of higher education in ways not always possible in public institutions.

As stated in the introductory article to the current edition of "Who's Who in America":

"Private liberal arts colleges have been the basis and the backbone of higher education in America. It is these institutions that have pioneered and made possible the vast and effective structure of tax-supported education. Private junior colleges showed the way to our burgeoning system of public junior colleges; private preparatory schools have pioneered much that is now incorporated in our comprehensive system of public secondary education. In the case of all three groups, from an enrollment standpoint, the offspring dwarfs the parent."[2]

The Danforth Foundation Report of 1966, recognized by all educators as an authoritative study, lists these distinctive assets of private institutions:

"(1) Freedom to experiment and serve special purposes, academic and social;

"(2) Responsiveness to able leadership;

"(3) A good record of preparation for graduate and professional study;

"(4) Concern for progress of individual students;

"(5) Close student-faculty relationships;

"(6) The espousal of human values."[3]

These concerns over the progress of individual students and the close student-faculty relationship are in my opinion the main reasons why you have so relatively little unrest and rioting and open rebellion in small private institutions, as compared with what is going on in state institutions and in some of the larger private institutions which have become almost entirely secularly oriented.

I should add to the list of distinctive assets listed by the Danforth Foundation Report the moral, spiritual and patriotic training given in many of these private institutions. This to my mind is the most important contribution they made, for if we lose our moral and spiritual moorings in this country, we will cease to be a great nation.[4]

CONGRESSIONAL PURPOSE IN PROVIDING AND EXPANDING THE DEDUCTIONS AVAILABLE FOR CHARITABLE CONTRIBUTIONS

Private higher education stands at the crossroads today. Congressional policy also stands at the crossroads today. The present Bill drastically reverses a long-standing trend of Congress to favor charitable giving. The deduction for charitable contributions has been a part of the Income Tax Law since the first Internal Revenue Act was passed in 1913. The purpose was no mere gesture of generosity on the part of Congress. The object was to provide the greatest amount of public benefit at the least amount of cost to the government. I quote from the report of this Committee to that Congress:

". . . The exemption from taxation of money or property devoted to charitable and other purposes is based upon the theory that the government is compensated for the loss of revenue by its relief from financial burden which would otherwise have to be met by appropriation from public funds, and by the benefits resulting from the promotion of the general welfare."[5]

Senator Hollis explained the deduction to the Senate in these words:

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[2] Marquis, *Who's Who, Who's Who in America,* Volume 35 1968–1969), p. 23.

[3] The Danforth Foundation Report of 1966.

[4] As stated by the perceptive Frenchman, Alexis de Tocqueville, who visited our country in the 1830's:

"I sought for the greatness and genius of America in her commodious harbors and her ample rivers, and it was not there; in her fertile fields and boundless prairies, and it was not there; in her rich mines and her vast world of commerce; and it was not there. Not until I went to the churches of America and heard her pulpits aflame with righteousness did I understand the secrets of her genius and power. *America is great because she is good,* and if America ever ceases to be good, America will cease to be great."

[5] H.R. Rept. No. 1860, 65th Cong., 3rd Sess., p. 17.

"For every dollar that a man contributes for these public charities, education, scientific, or otherwise, the public gets 100 per cent; it is all devoted to that purpose. If ite were the Federal Government or local governments and the taxes were imposed for the amount, they would only get the percentage, 5 per cent, 10 per cent, 20 per cent, or 40 per cent, as the case might be." [6]

To further emphasize this point, Senator Hollis requested that an excerpt from the Washington Post, which strongly favored the deduction, be incorporated into the record:

"If a man with a $2,000,000 income wished to give 20 per cent of it to charity, the government, under the proposed exemption, might lose a little revenue, but it would be infinitesimal compared with the amount that would be given to the public." [7]

The 51 year history of the charitable deduction demonstrates that Congress has been well satisfied with the policy behind it. The trend has always been to further expand and liberalize its provisions.

In 1952, the limit on the deduction was raised from 15 to 20 per cent of taxable income. Explaining the increased deduction, the Senate Finance Committee stated:

"Your committee is of the opinion that by increasing the 15 per cent limit to 20 per cent, much-needed relief will be given to colleges, hospitals, and other organizations who are becoming more and more dependent upon private contributions to enable them to balance their budgets and carry on their programs. The plight in which many of our educational institutions find themselves at the present time is due to the fact that their endowment income is inadequate to meet rising costs. It is only through the supplemental gifts by the alumni or other persons interested in the cause of education that they are able to continue their programs. Many of the smaller colleges whose alumni have not sufficient means to make adequate contributions are able to continue their existence only through gifts or contributions received by one or two prominent families in their community. Your committee believes that it is to the best interest of the community to encourage private contributions to these institutions and it is believed that this amendment will provide some assistance in this respect." [8]

In 1954, Congress further increased the attractiveness of charitable giving by raising the maximum possible deduction for individuals to 30 per cent [9] of taxable income. The appropriate committees of both Houses explained that:

". . . This amendment by your committee is designed to aid these institutions in obtaining the additional funds they need in view of their rising costs and the relatively low rate of return they are receiving from endowment funds." [10]

The same Congress provided that the taxpayer may compute his taxable income for purposes of the charitable deduction, before taking into account the loss carry-back.[11] This permitted him to have a higher charitable deduction.

The same act further liberalized the test to be met to entitle the taxpayer to the unlimited charitable deduction. Formerly, it had been necessary for the taxpayer to have contributed at least 90 per cent of his income to charities or taxes for each of the preceding 10 years; now the test has been relaxed to require only 8 out of 10 preceding years.[12]

In 1959, Congress added other organizations to which a taxpayer could make deductible contributions under the additional 10 per cent provisions (up to 30 per cent of taxable income).[13] In 1958, the unlimited charitable deduction was further liberalized.[14] In the Revenue Act of 1962, the charitable deduction was made even more attractive by an amendment which provided that taxpayers, who averaged income, could deduct charitable contributions before averaging in order to achieve a maximum deduction.[15] Another bill, passed in the same year, significantly increased the number of organizations to which taxpayers could

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[6] 65 Cong. Rec. 6728 (1917).

[7] *Id.* at 6729.

[8] Senate Report, 82d Cong., 2d Sess., 1952.

[9] Consisting of a basic limit of 20 per cent to individuals for all charitable gifts, plus an additional 10 per cent to certain qualifying charities. Int. Rev. Code of 1964, Sec. 170 (b)(1)(A).

[10] U.S. Code Congressional and Administrative News, 83d Cong., 2d Sess., 1954, pp. 4050, 4660.

[11] *Id.* at 4050.

[12] *Id.* at 4050–51.

[13] U.S. Code Congressional & Administrative News, 84th Cong., 2d Sess., 1956, 4586. See Int. Rev. Code of 1954, Sec. 170(b)(1)(A).

[14] U.S. Code Congressional & Administrative News, 85th Cong., 2d Sess., 1958, p. 4792.

[15] U.S. Code Congressional & Administrative News, 87th Cong., 2d Sess., 1962, p. 3431.

make deductible contributions of up to 30 per cent of taxable income.[16] In 1964, Congress provided that charitable contributions which were in excess of the 30 per cent ceiling, could be carried forward for five years.[17]

In summary, Congress during the 51 year history of the Internal Revenue Code has always enlarged, never restricted, the charitable deduction, although the same arguments now made have previously been made to Congress. The alternative method would be for government, through the imposition of taxes, to fund these institutions itself.

The House Bill represents a decision by the House to substantially end all efforts of the private sector in higher education. We doubt seriously that many House members even understood this. Under the guise of a tax reform policy a social planning policy is being implemented. No longer as a practical and economic matter will the private sector be able to make its contributions to health, welfare and education because under the Bill, as it presently stands, the private sectors' contributions to health, welfare and education will cease almost entirely. Under the guise of tax reform in an attempt to end tax inequities the present Bill throws the baby out with the bath water. Rather than treat the problem of abuses in charitable giving the Bill will virtually eliminate the entire subject matter of charitable giving.

Before addressing myself directly to the sections of the Bill which we feel adversely affect all of the colleges and universities of this great nation, let me state that, in principle, we are wholeheartedly in favor of any and all changes which will help eliminate areas of tax abuse. Conversely, we feel that no change should be made which goes beyond what is needed to correct the abuse.

No taxpayer should be allowed to make a profit from giving, and areas where this is possible should and must be changed. On the other hand, giving to education should and we feel must be encouraged in every case where the taxpayer gives more than he receives. We must not, under the guise of attempted equality among taxpayers, discourage giving where there is, in fact, a financial loss to the taxpayer in favor of the universities. Congress has historically seen the wisdom of encouraging voluntary giving to educational institutions by direct tax subsidy to the donor. Even if the tax savings to the donor were *equal to* the financial benefit to the university, the gifts should be encouraged because 100 per cent of the benefit goes directly to the university and if the financial assistance had not come in this direct manner, it would have to come directly from the government tax revenue.

PRESENT CRITICAL NEED FOR SPECIAL TAX TREATMENT FOR CHARITABLE GIFTS IN VIEW OF THE CURRENT FINANCIAL CRISIS OF PRIVATE COLLEGES AND UNIVERSITIES

Private institutions of higher learning have always outnumbered and still do outnumber the public institutions in this country. Of the 2,230 institutions of higher learning in the United States, 1,409 or 63 per cent are still privately controlled, and until recently more students were enrolled in these privately founded institutions than in their tax supported counterparts. Because, however, of the tremendous increase in the numbers attending colleges and universities, even though the number attending private colleges has vastly increased, the percentage has declined. In 1900 approximately 70 per cent of the students were enrolled in private colleges and 30 per cent in public institutions. Today the reverse is true. Approximately 30 per cent are in private and 70 per cent in public institutions.

The private institution's declining share of total enrollment can almost certainly be traced to elements of federal and state tax policy. On the one hand, increasingly burdensome taxes have dried up the well springs of private philanthropy, forcing even higher tuition charges in private institutions to meet rising costs. At the same time, these public revenues are used to subsidize the public colleges and universities whose tuition charges represent a much smaller percentage of educational costs per student.

The reasons for special tax treatment for private colleges and universities are therefore even more persuasive now than in the past. Although their share of the educational burden is smaller as a percentage of the total, they still educate more students than in the past and their financial contribution to education, in absolute terms, continues to grow.

The U. S. Office of Education estimated that in 1967–1968, 18.3 billions of dollars were spent for higher education, 7.6 billions of which were spent by the

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[16] *Id.* at 3895.
[17] Int. Rev. Code of 1954, Sec. 170(b)(5).

private institutions.[18] These figures are the expression of a profound commitment by the American people to a dual system of higher education, the pluralistic character of which has been considered its greatest strength, for it has permitted a great diversity of training.

By establishing the public institutions, our nation made an unparalleled and highly moral decision: that higher education should be available to almost anyone who wants it and can benefit by it. But that decision has put the very existence of the private institutions in jeopardy, for unless they are to become institutions solely for the well-to-do, they must remain competitive in some sense with public institutions, and student tuition must not price them out of the market. Hence, the private college must seek charitable support, because like the public schools, the hospital and the orphanage, it offers services which cannot fully be paid for by those who benefit.[19]

To fail to meet this need—to provide the means for survival—would be to render a great disservice to the American educational system, and to throw an even greater burden on public educational institutions.

Further, what has been said about the value of and need for charitable contributions by the private educational institutions would also apply (although to a lesser extent) to the needs of many public educational institutions which quite often rely heavily on private funds to supplement the financial support provided by governmental instrumentalities.

Although private institutions are performing a larger and more vital function than ever before, they are also facing an unparalleled financial crisis. There are some authorities, including the President of the Carnegie Foundation with whom we disagree, who predict the end of all but a few of our private colleges in the near future. That is a prediction many of us do not accept. But we are nevertheless aware that without even more tax considerations than we now have, and a more generous share of contributions, many institutions cannot survive.

One reason for this is the rising cost of education caused by the enlarged scope of knowledge they are called upon to teach, and to a great extent by inflation. In the decade 1956–1966, expenditures of private colleges and universities rose from $1,875 to $3,102 per student, the rate of increase being 65 per cent higher than that of prices in the economy as a whole.[20] Further, it is estimated that the ". . . cost per student will continue to advance at a rate of more than 15 per cent per year and . . . enrollment will grow by 3.4 per cent per year. Thus the costs of operating a typical private university will nearly triple in a decade."[21]

According to *Fortune Magazine*: ". . . No one has yet been able to estimate the deficit the whole community of 1,177 private four-year institutions is piling up. The way things are going, the combined *annual* deficit ten years from now could be in the neighborhood of five billion dollars."[22]

A carefully prepared article in the *U.S. News & World Report* of September 18, 1967 states:

"Prospects are that some of the weaker private colleges may disappear in the years just ahead. Other schools may be forced to merge in order to survive. Still others are likely to go under the public umbrella, joining state college systems. Several colleges already have taken this course."[23]

This increased cost cannot possibly be met without a great enlargement of contributions by private individuals. Of the total current fund income of privately controlled institutions of higher education of $4,216,599,000 for the year 1963–1964, $437,052,000 came from private gifts and grants and another $703,025,000 came from auxiliary enterprise income, much of it undoubtedly representing earnings of privately donated capital.[24] Although the total of these two items, amounting to $1,140,000,000, represents only 25 per cent of the total income of these institutions, it is this 25 per cent that keeps them

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[18] K. A. Simon and W. V. Grant, *Digest of Educational Statistics*, 1967 Edition, U.S. Department of Health, Education, and Welfare, Washington, D.C.; U.S. Government Printing Office, 1968, p. 16, table 20.

[19] W. Max Wise, *The Politics of the Private College*, New Haven, Connecticut, The Hazen Foundation, p. 80.

[20] Nelson, AAUP: Focus on Financial Crisis of Private Higher Education, *Science*, May 10, 1968, p. 635.

[21] Financial Problems of the Private Universities, *Science*, September 13, 1968.

[22] Norton Taylor, "Private Colleges: A Question of Survival," *Fortune*, Oct., 1967, p. 153.

[23] "The Coming Crisis in Private Colleges," *U.S. News & World Report*, Sept. 18, 1967, pp. 57–58.

[24] U.S. Department of Health, Education, and Welfare, Digest of Educational Statistics, 1967, p. 91.

from bankruptcy. Any substantial reduction of funds from these sources would almost certainly result in the demise of many private institutions whose viability is now marginal. Most of the balance of operating expenses comes from tuition, which cannot go much higher without crowding out deserving students. It is already too expensive in many institutions, being as high as $2,800 for undergraduate students.

ECONOMIC EFFECT OF REDUCED TAX INCENTIVES ON CHARITABLE CONTRIBUTIONS

In this situation, if private contributions diminish, federal and state subsidies must increase if these institutions are to survive. Consequently, any policy which will reduce tax incentives to private contribution is self-defeating. Indeed, the direct cost to government of the diminished capacity of private institutions would greatly exceed the loss of revenue under the present law. This is illustrated by the present marked tendency of private institutions to be absorbed into state systems.

Already colleges and universities of considerable size, such as Houston, Buffalo, Kansas City, Temple, Pittsburgh and others have gone from private to public control. This is even more true with respect to smaller colleges, but I have not had time or the resources to make a complete list of them. Allan Cartter, Chancellor of New York University, and Grayson Kirk, former president of Columbia, are two among many who have commented on this disastrous trend to our system of dual education. Cartter points out that each new institution taken over by the state raises the tax burden by a factor of ten to twenty times the amount of subsidies or contributions that might have been necessary to keep the college as a viable independent institution. The University of Buffalo, which was recently taken over by the State of New York, now costs the state 45 million dollars in operating support. Cartter indicates that a subsidy or contribution of three million to four million dollars probably would have been sufficient to let it prosper as an independent university.[35]

As respects the benefits which private institutions receive as a result of charitable deductions in the present law, it is highly significant that of all charitable contributions given to educational institutions of higher learning in 1965–1966, 68 per cent of that given by corporations, 82 per cent of that given by alumni, 86 per cent of that given by nonalumni, and 100 per cent of that given by religious organizations were given to *private* universities and colleges.[36] The public therefore recognizes that, in general, private institutions, rather than public, should be the object of their bounty, for public institutions are supported by taxes.

The following is a table of revenues and expenditures of all institutions of higher education for the period 1965–1966:

REVENUE AND EXPENDITURES FOR INSTITUTIONS OF HIGHER EDUCATION 1965–66[1]

[In billions of dollars]

	Public institutions	Private institutions	All institutions
Revenue:			
Current funds	7.4	5.4	12.8
Capital funds	1.5	1.0	2.5
Total	8.9	6.4	15.3
Expenditures:			
Current funds	7.1	5.5	12.6
Capital funds	2.1	1.3	3.4
Total	9.2	6.8	16.0
Revenue from private gifts:			
Current funds	.2	.5	.7
Capital funds	.1	.6	.7
Total	.3	1.1	1.4

[1] U.S. Office of Education, 1969, Financial Statistics of Institutions of Higher Education: Current Funds Revenues and Expenditures, 1965–66, and Financial Statistics of Institutions of Higher Education: Property, 1965–66.

[35] Norton-Taylor, *op. cit.* pp. 158, 180, 185.
[36] Norton-Taylor, *op. cit.* p. 158.

Interesting facts revealed by the above table include the following:

1. Current expenditures of private institutions constituted 43 per cent of current expenditures of all institutions.
2. In both public and private institutions current receipts were approximately equal to or exceeded current expenditures while capital receipts were significantly less than capital expenditures. In private institutions capital receipts fell $300 million short of equalling capital expenditures.
3. Private gifts and grants for the year 1965–66 totaled $1.4 billion for all institutions. Private schools received approximately 80 per cent of this amount ($1.1 billion) while public institutions received the rest.
4. Private gifts and grants were the major source of revenue in the capital account of private institutions. Private gifts accounted for 58 per cent of all capital funds received by private schools compared with 7 per cent for public schools.
5. Private gifts also played a major role in the current account of private institutions. Gifts accounted for 10 per cent of the current revenue received by the private sector. This revenue is extremely important as the margin for allowing private institutions to maintain the quality programs they have developed.

The conversion of a private school to a public school places a burden on the branch of government which is least prepared to meet the financial obligation. This branch is the state governments which now provide more than 40 per cent of all funds received by public institutions. The tax Bill under consideration will add considerably to the heavy educational load already being carried by the states without providing any additional means of assistance.[27]

With regard to the states represented by the members of the Senate Finance Committee, gifts to private schools in those states totaled $200 million in 1965–1966. These gifts represented 52 per cent of the capital receipts of the schools involved and 13 per cent of their operating funds. Given the magnitude of private gifts in the total picture, it is now difficult to imagine the consequence if these institutions were denied a portion of their current and capital proceeds.[28]

Our experts tell us that the effect of the House Bill in its present form will be to virtually eliminate all *substantial* giving which accounts for between 70 and 80 per cent of all donations to higher education. They point out that if the donor pays more taxes and has fewer net assets, he will probably not give.

This need for charitable support to most private institutions is not diminished by the new massive programs of federal aid, for most of it has been limited to a relatively few institutions:

"During a recent year, six universities received 57 per cent, and 20 universities received nearly 80 per cent of all federal aid to higher education . . . for fiscal 1962, 100 institutions received 90 per cent of the research funds and 88 per cent of the NSF and NDEA fellowships. Thus the remaining 10 per cent of the research funds and the 12 per cent of the fellowships were shared by about 600 public and 1,400 private colleges and universities."[29]

Many constitutional scholars think that there are grave constitutional questions inherent in any program of direct federal aid to private parochial educational institutions managed or controlled by religious bodies. Moreover, there are some private institutions, such as my own, who do not accept federal aid.[30] The only means they have for survival is the philanthropy of the American people.

We have included as an appendix quotations from national leaders showing the absolute necessity for financing private educational institutions by this means.

COMPLEXITY OF THE BILL

The present Bill is terribly complex. It is so complex that one of our own University's lawyers told me that the Bill should be entitled "The Lawyers' and Accountants' Pension and Annuity Bill of 1969." I knew why as soon as I saw his fee statement for analysing the Bill. Even so, he frankly admitted that every

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[27] *Id.*

[28] *Ibid.*

[29] David D. Geddes, *The Role of Government in Higher Education*, Law School, University of Michigan, Annual Broomfield Essay, unpublished, p. 23.

[30] My University does accept federal research funds on the theory such is not federal aid, for we give a quid pro quo for it.

time he read the Bill he saw something new and he conceded that he was unsure of many of his conclusions. Not only are numerous sets of computations necessary to determine an individual's tax, each set of computations has its own set of subcomputations. Some tax experts have already opined that because it will be impossible for a person to determine the tax effect on a charitable contribution, at the time of making the contribution, most donors will be frightened into inaction. I would urge upon this Committee the need for simplification which cannot be done in a hurry. The Committee should take all of the time it needs in drafting this Bill to insure that clarity is aided rather than obstructed.

ANALYSIS OF BILL INCLUDING THE RECOMMENDED CHANGES THAT ARE NEEDED IF PRIVATE UNIVERSITIES ARE TO BE ENCOURAGED AND IN FACT SURVIVE

1. Limitation on Tax Preferences and Allocation of Deductions as they Adversely Affect Charitable Contributions

The House Bill introduced a new concept of "tax preferences" in an attempt to insure that an individual cannot avoid paying tax on at least one-half of his income. (Section 301 of the Bill.) It also introduced a new concept of allocation of deductions in an effort to prevent certain personal and itemized deductions from being utilized solely to reduce taxable income without charging part of these deductions against tax free income. (Section 302 of the Bill.)

Tax Preferences

Certain items of tax preference are income that escape taxation, such as interest on tax exempt governmental obligations and the excluded portion (one-half) of long-term capital gains. Other items of tax preference are not income, but are deductions which reduce taxable income and shelter income from tax. These include accelerated depreciation in excess of straight line depreciation and farm losses. Items of tax preference also include the appreciation in value portion of a charitable contribution of appreciated property. This item is neither fish nor fowl since by giving, a taxpayer should not realize income and it is anomolous to treat a charitable contribution like a shelter, such as excess depreciation, because the donor parts with the property given. Nothing is sheltered by a contribution whereas depreciation shelters the cash flow from a property which the owner gets and keeps. Similarly, one-half of excluded capital gain and tax exempt interest is received and kept by the taxpayer. Not so with the appreciated property given to charity.

The concept of the Bill is to treat disallowed tax preferences as taxable income. The amount of disallowed tax preferences is the amount by which tax preference items exceed the allowable limit and this limit is the greater of one-half of the sum of items of tax preference plus adjusted gross income, or $10,000. To illustrate: If a man has adjusted gross income of $250,000 plus $250,000 in items of tax preference (other than the appreciated portion of a gift of appreciated property to a qualified charity) one-half of these two items is still $250,000 and accordingly the tax preference does not exceed the limit thereon and there is no disallowed tax preference and no increase in taxable income. However, if this same person were to have made a charitable contribution of appreciated property worth $75,000 but with a zero basis, one-half of all items of tax preference including the appreciated portion of the contributed gift plus adjusted gross income would exceed the limit on tax preference by $37,500, and accordingly his taxable income would be increased in that amount.

In short, if an individual's items of tax preference are greater than adjusted gross income, plus $10,000, one-half of the difference is the amount of his increased taxable income.

Allocation of Deductions

Turning now to the allocation of deductions concept, certain expenses are classified as "allocable expenses." These include personal and itemized deductions such as interest, taxes, certain losses, charitable contributions, net operating losses, medical and dental expenses. The Bill is so complex that I cannot hope, in the time allotted, to explain the new terms, definitions and formulas used to allocate expenses. I can state briefly that in essence all of the allocable expenses must be apportioned against taxable income and preference items so that only the portion of such expenses which are allocable to taxable income can be deducted to reduce taxable income. For example, if an individual's preference

items (plus certain intangible drilling costs and development costs) are equal to his taxable income, he can only use approximately one-half of his allocable expense deductions to reduce his taxable income. This also is anomolous because interest and property taxes can be substantial and principal items of expense which are incurred solely in connection with the earning of income—for example, the mortgage interest and property taxes on a shopping center or apartment house. And yet, to the extent of tax preference items, this deduction can be disallowed. Most significantly, however, a charitable contribution is the only item of allocable expense that can also be a tax preference item. A charitable contribution is an allocable expense even if it is a cash gift and not a gift of appreciated property and it is reduced as a deduction proportionately to items of tax preference including the appreciation portion of the charitable contribution itself.

Multiple Effect of Preference Limitations and Allocation of Deductions

The following generalizations can be made. The larger the charitable gift the less as a percentage can be taken as a charitable contribution deduction, and the more types and amount of tax preference items the taxpayer has, (including the appreciation in value portion of a gift of appreciated property), the more costly is the charitable gift whether it is in the form of appreciated property or in cash. Not only does the donor lose a portion of his contribution deduction, he also loses a portion of his other deductions such as interest and taxes. If his contribution is a gift of appreciated property and it is so substantial that it alone or in combination with other preference items exceeds his taxable income by more than $10,000, his income is further increased. I have prepared an appendix to this statement that illustrates these points.

The multiple effect of losing not one but many deductions plus increasing the donor's taxable income will make the tax or many substantial gifts of appreciated property as great or greater than the value of the gift itself. Not only will the donor part with the value of the donated property and receive nothing but psychic satisfaction therefor, he will not have a tax benefit or incentive to make the gift and he will pay increased taxes that can be almost as great or as great as the gift itself. In these circumstances, substantial contributions simply will not be made either in the form of appreciated property or otherwise. We strenuously urge the elimination of the appreciation portion of a gift to charity as an item of tax preference under Section 301 of the Bill, and the elimination of a charitable contribution deduction as an item of allocable expense under Section 302. We note with approval that the administration has made the same recommendations.[31]

2. Increase in Limit of Charitable Contribution Deduction

Section 201(a) of the House Bill amends Section 170(b)(1) of the Code to increase the maximum charitable contribution deduction allowable to an individual, for a gift to universities and certain other charities, from 30 per cent of adjusted gross income to 50 per cent of the taxpayer's contribution base. This increase was highly commendable and appeared, at first blush, to be a further liberalization of the long-standing Congressional intent to favor giving to private education. The appearance is illusory, however, because subparagraph (J) of Section 170(b)(1) added by Section 201(a) of the House Bill places a top limitation of 30 per cent of the taxpayer's contribution base on gifts of appreciated property. Inasmuch as the 20 percent increase in the limitation will only apply to gifts of cash or property which has not appreciated in value, the increase will not prove very meaningful to higher education because most donors will not contribute amounts that substantial in any form but appreciated property. I can illustrate this by an analysis of giving to my own University. Over the three-year, nine-month period from the beginning of 1966 through August 1969, we determined that the largest single gift of cash was $10,000. During the same period we received 85 gifts of property, the values of which all exceeded $100,000 each. In fact, during such period we received gifts of stocks, securities and real property worth approximately $18,900,000.

[31] See the statement of the Honorable David M. Kennedy, Secretary of the Treasury, and the statement of the Honorable Edwin S. Cohen, Assistant Secretary of the Treasury for Tax Policy on September 4, 1969, before this Committee.

For the same period the total cash gifts were only approximately $3,495,000. As a percentage, cash gifts were 15 per cent of the total, stocks and securities were 9.4 percent of the total and real property was 73.7 per cent of the total. Art objects, valuable books, etc. were 1.2 per cent of the total and miscellaneous was only .7 per cent.

My University is not unique. Many large Eastern private educational institutions receive the bulk of their gifts in the form of appreciated stocks and securities. The principal difference between their situation and that of my own University would be the fact that real property is the more common gift in the West. The foregoing figures from my own University clearly substantiate the fact that the proposed Bill in its present form will not encourage increased giving of this type. We recommend that the entire proposed subparagraph (J) of Section 170(b)(1) be stricken from the Bill, thus allowing the full 50 per cent deduction regardless of the type of property given.

Although we disagree with the recommendation of Treasury [55] to the effect that the 30 per cent limitation should remain on gifts of appreciated property, we do note with mixed approval Treasury's suggestion that the 30 per cent limitation apply only to the appreciation element in a charitable gift of property so that the basis of the property could be counted against the additional 20 per cent allowance.[56]

If this recommendation of Treasury is adopted, it would be more helpful to private higher education than the present law, but we again urge a full 50 per cent limitation on all gifts to higher education. The donor of any type of property, including cash, receives no economic benefit by reason of the gift other than the tax savings resulting from the charitable contribution deduction. The amount of savings varies from taxpayor to taxpayer without regard to what has been given or the multitude of circumstances surrounding the donor's acquisition of the property given or his cost base therein. The tax treatment should be the same whether he found the property, received it by inheritance or gift, or accumulated it by wise investment over the years and regardless of his cost base. In all such cases, he has parted with something that had a value to him on the date of the gift equal to the property's fair market value.

3. Gifts of Appreciated Property—Future Interests, Tangible Property, Ordinary Income Property, Elections

We are vigorously opposed to the provisions of Section 201(c) of the Bill (amending Section 170(e)) as they affect future interest gifts of appreciated property to colleges and universities. The donor is forced into making the Hobson's choice of either reducing his deduction to the amount of his tax basis or taking a charitable deduction for the fair market value of the property, but at the same time including the appreciation in value of the property in his taxable income. Additionally, in the case of a future interest gift, the law would reduce the charitable contribution deduction still further in the amount of the value of the right to receive income for life. This will simply eliminate this form of giving.

Apparently the rationale behind amended subsection (e) is the same rationale behind the limitation on gifts of appreciated property. It proceeds upon the erroneous assumption that the donor-taxpayer who gives appreciated property realizes a benefit that is greater than a person who gives cash or unappreciated property. The fallacy lies in treating the gift as if the donor had sold the property. This is simply not the case. It is not unfair for a person giving appreciated property to avoid the payment of income taxes on the appreciation portion of the gift for the simple reason that his total wealth is reduced by the value of the gift. To say that such a giver is favored over a person who gives cash is to engage in specious reasoning because both have reduced their wealth by the exact value of the gift. The reason why Congress has historically favored charitable contributions is because it has recognized that the same amount of good that is done with these contributions would cost more if it were done by the government itself with tax dollars. The public receives more value than if the same amounts were collected from taxes and disbursed to charities. Accordingly, gifts of appreciated property should not be penalized.

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[55] Edwin S. Cohen statement, *op. cit.* p. 35.
[56] Edwin S. Cohen statement, *op. cit.* pp. 35–36.

To penalize the giver of appreciated property on the theory that his gift is analogous to the sale of such property is illogical because the theory fails to consider the fact that a donor is never forced to give his property away or to sell it. If the donor will be treated as if he had made a sale, he will probably merely continue to hold the appreciated property. There is absolutely no tax avoidance by such postponement of the recognition of gain. Unless the donor can receive a tax deduction equal to the full value of the property, admittedly a tax deduction equal to the full value of the property, admittedly a tax advantage, he will not only not make the gift *he will probably not sell the property* but will continue to hold it.

Tangible Personal Property—Art Objects

Section 201 (c) of the Bill not only forces the undesirable Hobson's choice upon a donor who gives appreciated real or intangible "capital gain" property in the future interest form, it requires the same bad choice for a present gift of tangible personal property which has appreciated in value. This would effectively eliminate gifts of valuable books to universities and college libraries and it would eliminate gifts of valuable art objects to museums supported by such institutions. Culture should not be stifled when the solution to the supposed problem already exists. The only abuse to be corrected is one of valuation. The proposed cure goes way beyond the ill. We are advised that no taxpayers have successfully rebutted the determinations made by the Internal Revenue Service's elite panel of art object appraisers. Accordingly, we think the provisions of Section 201 (c) go too far in discouraging gifts of this valuable property. We recommend that the election not be required for gifts of this kind of property to universities and museums, and we observe with approval that Treasury makes the same recommendation. Assistant Secretary Cohen stated:

"The problems of valuation of tangible personal property have been substantially resolved by changes in the income tax form, by improved audit programs, and by the creation of a special advisory group to the Commissioner of Internal Revenue on valuation of art objects." [34]

Importance of Future Interest Gifts of Real and Intangible Property (Stocks and Securities)

We take serious issue, however, with the fact that the administration found the other limitations of Section 201 (c) of the Bill "appropriate even though they go beyond our recommendations on April 22, 1969." [35] To illustrate the importance of gifts of future interests in real and intangible property to my own University contrasted with gifts of valuable art objects, I would again like to refer to the record of giving to my school for the three-year, nine-month period from the beginning of 1966 through August 1969. Over 80 per cent of all gifts to the University—about $19,000,000 in value—were gifts of appreciated real and intangible properties in future interest form whereby the donor reserved a lifetime income interest in the donated property and whereby, at his death, my University will receive the entire property. Art objects, on the other hand, constituted about 1 per cent in value of the gifts given.

The administration would recommend favorable treatment for gifts of art objects but not for future interest gifts of real and intangible property which is "capital gain" type property. The figures speak for themselves as to the importance of future interest giving of "capital gain" property at my own University.. We are not unique. Hundreds of institutions around the country receive the bulk of their donations in similar form.

Ordinary Income Property

The only abuse in the entire area covered by Section 201(c) is with regard to gifts of so-called "ordinary income" property—which, if sold, would have resulted in ordinary income as opposed to the realization of capital gain. The solution is simple. Disallow a portion of the deduction to the extent the donor makes a profit from the gift, e.g., if his tax savings exceed the value of the gift. Other provisions of the Bill either cure or overcure any abuses that may be inherent in the making of future interest gifts. We submit that the 80 percent and 50

[34] Edwin S. Cohen statement, *op. cit.*, p. 37.
[35] Edwin S. Cohen statement, *op. cit.*, p. 36.

percent limitations will prevent most donors from making a profit from a gift of appreciated property whether it is a present gift or a future interest gift. If appreciated capital gain property can be given to private colleges and universities without the burden of making the unfavorable election, colleges and universities may receive even more donations. They need the help.

Penalty of Giving Mixed Property

There is an additional trap for the unwary in Section 201 (c) of the Bill amending Section 170 (e) of the Code. An election is required for the gift of property, *any* portion of the gain on which . . ." would be taxed as ordinary income. This provision would apply to present interest gifts as well as future interest gifts.

Many properties are mixed and frequently part is "capital gain" property and part is "ordinary income" property. On the transfer or sale of corporate stock or bonds in certain situations, there is partial ordinary income treatment because of accrued but unpaid dividends or interests. Property "used in trade or business" receives capital gain treatment on its sale but such property is frequently subject, on disposition, to depreciation or investment credit recapture and ordinary income treatment. Whether or not there is depreciation and investment credit recapture can only be determined, in many instances, long after the event of sale. The "any portion" language would cause the tail to wag the dog and result in disastrous tax consequences to unwitting and unknowing donors. Gifts of ordinary income property have been abused. The solution is simple. Deny a portion of the deduction to the extent that the tax savings exceed the value of the gift. No election should be required if it will prevent any gift from being made. We strongly urge repeal of Section 201 (c) of the Bill.

4. "Set-Aside" Trusts

The provisions of Section 201 (f) of the Bill, amending Section 642 (c), would disallow an income tax deduction to nonexempt trusts or estates which set aside all or a portion of their income for charity. This will apply not only to trusts created in the future but also to thousands of presently existing irrevocable trusts. We think this is most unfair. These provisions will also apply unfairly to estates of persons who have died since April 22, 1969, and who will die before enactment of the Bill. We suggest that such provisions should not apply to trusts or estates that were created or came into existence prior to the final enactment of the Bill. This is an absolute minimum requirement of fairness but, beyond this, we think a further amendment should be made to allow trusts and estates to take a deduction for capital gains realized as a result of the sale of trust or estate assets which have been set aside for charity. We do not object to requiring current ditributions of ordinary income within one or two years, as provided in the Bill, but to require distribution of capital gains to avoid payment of taxes by the trust may simply result in donors not making "set-aside" gifts of property.

If the trust or estate has to pay a tax on the capital gains realized on sale of assets (and prudent trustees or executors must make sales from time to time), the taxes paid will reduce the amount ultimately going to charity. This is true for most, if not all, presently existing trusts and estates which, because the governing instruments are irrevocable, will not allow current distribution of capital gains to the charity. At the Brigham Young University we have several substantial irrevocable life income retention trusts which hold blocks of land as their principal assets. Some stocks are similarly held. The value in these trusts is over $10,000,000. The trusts were established in reliance upon the existing law, and the donors were advised by their own tax counsel that when the property was sold the capital gains would not be subject to taxes because the University is considered to be the owner of the property. To apply the law to these pre-existing trusts would be unjust.

5. Present gifts of fractional interests in property—troublesome "entire interest" phrase

The House Bill reveals an interesting pattern. The same subject is treated in similar but slightly differing ways in different portions of the Bill so that even if one or two provisions are amended the problem, from our viewpoint, is not solved. Thus, for instance, the appreciated portion of a gift is treated as a tax

preference, and all charitable contributions are subject to allocation of deductions. The Bill further penalizes the gifts of appreciated property, as already noted, by forcing a disfavored election if appreciated property is given in future interest form. The Bill in three different places, by the use of the phrase "entire interest," further discourages the creation of future interests in a way that is most deceptive and in a way that will also discourage present interest gifts of fractional interests in property if knowledgeable donors are aware of the hidden traps. The apparent Congressional intent in using the "entire interest" phrase was to discourage a donor from creating a split interest as between owner and user, as between the income and principal beneficiary, as between the life tenant and the remainder man, with the added requirement that there be no reversionary interest in the donor.

We first refer to the use of the troublesome phrase "entire interest" which appears in Section 201 (b) (1) of the Bill adding subparagraph (H) to Section 170 (b) (1) of the Code. The apparent subject matter is the denial of a deduction for the gift of an interest in income from property which is transferred to a trust unless certain conditions are met, or unless a deduction would be allowed under that section for a gift of the donor's "*entire interest*" in such property. This phrase is susceptible of an interpretation that would deny a deduction for a gift of a fractional interest in property that is a present gift and not a future interest gift.

The "*entire interest*" phrase appears in Section 201(a)(3) of the Bill, which adds paragraph 8 to Section 170(b). This section seems to deny a deduction for the mere use of property by a charity, but again could result in the denial of a deduction for a present gift of a fractional interest.

Section 201(c)(4) of the Bill requires an allocation of a taxpayer's adjusted basis whenever the donor contributes less than his *entire interest* in property. The same subject, incidentally, is also treated in the same way for "Bargain Sales" which will be discussed later. For the reasons stated in our discussion of bargain sales we strongly recommend repeal of Section 201(c)(4).

If a donor makes a present gift of an undivided one-half interest in a parcel of real property, there is no life tenant or remainderman, there is no reversionary interest in the one-half given, and there is no division between income and principal beneficiary since the recipient is fully entitled, on a current basis, to one-half of the income. We think it should be made perfectly clear in subsection 8 of Section 170(b) that fractional interests in properties, divided or undivided, may be given as a present interest without disfavored treatment and that the phrase "entire interest" does not apply to fractional present interests. We have urged amendments that will allow the creation of future interest gifts without disfavored treatment to the donor or the charity. Subparagraph (H) of Section 170(b)(1) should be deleted in its entirety as it disfavors future and present gifts.

6. "Split Interest" Trusts—Income Tax Deductions

The provisions of Section 201(e) of the Bill adding subsection (h) to Section 170 coupled with the provisions of new Section 664(d) will prove very harmful to institutions of higher education. Subsection (h) denies a deduction for a contribution of a property remainder interest in trust unless the trust is a charitable remainder annuity trust or a charitable remainder unitrust. The annuity trust and unitrust concepts require an annual payment to the grantor of either (a) a sum certain, and (b) a fixed percentage of the net fair market value of trust assets based on annual redeterminations of the market value.

The problem which these provisions of the Bill attempt to solve is the possibility that the charity may ultimately receive a remainder interest of a value far less than the value used by the donor to determine the amount of his deduction. The supposed danger was felt to be that the investment policy of the trustee would favor the donor to the detriment of the charity. The proposed solution may actually end up hurting the charity even more. Thus, for instance, if a university were to guarantee a return of 9 per cent to the donor, based on today's high interest rates, a subsequent decline in interest rates and yield to the trust will reduce the amount ultimately going to the charity. In fact, the guaranteed pay-out could eliminate the corpus. Most of the Bill makes the donor chary. These provisions should make the donee wary.

Annual value determinations can be very costly to perform and would, accordingly, reduce the amount ultimately going to the university. This requirement will be a breeding ground of litigation. Even under the present law many estates litigate for years over date and death values. Imagine the perennial litigation that this determination of annual value will cause. Also, as the property appreciates in value, the fixed percentage pay-out would force sales of the trust property in order to meet the pay-out. Under the scheme of the Bill (see discussion of "Set-Aside Trusts") the trust would be required to pay taxes, thereby further reducing the amount to ultimately go to the university.

The problem can be more easily solved by simply requiring gifts of remainder interests in trusts to be made either to independent trustees or to the university itself as trustee or co-trustee. This solution would allow a flexible investment policy to take advantage of varying investment climates and yields over the life of the trust. In the case of the independent trustee, its fiduciary duty would require it to consider the interest of both donor and donee. In the case of the charity acting as a trustee or co-trustee, its own self-interest would assure an investment policy that would not favor the donor. We do suggest, however, that such special treatment only be afforded to those charities which have been historically favored over other charities, namely, churches, colleges, hospitals, etc.

In any event, we submit that the proposed effective date of these provisions is most unfair because many charities have received considerable amounts of remainder gifts in trust since April 22, 1969, in irrevocable form, so that it is now too late to make any alterations or corrections to the governing instruments. Those who created these trusts acted in good faith and should not be penalized. Neither should the charities.

To illustrate the unfairness of the April 22, 1969 date, my own University has received gifts of remainder interests in trust form since April 22, 1969, totaling $3,264,434 in value. It is too late to amend the irrevocable trust instruments to allow the donor to take a deduction.

7. Split Interests—Estate and Gift Tax Deductions

Section 201(h) of the Bill amends subsection (e) of Section 2055 and subsection (c) of Section 2522 in a manner parallel to the amendments discussed under paragraph 6 above so that gift tax and estate tax deductions are disallowed unless the gift or bequest is made to a charitable remainder annuity trust or a charitable remainder unitrust. We recommend the same changes as above so that the deduction would be allowed for gifts of remainder interests to churches, colleges and hospitals, if the gifts are made to an independent trustee or to the charity itself as trustee or co-trustee.

We also note inferentially that the administration is critical of the April 22, 1969 effective date, and it has recommended that the new rules should only apply to persons dying after December 21, 1970, to provide time for the amendment of wills and so that the new rules will not apply to trusts created heretofore that cannot be amended.[36]

8. Pooled Split Interest Trusts

The proposed charitable remainder annuity trust and the charitable remainder unitrust requirements coupled with the present "set-aside" provisions will effectively eliminate the pooling of trust funds. Hundreds of universities now have existing pooled reserved lifetime income charitable remainder trusts as receptacles for charitable contributions. The suggested changes made in paragraphs 4, 6 and 7 above must be made in order for these pooled fund trusts to continue as effective receptacles to receive charitable contributions.

9. Reserved Legal Life Estate to Donor

Section 201(a)(2) adds a new subsection 8 to Section 170(b). This subsection 8 appears to treat only the subject of disallowance of a deduction for mere use of property. The first sentence, however, is susceptible of an interpretation that no deductions would be allowed for the gift of a remainder interest following the creation of a legal life estate unless the grantor is assured of payments in the same manner as if the conveyance were made to a charitable remainder

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[36] Edwin S. Cohen statement, *op. cit.*, p. 39.

annuity trust or a charitable remainder unitrust. If this is a correct interpretation, it will probably mean an end to the creation of legal life estates with gifts of the remainder interest to charity. Accordingly, we think the subsection 8 should be amended to clarify the fact that it only applies to the mere use of property by the donee.

10. Bargain Sales

"Bargain sales" to universities would no longer be advantageous from a tax standpoint by reason of new proposed subsection (b) of Section 1011 of the Code, which is added by Section 201(d) of the Bill. This subsection would require the donor-seller to allocate his cost basis in the property "sold" between what he receives on the sale and what the university receives from the gift.

This is another example of how the Bill goes further than is necessary to avoid abuses. Regardless of the income tax bracket of the donor-seller, in every case of a "bargain sale," when he combines what he gets from the sale with the tax savings resulting from the gift, he receives less than he gives *unless* the appreciation (which he is really giving away) would have resulted in ordinary income had he sold the property for the full market value. Abuse can be prevented by leaving the present law unchanged except to disallow a portion of the charitable contribution deduction to the extent that the donor made a "profit" by giving "ordinary income" property.

We cannot express too strongly our feeling that the sole test in the area of private support to education should be "has the donor given more than he receives?" In other words, on a "bargain sale," does the amount he received from the sale to the university plus the tax savings resulting from the charitable contribution deduction equal more or less than the market value of the property involved? Even if he receives back 99 per cent, the practice should be encouraged because the benefit which flows to the university is direct and immediate without the necessity of funds first flowing to the government and then back to the university.

11. Gifts of Income Interests

We disapprove of the provisions of Section 201(g) of the Bill repealing Section 673(b), and we also disapprove of the provisions of Section 201(a) amending Section 170(b)(1), subparagraph (H). The first provision eliminates entirely a deduction for a gift in trust of an income interest for two or more years where the grantor retains a reversionary interest. The second provision denies a deduction for transfer to a trust of an income interest in property for a term certain, when the remainder goes to noncharitable remaindermen and when the donor does not have a 5 per cent or more reversionary interest to take effect within 10 years. In order to be entitled to a contribution deduction the donor must be taxable on the income. These two provisions of the Bill will effectively eliminate gifts of income interests. This will cause some economic loss to institutions of higher education.

We note with favor that the administration believes the Bill is unduly stringent in permitting a deduction for the value of a charitable income interest only where the income is taxable to the grantor under other rules.[37] We are of the opinion that, while the income gift in short term trust form has been abused, there should be no reason why the long term income gift should not be encouraged as suggested by the administration.[38] On the other hand the short term or any other abuse can be solved by merely denying a portion of the deductions to the extent that the donors "make a profit" from the gift, e.g. when the tax savings exceed the value of the gift. We also make the same suggestion noted earlier that the trustee should be an independent trustee or the charity itself should be a trustee or co-trustee.

12. Information Returns—Publicity

We vigorously oppose the requirement of filing information returns. Sections 101 (d) and (e) of the Bill require colleges and universities to file detailed information returns and provide for publicity of the information contained therein.

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[37] Edwin S. Cohen statement, *op. cit.*, p. 36.
[38] Edwin S. Cohen statement, *op. cit.*, pp. 36–37.

Not only will this be extremely burdensome and costly to the universities, with no offsetting revenue to the government, because they are tax exempt, many substantial contributors prefer to remain anonymous. The donors, of course, must file their own returns and so there are no aspects of evasion involved. My own University and hundreds of other independent colleges and universities in this country are principally supported by funds made available by exempt churches. This same requirement, as it applies to these churches, will prove even more burdensome and costly and we submit will serve no good purpose.

To grasp the magnitude of the burdens that would be imposed on private colleges and universities and the churches which support many of these institutions consider the tithe program alone of many churches, my own included, whereby the members pay a portion of their annual income to their church to support it. Many tithes are paid in kind in the form of property. Section 101(d) of the Bill would require the return to show specifically the items of gross income, receipts and disbursements of exempt organizations as well as such other information as the Secretary may require. Records must also be kept in such form as required by the Secretary. We think it is all too obvious that the Secretary would require detailed records of value of properties, expenses, sale proceeds, etc. in connection with all properties given to or owned by the exempt organizations. With regard to the tithe program of churches alone millions of items would have to be reported.

At my own University 16,132 donors made contributions last year ranging from a few dollars to large valuable properties. We conduct numerous research projects for private industry as well as government. Revenues are received from tuition (25,000 students), cafeterias (we serve between 19,000 and 21,000 meals per day), dormitories (we house 6,480 students on campus), bookstores, theaters, bowling alleys, athletic and cultural events where admissions are charged, to name only a few of the sources of receipts. The list of expenditures would be just as great. Reporting of all these items would be a staggering load that would probably require the hiring of several accountants at our University for the sole purpose of merely filling out the forms and reports and the keeping of records required. Since no taxes are due from exempt organizations, the added cost and expense of record keeping and reporting to universities, as well as the government, is not justified.

13. Taxation of Passive Income from Controlled Corporations

Section 121(b) of the Bill, amending Section 512(b) of the Code by adding paragraph 15 thereto, would tax for the first time passive income received from corporations controlled by exempt organizations. The apparent problem was felt to be that the profits of unrelated trades and businesses conducted by such corporations were being siphoned off in the form of unreasonable rents, interest, etc. so that the corporation conducting the unrelated trade or business would pay no tax. On this point, and speaking solely for my own university, I want to make it absolutely clear that we do not oppose the taxation of the unrelated business income of charitable organizations which compete with private enterprise in the active conduct of a trade or business. We think charities should pay the same tax on business income as their noncharitable business competitors. My own church has followed this policy on a voluntary basis for a long time. Returns are required under existing law for the conduct of such business by charities and we do not disagree with this requirement. There is no good reason, however, for the taxation of passive income such as interest, annuities, royalties and rent received from corporations controlled by universities if the amounts of rent, interest, etc. paid are reasonable. The tax law is fraught with questions of reasonable value and reasonable rentals. The problem exists in every case when an individual rents property to or from his controlled corporation. This is a question of fact that the Internal Revenue Service and the courts have coped with very effectively. The solution should be based on fact determination and not absolute blind confiscatory fiat as is done under Section 121(b) of the Bill.

Other private institutions have of course the right to disagree with us as to the taxation of unrelated income and they may speak for themselves.

Appendix

Statements of Business Leaders Concerning Commitments of Business to Private Education and Education in General

1. Henry T. Heald, announcing the major program initiated by the Ford Foundation in 1960 with a grant of $46 million to five specially selected universities: "It is essential to the welfare of the Nation that each part of its traditional dual system of higher education—the privately and publicy supported colleges and universities—remains strong and reaches higher level of performance."

Selma J. Mushkin, ed., *Economics of Higher Education*, U.S. Dept. of Health, Education and Welfare, 1962, p. 259.

2. A General Motors spokesman: "The public institutions can meet these costs through higher taxes. The private institution, on the other hand, faces a more difficult problem and has turned to the corporation as one source of additional support. We believe it is sound to provide such assistance and in this way aid in preserving the historic balance between enrollment and in private colleges and universities and that in tax-supported institutions."

National Industrial Conference Board. *The Way and How of Corporate Giving.* New York: The Board, 1956, Ibid., p.108.

3. Frank Stanton of CBS, announcing the corporation's original higher education-support program, which limits aid to private schools: "These institutions have a special problem which separates them from the tax-supported State and other public institutions. . . . But because of the different basis of support on which our privately endorsed institutions depend, we are concentrating our contribution in this area. . . ."

The Why and How of Corporate Giving, Ibid., p. 98.

4. "If funds are given to states, there may be a tendency to favor the allocation of funds principally to state institutions and to give less consideration to the requests of private colleges. Moreover, there are constitutional restrictions on the states in reallocating funds to private institutions. In order for private college to obtain federal aid via state agencies, the college might also be asked to conform to certain inappropriate state requirements. . . . If, however, the use of state agencies as intermediaries would result in a relative concentration of federal funds in state colleges, the effect would be to weaken the relative competitive position of private colleges in obtaining resources. For example, more faculty personnel would presumably be drawn toward state schools. . . . It is impossible to assess accurately the relationships between cost and output or to assess the changes in overall efficiency which would result from a shift of resources from private to state colleges. The products of both types of schools can probably be differentiated, but both types of products undoubtedly provide economic returns to the Nation. In the absence of objective evidence concerning these returns, it may be unwise to risk discrimination in favor of one educational product to the disadvantage of another."

Mushkin, *op. cit.*, p. 211.

5. "Because of its expanded needs, the nation can make full use of the facilities afforded by virtually all private institutions. Economically, it makes no sense to establish new institutions while staff and space in existing colleges and universities go underutilized. More important, in the minds of many, is the desirability of maintaining a pluralistic system of higher education and avoiding a monolithic scheme of support and control. A strong independent sector, it is argued, not only has its intrinsic values in a democratic society, but also is a useful competitive element and counterbalance to the public sector. Forcing private institutions to become just like their public counterparts eligible for tax support would indeed diminish their values for preserving a dualistic system."

Logan Wilson, "Higher Education and the National Protest," presented to AEC meeting, Denver, Colorado, 1968.

6. "It is said that the private universities set standards for all to aspire to. In some disciplines they do: in medicine (e.g., at Western Reserve, Johns Hopkins, Harvard, N.Y.U., Duke), in law (e.g., at Harvard, Yale, Columbia, and Stanford), in engineering (e.g., at Caltech and M. I. T.) For this reason, not surprisingly, presidents of state universities themselves are very solicitous of the private colleges, whose higher standards give the presidents something to shoot at, and an extra leverage on state-house appropriation committees. Their solicitude may decline as the public institutions exploit the situation to increase their own excellence—unless the private institutions find the means to keep movng ahead."

Duncan Norton-Taylor, "Private Colleges: A Question of Survival," *Fortune*, October, 1967, p. 154.

DEMONSTRATION OF COMBINED EFFECT OF LIMITATION ON TAX PREFERENCE WITH ALLOCATION OF DEDUCTIONS TO SHOW HOW A DONOR OF APPRECIATED PROPERTY IS PENALIZED COMPARED TO AN INDIVIDUAL WHO MAKES NO DONATION

[Calculations of minimum tax]

1. Adjusted gross income[1]	$250,000	$250,000	$250,000	$250,000	$250,000	$250,000
2. Items of tax preference, other than sec. 84(c)(1)(A)[1]	0	0	250,000	250,000	250,000	250,000
3. Items of tax preference under sec. 84(c)(1)(A) (appreciation in charitable contribution)[1]	0	75,000	0	75,000	0	75,000
4. Sum of items of tax preference (line 2 plus line 3)	0	75,000	250,000	325,000	250,000	325,000
5. Line 1 plus line 4	250,000	325,000	500,000	575,000	500,000	575,000
6. 50 percent of line 5 (limit on tax preferences under sec. 84(d)(1))	0	162,500	250,000	287,500	250,000	287,500
7. Disallowed tax preferences: line 4 minus line 6 (sec. 84(b))	0	0	0	37,500	0	37,500
8. Allocable expenses, other than sec. 277(c)(1)(A)(iv)[1]	30,000	30,000	30,000	30,000	30,000	30,000
9. Allocable expenses under sec. 277(c)(1)(A)(iv)[1]	0	75,000	0	75,000	0	75,000
10. Allocable expenses (line 8 plus line 9)	30,000	105,000	30,000	105,000	30,000	105,000
ALLOWABLE TAX PREFERENCES						
11. Line 4 minus line 7	0	75,000	250,000	287,500	250,000	287,500
12. Minus fixed amount under sec. 277(c)(2)(A)	10,000	10,000	10,000	10,000	10,000	10,000
13. Minus exempt interest (included in line 4 on pre-July 12, 1969 obligations) (sec. 277(c)(2)(B))[1]	0	0	0	0	0	0
14. Plus adjustment for depletion and intangibles (sec. 277(c)(2)(C))[1]	0	0	0	0	100,000	100,000
15. Plus deduction under sec. 218 (LTP carryover) (sec. 277(c)(2)(D))[1]	0	0	-0	0	0	0
16. Algebraic sum of lines 11 through 15 (allowable tax preferences)	0	65,000	240,000	277,500	340,000	377,500
TAXABLE INCOME						
17. Adjusted gross income (line 1)	250,000	250,000	250,000	250,000	250,000	250,000
18. Plus disallowed tax preferences (line 7)	0	0	0	37,500	0	37,500
19. Allocable expenses (line 10)	30,000	105,000	30,000	105,000	30,000	105,000
20. Minus allocable expenses deducted in computing adjusted gross income[1]	0	0	0	0	0	0
21. Minus allocable expenses other than those deducted in computing adjusted gross income (line 19 minus line 20)	30,000	105,000	30,000	105,000	30,000	105,000
22. Minus deductions not included in AGI or allocable expenses[1]	3,000	3,000	3,000	3,000	3,000	3,000
23. Algebraic sum of lines 17, 18, 21, and 22 (taxable income without regard to sec. 277)	217,000	142,000	217,000	179,500	217,000	179,500
24. Modified adjusted gross income (line 23 plus line 10) (sec. 277(c)(3)(B))	217,000	247,000	247,000	284,500	247,000	284,500
25. Sec. 277 fraction: line 16/line 16 plus line 24	0	.208	.493	.494	.579	.570
26. Disallowed deduction: line 10 times line 25, or line 16, whichever is less (sec. 277(a))	0	$21,840	$14,790	$51,870	$17,370	$59,850
27. Taxable income: line 23 plus line 26	$217,000	163,840	231,790	231,370	234,370	239,350
28. Tax on line 27	122,880	86,191	133,226	132,939	135,039	138,523
29. Tax under present law	122,880	71,700	122,880	71,700	122,880	71,700
30. Increase in tax resulting from proposals	0	14,491	10,346	61,239	12,159	66,823

[1] Indicates assumed figures.

Note: Transitional rules not taken into account. Assumption: married, joint return, present rates without surtax, basis of contributed property equals 0.

DEMONSTRATION OF COMBINED EFFECT OF LIMITATION ON TAX PREFERENCE WITH ALLOCATION OF DEDUCTIONS, TO SHOW HOW A DONOR OF APPRECIATED PROPERTY IS PENALIZED COMPARED TO AN INDIVIDUAL WHO MAKES NO DONATION

[Calculations of minimum tax]

1. Adjusted gross income [1]	$50,000	$50,000	$50,000	$50,000	$50,000	$50,000
2. Items of tax preference, other than sec. 84(c)(1)(A) [1]	0	0	50,000	50,000	50,000	50,000
3. Items of tax preference under sec. 84(c)(1)(A) (appreciation in charitable contribution) [1]	0	15,000	0	15,000	0	15,000
4. Sum of items of tax preference (line 2 plus line 3)	0	15,000	50,000	6,5000	50,000	65,000
5. Line 1 plus line 4	50,000	65,000	100,000	115,000	100,000	115,000
6. 50 percent of line 5 (limit on tax preferences under sec. 84(d)(1))	0	32,500	50,000	57,000	50,000	57,500
7. Disallowed tax preferences: line 4 minus line 6 (sec. 84(b))	0	0	0	7,500	0	7,500
8. Allocable expenses, other than sec. 277(c)(1)(A)(iv) [1]	10,000	10,000	10,000	10,000	10,000	10,000
9. Allocable expenses under sec. 277(c)(1)(A)(iv) [1]	0	15,000	0	15,000	0	15,000
10. Allocable expenses (line 8 plus line 9)	10,000	25,000	10,000	25,000	10,000	25,000
ALLOWABLE TAX PREFERENCES						
11. Line 4 minus line 7	0	15,000	50,000	57,500	50,000	57,500
12. Minus fixed amount under section 277(c)(2)(A)($10,000)	10,000	10,000	10,000	10,000	10,000	10,000
13. Minus exempt interest (included in line 4 on pre-July 12, 1969 obligation) (sec. 277(c)(2)(B)) [1]	0	0	0	0	0	0
14. Plus adjustment for depletion and intangibles (sec. 277(c)(2)(C)) [1]	0	0	0	0	50,000	50,000
15. Plus deduction under section 218 (LTP carryover) (sec. 277(c)(2)(D)) [1]	0	0	0	0	0	0
16. Algebraic sum of lines 11 through 15 (allowable tax preferences)	0	5,000	40,000	47,500	90,000	97,500
TAXABLE INCOME						
17. Adjusted gross income (line 1)	50,000	50,000	50,000	50,000	50,000	50,000
18. Plus disallowed tax preferences (line 7)	0	0	0	7,500	0	7,500
19. Allocable expenses (line 10)	10,000	25,000	10,000	25,000	10,000	25,000
20. Minus allocable expenses deducted in computing adjusted gross income [1]	0	0	0	0	0	0
21. Minus allocable expenses other than those deducted in computing adjusted gross income (line 19 minus line 20)	10,000	25,000	10,000	25,000	10,000	25,000
22. Minus deductions not included in AGI or allocable expenses [1]	3,000	3,000	3,000	3,000	3,000	3,000
23. Algebraic sum of lines 17, 18, 21, and 22 (taxable income without regard to sec. 277)	37,000	22,000	37,000	29,500	37,000	29,500
24. Modified adjusted gross income (line 23 plus line 10) (sec. 277 (c)(3)(B))	47,000	47,000	47,000	54,500	47,000	54,500
25. Sec. 277 fraction: line 16/line 16 plus line 24	0	.096	.46	.465	.657	.641
26. Disallowed deduction: line 10 times line 24 or line 16, whichever is less (sec. 277(a))	0	$2,400	$4,600	$11,625	$6,570	$16,025
27. Taxable income: line 23 plus line 26	$37,000	24,400	41,600	41,125	43,570	45,525
28. Tax on line 27	10,790	5,804	12,908	12,568	13,853	14,822
29. Tax under present law	10,790	5,020	10,790	5,020	5,020	5,020
30. Increase in tax resulting from proposals	0	784	2,118	7,648	8,333	9,802

[1] Indicates assumed figures.

Note: Transitional rules not taken into account. Assumption: married, joint return, present rates without surtax, basis of contributed property equals 0.

The CHAIRMAN. The next witness is Dr. Roland C. Matthies, cochairman, Committee on Gift Annuities.

STATEMENT OF DR. ROLAND C. MATTHIES, COCHAIRMAN, COMMITTEE ON GIFT ANNUITIES; ACCOMPANIED BY CONRAD TITEL, ATTORNEY; AND JAMES COUSINS, PRESIDENT, COMMITTEE ON CATHOLIC CHARITABLE GIVING

Dr. MATTHIES. Mr. Chairman, members of the distinguished committee, may I introduce my colleagues, Mr. Conrad Titel, attorney from new York City, and Mr. James Cousins, president of the Committee on Catholic Charitable Giving.

We appreciate this opportunity to speak with you on behalf of approximately 600 educational, religious, and publicly supported charitable institutions. It is our belief that we speak from a background of private philanthropy that has had long recognition.

I speak as the official representative of the Committee on Gift Annuities of New York City which is a constituted group of approximately 25 individuals working in conference on behalf of approximately 600 institutions engaged in what is known as deferred giving.

I am Roland C. Matthies, vice president of the Wittenberg University in Springfield, Ohio, speaking for that institution, which has had a large experience in deferred giving, and I speak on behalf of the committee on gift annuities. The Committee on Catholic Charitable Giving joins in this testimony.

There has been little public information given in the area of deferred giving. Much of the publicity that has occurred in the public media regarding the tax reform legislation of the House has pertained to areas other than what is known as deferred giving.

Briefly, a deferred gift is the acceptance by charitable or educational institutions of a gift with the understanding that it will pay back to the donor an income. Out at Wittenberg University we entered into our first agreement of this kind back in 1899. This provided the foundation financially for the first building of our theological school.

Since that time we have written in our small institution hundreds of agreements of this kind. So that at the present time out of our approximately $13 million of endowments at our small institutions, over $4 million is involved in this kind of contractual relationship.

In other words, almost one-third of our endowment is now tied up, as it were, in this type of agreement. We will be the beneficiary, of course, as death ensues or as the term of the agreement ends. We have, therefore, in hand, something that might not be nearly as realistic at the time of death.

The kind of giving about which I speak is roughly divided into three areas of contractual relationship. The first is known as the charitable remainder trust. The charitable remainder trust is simply a gift received by the charitable institution of educational education separately, invested by it, and the income from that separate investment being paid back to the donor.

State laws with regard to the operation of trusts would apply in such a situation.

Under present legislation and regulations, there is no capital gains imposed upon the reinvestment by the trust when it turns over the assets into something more liquid or something more desirable, and the donor is given the benefit of the full fair market value as his charitable contribution deduction.

I am grateful to the proper foundation laid by the previous speaker in explaining to you the many benefits that private universities and related institutions receive from what is known as deferred giving.

There is a second area of deferred giving known as the life income contract. The life income contract is simply the charitable trust put into a pooled arrangement where the institution receives a number of gifts, puts them in a pool of investments and pays back to the donor the average earnings of that pool.

Here, again, the tax implications under present law are the same in that the donor is permitted to give at a fair market value and the receiving institution is not penalized when transfer or reinvestments are made and a capital gain ensues.

Under the proposed legislation of the House of Representatives in H.R. 13270, two very unrealistic contracts are being predicated upon the idea that this will be a better substitute for the present charitable remainder trust. These are called a charitable remainder unit trust and a charitable remainder annuity trust, both of which I may state with some experience of 26 years will have the effect of thoroughly confusing present benefactors as well as potential benefactors as they attempt to determine what the regulations would prescribe.

This past Monday I received a check on behalf of the Wittenberg University from a 63-year old unmarried woman and in the amount of $2,000, accompanied by a brief note from her, "I would like your usual life income contract as I have received in the past."

This woman in previous years had made a $3,000 and a $2,000 gift under life income contracts. It was my unhappy responsibility to reply to her that H.R. 13270 enacted by the House of Representatives has now put this kind of giving in a questionable state and I would be ill-advised to recommend to you that you enter into a life contract with us or with anybody else at this time for the reason that the bill is making retroactive its application to April of 1969.

And it would be entirely possible if the Senate chooses to follow the House recommendations that a life income contract would be killed very effectively.

The third type of deferred gift is known as a charitable gift annuity and is probably the one that has been in existence the longest period of time. Under this plan the donor is paid a guaranteed rate of return based upon——

Senator Gore. Mr. Chairman, could I ask a question at this point?

Senator Anderson. Go ahead.

Senator Gore. Before you leave that point, just a brief question. Suppose—if the bill is finally passed on this particular point, if it went into effect on the date of enactment, then you could answer the lady differently; is that correct?

Dr. Matthies. I certainly could, but in the meantime we are filled with all sorts of reservations and cannot advise her because of the implications in the House bill.

Senator GORE. Thank you very much.

Dr. MATTHIES. The charitable gift annuity, then, the third type of deferred gift, has a guaranteed income as against the other two types where the earnings are paid back. Here the guaranteed income is based upon the age of the donor at the time his gift is made. There are regular Federal tax on this plan very concretely established by an Internal Revenue ruling in 1962 which has clearly established the grounds upon which capital gains would be taxed in a charitable gift annuity.

I point out, gentlemen, that all three of these plans have had national acceptance. In speaking on behalf of the 600 institutions I probably minimized the fact that there are hundreds and hundreds of other institutions that are engaged in raising funds by deferred giving. Raising this type of funds from deferred giving, there being again three typical kinds of fundraising on the part of higher education and publicly supported charities, one being the annual gift with which all alumni are so familiar, the annual repetitive gifts.

Two being the campaign, the outright gift made without restriction at the time of a definitely planned campaign.

And three, this growing area known as deferred giving.

I point out that in 1938 the Senate Finance Committee very effectively rejected a House of Representatives provision seeking to restrict the charitable contribution deduction. I point out to you that Mr. Williams referred to the dignity of philanthropy with which I heartily concur. It is my position and that of the institutions that we represent and speaking in this very informal manner, that the dignity of philanthropy is one that is not to be confused with the person who hopes to make a killing, as it were, on a charitable gift.

Again, I think of the 26 years of experience in my life in knowing hundreds of people who wish to support a cause and who are thus thankful to the Congress for having made it an exemplary gift through the help of tax relief.

Gentlemen, we thank you for this opportunity and offer our services to your staff.

Senator GORE. Thank you for your testimony. I take it from your remarks that when you wish to applaud but also preserve the dignity of philanthropy you, too, agree with taking the profit from it.

Dr. MATTHIES. I certainly do.

Senator GORE. Thank you.

Senator BENNETT. No questions, Mr. Chairman.

Senator ANDERSON. Senator Miller?

Senator MILLER. You mentioned three kinds of deferred giving. Where do you classify the gift of real estate, income-producing real estate, with a retained life interest?

Dr. MATTHIES. The production of a retained life income through a life income contract would be involved if the gift of the property was put into a pool of investments. But it would be a charitable reminder trust if the institution separately operated this piece of property as an independent part of its investment procedure.

Senator MILLER. I am thinking of a case where somebody gives the institution the remainder interest, reserving a life estate to himself and operating the property himself.

Dr. MATTHIES. This would be called the retention of a life income interest that would be, we think, prohibited under the proposed legislation as the House has passed it.

The House has stated in its bill that only the giving of the whole would be recognizable under the charitable contribution deduction and we are seriously concerned that this would prohibit the giving of an undivided interest or even the retention of a life interest.

Senator MILLER. I understand it that way but I was wondering why you left this fourth example out.

Dr. MATTHIES. Probably because it is generally considered in the operation of an institution as very similar to that as the operation of a charitable remainder trust in that the tax is quite the same.

Senator FANNIN. No questions.

Senator GORE. I have an actual case that I asked the staff to prepare. I talked to a very distinguished president of a university Monday who seemed unconvinced that anyone realized the monetary benefit or could realize a monetary benefit from a so-called charitable philanthropy.

Let me give you a case, a simple one, not involving State taxation which increased the profit to the donor so-called, but rather dealing purely with Federal taxation. For a gift of a fully depreciated item with a market value of $100, one in the 70-percent bracket, considering the surtax, would receive a tax reduction of $77, plus a capital gains benefit of $27.50, thus receiving a tax benefit of $104.50.

Now, what would be your attitude with respect to such a charitable gift? You have already said you could strike out the $4.50. What about the remaining $100?

Dr. MATTHIES. May I point to our tax counsel for advise on this.

Mr. TITEL. Sir, I think we are all in agreement that it is wrong for a taxpayer to make a profit when he gives something away. I think what we are talking about here is the unusual case, the exception. In the vast majority of cases it costs the donor a sizable amount to make that gift and the charitable reduction is usually not viewed in the concept of reducing the value of a gift but enabling the donor to give more than he initially intended.

I think the provisions in the House bill, if followed, answer your question. If I might answer the question you raised before about giving depreciated property, property which has gone down in value, sections of the Code 1245 and 1250, which came into existence in 1962, reduced any depreciation taken out, so that is now provided by law.

Senator GORE. You gentleman have been very helpful. I know you understand, as certainly I am beginning to understand, that we are dealing with the most fundamental rewriting of the tax law that has ever been undertaken at one time in our country.

(Dr. Roland C. Matthies' prepared statement and the prepared statement of the Committee on Catholic Charitable Giving follow:)

STATEMENT OF DR. ROLAND C. MATTHIES, CO-CHAIRMAN, COMMITTEE ON GIFT ANNUITIES

Presented by Committee on Gift Annuities—sponsored by over 600 educational, religious, and other charitable organizations.[1]

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[1] A list of the sponsors was made a part of the official files of the committee.

SUMMARY

The charitable contribution deduction is not a loophole.—It differs from other deductions and tax preferences in that the donor is not motivated by profit but by helping better our nation. [See p. 1.]

Congress has since 1917 continually liberalized the tax incentives for those who support philanthropies.—H.R. 13270 reverses a 50-year trend of increased encouragement to charitable giving. With the grave problems facing our nation now is a time for increased, not decreased, incentives for those who contribute to benefit mankind. [See pp. 1 and 2.]

Gifts of appreciated property.—Present law which allows a deduction for the fair market value with no capital gains tax on the appreciation should be retained. In 1938 the Senate rejected a House bill which would have changed this and we ask that it do so again. Appreciated property gifts often comprise over 50% of a charity's support from the private sector and this support would be greatly diminished if the law is changed. [See pp. 2 and 3.]

Allocations of deductions

1. The charitable deduction should not be one of the deductions subject to allocation. A donor would delay his gift until he knew the sources of his income and the amount of his capital gains. A postponed gift is often a lost gift. Even if the gift is made, it would likely be reduced. [See p. 3.]

2. Appreciation on contributed property gifts should not be considered a tax preference which would reduce a donor's other itemized deductions. Such a provision penalizes the generous individual—the larger his gift the smaller his itemized deductions for interest, taxes, medical expenses, contributions, etc. This provision is an indirect way of taxing the appreciation. [See p. 3.]

Limit on tax preferences.—Appreciation on contributed property should be deleted from the Limit on Tax Preferences provision of H.R. 13270. It is an indirect tax on appreciation and will inhibit charitable gifts. [See p. 4.]

Life income (deferred) gifts.—A donor who would like to make an outright gift but cannot afford to relinquish the income earned by his property, contributes the property to charity, retaining life income. On death the income payments terminate and the charity has the unrestricted use of the property. This is an important source of support for most charities. H.R. 13270 eliminates so many of the tax incentives and makes the law so complicated that if enacted this important source of charitable support would evaporate. These gifts in the main are made by older individuals who are comfortably situated but by no means wealthy.

1. Tax benefits for the long established and traditionally used charitable remainder trusts, life income contracts, and gift annuities should be retained. [See pp. 4 and 5.]

2. No capital gains should be incurred when charitable remainder trusts and life income contracts are funded with appreciated property and the deduction should be based on the fair market value, not the cost-basis. [See pp. 5–8.]

3. Capital gains incurred by charitable remainder trusts and life income contracts pooled funds should continue to be exempt from taxation since they are permanently set aside for charity. [See pp. 5–8.]

4. Gift annuities funded with appreciated property should be exempt from the bargain sale provisions of H.R. 13270. [See p. 9.]

5. The retroactive dates of H.R. 13270 are extremely harsh. They would apply to irrevocable gifts made many years ago as well as to gifts made this year before announcement of proposed change was made. [See pp. 5–7.]

Gifts of real property with retained life estate and gifts of undivided interest in property.—H.R. 13270's broad language could unintentionally remove present benefits. The language should be clarified. [See p. 10.]

Increased ceiling on deductability.—This is favored and shows Congressional intent to encourage charitable gifts. However, it is inconsistent to raise the ceiling and at the same time abolish many existing charitable deductions applicable against the ceiling. [See p. 10.]

STATEMENT

Mr. Chairman and members of the committee, I am Roland C. Matthies, Vice President and Treasurer of Wittenberg University, Springfield, Ohio and appear before you as Co-Chairman of the Committee on Gift Annuities—sponsored by over 600 educational, religious and other charitable organizations. Their names

are attached to our written statement. The Committee on Catholic Charitable Giving, chaired by James A. Cousins and sponsored by over 100 Catholic educational, church and social welfare organizations, joins in our testimony.

We thank you for this opportunity to present our views and support your efforts to make our tax laws more equitable and remove loopholes. The charitable deduction, however, is not a loophole. It differs from other deductions and tax preferences in that the donor gives up his money and property to help worthy causes and better our nation. He is motivated not by profit but by generosity. Thus charitable gifts should not be treated and lumped together with real estate depreciation, capital gains, tax-exempt interest, etc.

Congress has since 1917 continually liberalized the tax incentives for those who support philanthropies—each time stating the liberalization was designed to further aid charities to obtain additional funds to meet rising costs and the increased needs of our society. Congress has reiterated on many occasions that the Government is compensated for any loss of revenue by its relief from financial burdens which otherwise would have to be met by appropriations from public funds and by the benefits resulting from promotion of the general welfare.

The House-passed tax bill (H.R. 13270) reverses a 50-year trend of increased encouragement to charitable giving. With the grave problems facing our nation, now is the time for increased, not decreased, tax incentives for those who generously contribute to benefit mankind. The organizations sponsoring the Committee on Gift Annuities are dependent upon support from the private sector and they and the nation have benefited greatly from gifts encouraged by present law.

In the past the Senate has declined to accept a House-passed bill detrimental to charitable organizations and the nation. In 1938, the House of Representatives passed a bill calling for the contribution deduction to be measured by donor's cost—not the fair market value at the date of the gift. However, the 1938 Tax Act as finally passed did not contain the House provision on appreciated property gifts to charity. The Senate Finance Committee rejected the House provision, stating:

> "Representations were made to the Committee by officials of educational and charitable institutions that the effect of such a provision would be to discourage the making of charitable gifts in property. The Committee believes that charitable gifts generally are to be encouraged and so has eliminated the provision of the House Bill." (S. Rep. No. 1567, 75th Cong. 3rd. Sess. 1938).

The needs and problems of our nation are greater now than they were in 1938 and there is all the more reason for the Senate to reject the House bill's restrictive provisions on charitable gifts.

The Committee on Gift Annuities respectfully submits the following comments on those provisions of H.R. 13270 which are of greatest concern:

1. Gifts of appreciated property

Present law allows a deduction for the fair market value with no capital gains tax on the appreciation. In many instances appreciated property gifts comprise more than 50% of a charitable organization's support from the private sector. To stifle this major source of support would be a death blow to many institutions. The Treasury estimates that increased Government revenue by changes in current law on gifts of appreciated property would be insignificant. We ask that the current law be retained.

Also, appreciation in the value of property donated to charity should not be considered a tax preference which under the Allocation of Deductions provision would reduce a donor's itemized deductions for interest, taxes, medical expenses, charitable contributions, etc. To enact such a provision would be an indirect way of taxing appreciation on property gifts and would greatly inhibit important support from the private sector.

2. Allocation of deductions—a two-edged sword

The allocation deductions provision of H.R. 13270 as it applies to charitable gifts has two aspects:

Aspect 1.—By including the charitable contribution deduction in the itemized deductions to be allocated between taxable and non-taxable (tax preferred) income, it *reduces* the charitable deduction. A donor would have no way of ascertaining the tax consequences of his gift until the end of the year when he knows the items which comprise his income and the amount of his capital gains. Chari-

table gifts will thus be postponed. An axiom of fund-raising is that a postponed gift is often a lost gift. The charitable gift is a voluntary act and should not be lumped together with deductions for taxes, interest, casualty losses, etc. We ask that charitable contributions not be subject to the allocation rule.

Aspect 2.—By considering the amount of appreciation on property contributed to charity as non-taxable (tax preferred) income, it reduces donor's charitable deduction *as well as his other itemized deductions.* We support Secretary of the Treasury, David M. Kennedy and ask that appreciation on contributed property not be considered a tax preference which under the Allocation of Deductions provision would reduce a donor's itemized deductions for interest, taxes, medical expenses, charitable contributions, etc. Such a provision penalizes the generous individual who contributes his property to better our nation. The larger the gift, the smaller his itemized deductions.

3. Limit on tax preferences

We support Secretary of the Treasury, David M. Kennedy and ask that appreciation on contributed property be deleted from the Limit on Tax Preferences provision of H.R. 13270. This provision is an indirect way of taxing the appreciation on gifts of property and will inhibit such donations.

4. Life income (deferred) gifts

Life income gifts (so-called deferred gifts) are an important and growing means of support for our nation's charitable organizations. Many donors would like to make outright gifts but cannot afford to relinquish the income earned by their property. So they give their securities and other property to a charitable organization retaining life income. On death, the income payments terminate and the securities and property are owned outright by the charity. Most life income gifts would be outright gifts if the donors could afford to give up income. The vast majority of these gifts are made by contributors in their late 60's and early 70's. These gifts are often made by women. The donors are comfortably circumstanced but by no means wealthy. They are dedicated and committed to the causes they support with their life income gifts.

Life income gifts have been an important source of support for many charitable institutions for more than half a century. At Wittenberg University, for example, we wrote our first charitable gift annuity in 1899 and from it came the building first housing our School of Theology. At present we have 134 life income gifts totalling 4 millions of dollars. This is one-third of our entire endowment. More than 60% of our life income gifts were in the form of securities and other property.

An increasing number of organizations now depend on the three types of life income gifts (charitable remainder trusts, life income contracts and gift annuities) to overcome the inadequasies of outright giving.

The life income gift is important to the institution because it assures funds for its work. Because most of these gifts are made by older donors, these gifts often mature within a few years after the gift is made. These plans stimulate greater interest in the charitable institution and donors often add to these gifts. Also, outright gifts are often made after a life income plan is created. H.R. 13270 removes the major tax incentives to these gifts and if enacted a most important source of support would evaporate.

CHARITABLE REMAINDER TRUSTS

A donor creates a charitable remainder trust by *irrevocably* transferring money, securities, or other property to a trustee often the charitable institution who pays the income from the transferred properties (or reinvestments) to the donor for his life. Then the trust principal becomes the sole property of the charity. Present law provides there is no capital gain on the transfer of appreciated property to fund a charitable remainder trust; nor is there a capital gain if the property transferred is later sold by the trust and the gain permanently set aside for charity. We ask that these rules be retained. Abuses in the investment policies of these trusts are rare and means are now available to (and used by) Internal Revenue Service to curb any abuses which exist.

The very complicated provisions for charitable remainder annuity trusts and charitable remainder unitrusts should not be substituted for the widely used and understood traditional charitable remainder trusts. Many donors who create charitable remainder trusts are financially unsophisticated. They are

familiar with the trusts now approved by the Congress. We request no change in the law be made which would greatly inhibit these gifts.

Should the Senate decide to abolish the tax incentives for the traditional charitable remainder trust (substituting the annuity trust and unitrust), we ask that the law for the *income tax* charitable deduction not be retroactive to April 22, 1969 (H.R. 13270 so provides) but be effective with the passage of the Tax Reform Act. Many donors have created trusts since April 22, 1969. The unitrust and annuity trust provisions of H.R. 13270 were not mentioned in the May 27, 1969 "tentative decisions" of the House Ways and Means Committee; nor were they mentioned in the proposals submitted by the Treasury Department under the Nixon Administration on April 22, 1969.

H.R. 13270 allows no *estate tax* charitable deduction for a charitable remainder interest in a trust unless it is a unitrust or annuity trust. This estate tax change would affect estates of donors dying after the bill is enacted. However, it would apply to charitable remainder trusts created before the bill's enactment—no matter how long ago. Thus, the estate of a donor who created an irrevocable charitable remainder trust 10 years ago, for example, but who dies after the bill's enactment, would lose the estate tax charitable deduction unless the charitable remainder trust is a unitrust or an annuity trust. Virtually no existing charitable remainder trust is a unitrust or annuity trust.

(EXAMPLE.—In 1959 donor transferred cash and securities to a trustee directing the trustee to pay the income to him for life and then to his wife if she survives him. On the death of the survivor, the principal goes to the donor's college. On donor's death in 1969 the trust principal is worth $100,000 and his wife is 65 years old.)

Estate tax consequences under current law.—On donor's death the entire value of the trust principal ($100,000) is included in his gross estate. The estate then deducts $66,580 as a charitable deduction—the value of the charitable remainder (using Government tables) based upon the wife's age at the donor's death.

Estate tax consequences under House-passed bill.—The entire $100,000 would be included in donor's gross estate as under current law. However, there would be no charitable deduction for the value of the charitable remainder unless the trust is a unitrust or an annuity trust. This is so even though the donor created the trust long before the passage of the House bill. Enactment of this provision would result in great hardship. Substantial estate taxes will have to be paid because of this retroactive change. These taxes will usually not come out of the trust principal but out of the estate's other assets—reducing or even eliminating bequests to the donor's wife, children, and other family members. The retroactive date is so harsh and unfair that it must, in our opinion, be an oversight. The harsh effective date also applies to life income contracts and gifts of remainder interests in real property (donor contributes real property retaining a life estate).

We respectfully ask that if the Senate adopts the provision of H.R. 13270 on estate tax treatment of charitable remainder trusts, life income contracts, and gifts of remainder interests in real property, the law be effective after the passage of the Tax Reform Act and be applicable only to charitable remainder trusts, life income contracts, and remainder real estate gifts made after the passage of the Act.

Funding a charitable remainder trust with appreciated property—present law should be retained.—Whether a new trust format is adopted or the traditional charitable remainder trust is retained, we ask that the charitable deduction for gifts of appreciated property be based upon the fair market value of the property transferred to the trust at the time of its creation—rather than requiring (as does H.R. 13270) the donor to base his deduction upon his cost-basis or pay a capital gain if he elects to compute his deduction based on the fair market value. However, if the Senate accepts the House provision, we ask that the language of the bill be clarified. If a donor elects to base his deduction on the fair market value of his gift, capital gain should be limited to the part of the gain allocable to the charitable remainder (the future interest). There should be no capital gain on the part allocable to donor's retained life interest.

No capital gain under present law on sales by charitable remainder trust.—We also request that capital gains incurred by the trust and permanently set aside for charity not be taxed. Present law so provides. Many existing trusts were created on the assumption that the capital gains—which eventually go to the charity—would not be taxed. To tax the trust's capital gains is to tax the

charity because the tax would come out of the trust principal which goes to the charity on the donor's death.

H.R. 13270 would tax capital gains permanently set aside for the charity except if the trust is a unitrust or annuity trust. If this Committee decides to tax capital gains permanently set aside for the charity under the traditional charitable remainder trust, we would then prefer the enactment of H.R. 13270's provisions on the unitrust and annuity trust because capital gains (under the House bill) for these trusts are only taxed to the extent they are paid to the life income beneficiary.

LIFE INCOME CONTRACTS

A life income contract is very much like a charitable remainder trust. The main difference is that donor's irrevocable gift is co-mingled in a pooled fund maintained by the charity with the life income contract gifts of other donors. In the trust a donor's gift is separately invested. Donor's income under a life income contract is determined by multiplying the percentage return earned by the pooled fund by the amount of money or value of property donor contributed. On donor's death, the payments terminate and the charity has the unrestricted use of the gift. This is an important source of support. It makes these types of gifts available to the donor of modest means who cannot afford to fund a separate charitable remainder trust. It also eases administration of the gift by the charitable organization. We ask that present law governing life income contracts (no capital gain on transfer of appreciated property nor capital gain when the property transferred is later sold by the life income pooled fund) be retained. As with the charitable remainder trust: (1) The deduction should be based upon the full fair market value without imposition of capital gains tax and (2) capital gains incurred by the life income pooled fund and permanently set aside for charity should not be taxed. To tax the capital gains incurred by existing life income contract pooled funds (which are permanently set aside for charity and not paid to the life income beneficiaries) would create havoc in administration and unfairness among the many thousands of participants. Keeping track of the capital gains attributable to each gift of appreciated property would be so extremely complicated and time consuming that enactment of a provision taxing the pooled fund's capital gains would be the death knell for this type of gift plan which allows donors of modest circumstances to be philanthropists during their lifetime.

CHARITABLE GIFT ANNUITIES

A donor irrevocably transfers money and often appreciated property to a charitable instituiton in exchange for the institution's promise to pay him a fixed income for life. Since the rate of return is substantially lower than that offered by a commercial insurance company, the donor makes a substantial charitable gift. We ask that present tax treatment when appreciated property is contributed for an annuity be retained. (Detailed in Rev. Rul. 62-136, 1962-2 C.B. 12).

Under H.R. 13270, a transfer of appreciated property for a gift annuity could be construed as a bargain sale—the donor receiving an annuity rather than cash as consideration from the charitable institution. Thus, a donor who transfers property with a fair market value of $10,000 for an annuity having an actuarial value of $6,000 (what it would cost to obtain the same annuity from a commercial insurance company) could be treated in the same manner as a donor who transfers the same property for $6,000 in cash. Under H.R. 13270 which allocates the cost-basis of the property between the portion of the property "sold" and the portion of the property "given" to the charity, appreciation now untaxed on a transfer for a gift annuity could be taxed. And in those instances where part of the gain is now taxed, a larger part of the gain could be taxed.

(EXAMPLE.—Donor transfers property with a $6,000 cost-basis and a present fair market value of $10,000 for an annuity with a $6,000 actuarial value. If the annuity is treated as a bargain sale (donor received an annuity with an actuarial value of $6,000 instead of $6,000 in cash), donor has a capital gain. The basis allocated to the $6,000 sale (actuarial value of annuity) is $3,600. Thus, the capital gain is $2,400 ($6,000 actuarial value minus $3,600 allocated basis). Under present law, there is no capital gain since the cost-basis equals the actuarial value.)

If H.R. 13270's provision on bargain sales is enacted, we ask that the law specifically provide that the transfer of appreciated property for a gift annuity is not a bargain sale.

5. Gifts of Real Property With Retained Life Estate; Also Gifts of Undivided Interest in Property

H.R. 13270 [Sec. 201(a)(3), p. 121, line 8] provides that "where a taxpayer makes a charitable contribution of less than his entire interest in property", no charitable deduction is allowed unless the transfer meets the unitrust or annuity trust rules. This language could be interpreted to deny a charitable deduction for a gift of real estate subject to the donor's retention of a life estate (e.g., farmer gives his land to church retaining only right to use it for his life). Presumably H.R. 13270 intends to deny a charitable deduction for the fair rental value of property which a donor allows a charity to use rent free. However, the bill's broad language could easily be interpreted to deny a deduction for a remainder interest gift in real property as well as a gift of an undivided interest in real or personal property.

If the Committee on Finance decides to abolish the deduction for gifts of the use of property, we ask that H.R. 13270 be clarified so that present tax treatment is retained for gifts of real property subject to donor's retained life estate and for gifts of undivided interests in property.

6. Increased Ceiling on Deductibility

We applaud H.R. 13270's provision which increases the ceiling on deductibility from 30% to 50%. However, we call to this Committee's attention the inconsistency of the House bill in increasing the ceiling on deductibility and then abolishing many of the existing charitable deductions which are applicable against the ceiling.

7. Conclusion

Mr. Chairman and members of the Committee, we thank you again for this opportunity to present our views. H.R. 13270 removes many long-established and important tax incentives to supporting the charitable institutions so vital to our nation. We have not commented on all of the provisions of H.R. 13270 affecting charitable gifts—only those which are of greatest concern. However, we also believe that there should be no change in the present tax treatment of bargain sales and short-term trusts for the benefit of charity.

We are aware of the times pressures and heavy workload of the Committee and have made our remarks as brief as possible. If the Committee wishes amplification on any point, we would appreciate the opportunity to submit a supplemental statement. We are available, if it is the Committee's pleasure, to meet with members of the Committee's staff.

We agree with the Treasury that,

> "Private philanthropy plays a special and vital role in our society. Beyond providing for areas into which Government cannot or should not advance (such as religion), private philanthropic organizations can be uniquely qualified to initiate thought and action, experiment with new and untried ventures, dissent from prevailing attitudes and act quickly and flexibly."
>
> "* * * In doing so, they enrich the pluralism of our social order. * * *"
>
> (Treasury Dept. Report on Private Foundation: U.S. Government Printing Office, February 2, 1965, P. 5.)

Accordingly, we ask that the new tax law continue the long established and essential tax incentives to charitable giving which undergird our nation's educational, religious, hospital, health, social welfare and other charitable organizations.

Testimony of the Committee on Catholic Charitable Giving

Appreciation

The Committee on Catholic Charitable Giving expresses its gratitude on behalf of its one hundred and nine sponsoring organizations and institutions for the privilege and the opportunity to make this presentation to the Senate Finance Committee.

The Committee on Catholic Charitable Giving is well aware of all of the problems which you must face. May we say that our presentation is not a negative one, as we do support parts of the Bill being considered.

THE COMMITTEE ON CATHOLIC CHARITABLE GIVING

The Committee on Charitable Giving is a voluntary association of fifteen persons chosen by a majority vote of the Committee from important religious, educational and charitable organizations engaged in obtaining funds through deferred giving.

The scope and function of the Committee on Catholic Charitable Giving is best described by the following excerpt from the Official Catholic Directory for 1969, page thirteen, under the general heading, United States Catholic Conference:

> The Committee on Catholic Charitable Giving was approved by the Bishops' Committee of The Society for the Propagation of the Faith in April, 1968. The Committee is sponsored by the National Office of The Society for the Propagation of the Faith and it is responsible to the National Director for all activities.
>
> The Committee studies and recommends the proper range of rates for gift annuities and the accepted methods of yield computation for life income agreements.
>
> The Committee also ascertains and reports as to legislation in the United States and in the various States regarding gift annuities, life income agreements and trusts, their liability, etc. The Committee has the right to undertake to study and educate sponsoring organizations on all the various ways of giving, including outright giving and deferred giving.

The Committee on Catholic Charitable Giving is the representative of over one hundred religious, educational and charitable organizations which solicit and receive gifts for their respective purposes that are subject to charitable remainder trusts, gift annuities or life income agreements. The organizations represented by the Committee on Catholic Charitable Giving are listed in the Official Catholic Directory for 1969. Conferences are held by the Committee on Catholic Charitable Giving for the members of the institution that they represent every two years. At these Conferences, speakers, well-known in their respective fields, including representatives from the Insurance Department of the State of New York and the Internal Revenue Service, have lectured to the participants and conducted workshops aimed at assisting them in operating more efficiently, and also to aid them in complying with the laws of the Treasury Department, the various Insurance Departments and other State laws.

The Committee on Catholic Charitable Giving is aware of the fact that overemphasis of the tax aspects of the gift rather than of the institution's worth and needs has resulted in Congressional legislation and Internal Revenue Service rulings which have decreased tax benefits for donors. The Committee on Catholic Charitable Giving is also aware of the fact that gifts to educational, religious, social welfare and other philanthropic institutions are encouraged by the federal income, estate and gift tax laws. Except in most unusual circumstances, a donor sacrifices substantial conomic worth when he makes a philanthropic gift. Thus, his prime giving motive is his belief in the philanthropy's work and goals. Tax savings become important only after he decides to make the gift. They reduce the cost of giving and enable a donor to contribute more than he initially thought possible. Therefore, charitable gifts should not be treated and lumped together with real estate, depreciation, capital gains, tax exempt interest, and so forth. The House Bill's provisions which deal directly with charitable contributions and those which deal with them indirectly (inclusion of appreciation on charitable gifts in the Limit on Tax Preference and in the Allocation of Deduction provisions) are extremely complex. Charitable organizations obtain support by being "easy to give to." The House Bill, by its very complexity, discourages charitable giving.

Specific Recommendations

CHARITABLE REMAINDER TRUSTS

Present law provides that there is no capital gain on the transfer of appreciated property to establish a charitable remainder (life income) trust; nor is there a capital gain if the property transferred is later sold by the trust and the gain permanently set aside for the charity. These rules should be retained. Abuses in the investment policies of these trusts are rare, and means are now available to (and used by) the Internal Revenue Service to curb any abuses which exist. The new Bill contains very complicated provisions for charitable remainder trusts, annuity trusts and charitable remainder unitrusts which should

not be substituted for the widely used and understood, charitable remainder trust. The House Bill allows no estate tax charitable deduction for a charitable remainder trust unless it is a unitrust or annuity trust. This estate tax change would affect estates of donors dying after the Bill is enacted. However, it would apply to charitable remainder trusts created before the Bill's enactment, no matter how long ago. To our knowledge no existing charitable remainder trust is a unitrust or an annuity trust. The retroactive date is so harsh and unfair that the Committee on Catholic Charitable Giving urges (if the Senate Finance Committee bill contains the House unitrust and annuity trust provisions) to make the change effective after the passage of the Bill and applicable only to charitable remainder trusts established after the passage of the bill.

CHARITABLE GIFT ANNUITIES

Present tax treatment when appreciated property is contributed for the annuity should be retained. (This was established in Rev. Rul. 62-136 and has received national acceptance since 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 considered within the scope of the ruling for a bargain sale.

LIFE INCOME CONTRACTS

Present law governing these contracts (no capital gain on transfer of appreciated property nor capital gain when property transferred is later sold by the life income pooled fund) should be retained. As with the charitable remainder trust, (1) the deduction should be based upon the full fair market value without imposition of capital gains tax, (2) the capital gains incurred by the life income pooled fund and permanently set aside for the charity should not be taxed.

GIFTS OF APPRECIATED PROPERTY

Present law allows for a deduction of the fair market value of the property with no capital gains tax on the appreciation. This should be retained. However, under the Allocation of Deductions the appreciation would be indirectly and partially taxed. This is a very complicated provision which not only will confuse prospective donors but will discourage them from making a gift of appreciated property.

ALLOCATION OF DEDUCTIONS

This part of the bill is equivalent to a two-edged sword.

1. It reduces the charitable contribution by having the charitable contribution deduction in the itemized deductions allocated between taxable and non-taxable income.
2. It reduces the charitable deduction, as well as the other itemized deductions because the amount of appreciation on property contributed to charity is considered as non-taxable (tax preferred) income.

ITEMS THAT WE SUPPORT

A. Extending the unrelated business income tax to cover all organizations now exempt.
B. Taxing organizations on income received from debt-financed investments.
C. The increasing of the ceiling on deduction allocations to 50 percent.

ITEMS THAT WE CONSIDER TO BE IMPORTANT WHICH WE WOULD BE WILLING TO SACRIFICE, IF NECESSARY

A. Rent-free use of property.
B. Two-year trusts.
C. Appreciated property gifts which could generate ordinary income if sold, for example, section 306 stock.
D. The unlimited charitable deduction.

GENERAL OBSERVATIONS

Deferred giving in recent years has become more and more important to our organizations in helping overcome the trend of steadily rising costs. "Current Giving" no longer adequately takes care of the needs of our institutions. It is im-

portant that our institutions be permitted to continue the use of deferred giving. Tax incentives to philanthropic giving are firmly woven into the tax laws. At the present time, there is a trend caused by the emphasis on the abuses of contribution deducations by a small minority of donors to religious, educational and other publicly supported institutions, to remove many of the tax incentives to giving, previously approved by Congress. May we respectfully request that your final Bill take into consideration the fact that the abuses are very small and the needs of the publicly supported organizations are very great.

The CHAIRMAN. Our next witness, then, will be Mr. William P. Thompson, associated general counsel for the National Council of Churches of Christ.

STATEMENT OF WILLIAM P. THOMPSON, NATIONAL COUNCIL OF CHURCHES OF CHRIST; ACCOMPANIED BY JAMES A. HAMILTON, ATTORNEY, DIRECTOR, WASHINGTON OFFICE, NATIONAL COUNCIL OF CHURCHES

Mr. THOMPSON. Mr. Chairman, members of the committee, I should like to be joined by Mr. James A. Hamilton, who is an attorney, a member of the bar of the District of Columbia, and is the director of the Washington office of the National Council of Churches.

Senator BENNETT. Mr. Chairman, may I interrupt a minute.

Are you the counsel?

Mr. THOMPSON. No, sir; I am not. I will make that clear right now. I myself am a lawyer. I am admitted to practice before the Supreme Court of the State of Kansas and before the Supreme Court of the United States. I did practice law for 20 years in Kansas but 3 years ago I was elected and now serve as stated clerk of the General Assembly of the United Presbyterian Church in the United States of America. This is the office which might be described as the permanent officer of the highest legislative, judicial, and administrative body in my denomination.

I am a member of the General Board of the National Council of Churches of Christ in the United States of America and of its executive committee. I am also chairman of its General Planning and Program Committee and, therefore, am personally quite familiar with the programs and operations of the National Council.

I appear today not in any staff capacity for that council but I do speak out of my association with it in the capacity of a representative of my own denomination.

The National Council is an association of 33 Protestant and Eastern Orthodox churches. I do not claim to speak for these denominations but rather for the General Board of the National Council of Churches which is its policymaking body and which is made up of delegates selected by the member denominations.

The general board of the council has adopted policies relating to tax reform and specifically to the proposals approved by the House in the bill now being considered by this committee. Only last week in Indianapolis, the general board adopted a resolution on this subject.

That resolution and the earlier policy statements are attached to my written statement which has been filed and I request that they be made a part of the record of this hearing.

The National Council of Churches favors tax reform to achieve

a more equitable sharing of the burden of public expenditures. We also urge that in this revision the Congress strive to simplify the Internal Revenue Code so that it is no longer a mystery known only to experts but, rather, a plain formula understandable by the average citizen.

However, we find among the proposals before this committee several which do not appear to contribute to the attainment of these goals and some others which would have unfortunate side effects on churches and voluntary charities which are meeting real needs within our society.

The National Council of Churches has adopted a comprehensive policy on tax exemption of churches covering ad valorem as well as income tax policy. The relevant part of that document declares that we are opposed to exemption from taxation of income which churches derive from unrelated business enterprises.

Our opposition to exemption of such income from taxation was elaborated last spring in a statement issued jointly with the U.S. Catholic Conference. That statement also supported elimination of the so-called Clay-Brown loophole. The statement, which is among those attached to my written statement, contains specific suggestions for the revision of the Internal Revenue Code to effect these changes.

Some of our suggestions were accepted by the House of Representatives. We urge you to concur in those and to give serious consideration to the other suggestions.

We are not only concerned about matters affecting the churches but also proposed changes in the law relating to private foundations. While the present law has been subject to abuses which should be prevented, some of the proposals go beyond correction and seem to us almost punitive. Private foundations have facilitated valuable experimentation and innovation in our Nation's life, much of which would have been impossible for public agencies but which have made possible the pointing of a direction and in this way have facilitated later public programs.

The proposals with reference to activities of foundations in voter registration, nonpartisan voter registration, and in efforts to influence legislation seem particularly repressive. We favor tax policies which would permit private foundations access to the free marketplace of ideas even though some of their activities might affect legislation.

On the principal subject of this hearing, we are deeply troubled because some aspects of the House bill suggest what we believe to be an ominous shift in public policy. Heretofore the tax laws have been designed to encourage giving to churches and private charities as contributing significantly to the welfare of our Nation. The House bill seems to us to reverse this stance and would make such gifts far more costly and, therefore, would curtail these essential sources of support.

Some sections of the bill would cause confusion as to the tax effects of particular contributions to charity. Prospective donors would hesitate while seeking advice from tax counsel and awaiting authoritative interpretations of the new provisions. In too many cases a gift postponed is a gift lost.

The cumulative effects of the proposed changes would seriously im-

pair the efforts of the private voluntary sector to secure gifts and grants at a time when inflation has already cut their activities. This will further restrict their efforts to help keep the Nation healthy, vigorous, educated, responsive, and purposive.

This difficulty results in part from lumping charitable contributions together with tax preferences and personal deductions. In our judgment, they are actually different in kind. Excess depreciation, hobby farm losses, interest on borrowings, tax-free interest on municipal bonds, oil depletion allowances, untaxed capital gains, all these are incidents of transactions primarily for the benefit of the taxpayer.

Charitable contributions, on the other hand, are for the benefit of others. Whether deductions are itemized or the standard deduction is taken, charitable contributions should be treated separately in our opinion.

If the law discourages such giving, the possible recipients are the real losers.

Another crucial issue is the tax treatment of gifts of appreciated property. Whether such gift is made outright or by one of the several arrangements which defer the use of the gift, such contributions should be encouraged. We fear that the repressive provisions of the bill stem from an erroneous comparison. A charitable contribution should not be compared with the sale of property.

The taxpayer who gives property to a charitable cause should never be taxed as though he had received valuable consideration, money or money's worth, in the transaction. He always has the option of keeping the property. If that is what the tax law encourages him to do, the losers will not be the Government, nor the prospective donor, or even other taxpayers, but the charitable causes which would otherwise have benefited.

Last week the general board of the National Council of Churches in Indianapolis said in part, philanthropy is not a loophole and it should not be treated as such. It is a voluntary act designed to help others and the philanthropist should not be penalized for undertaking it.

Tax policy which reduces the incentives to charitable giving would do the most harm to those that benefit the most, the young, the poor, the deserving, rather than handicapping those who are the benefactors.

Thank you, Mr. Chairman.

Senator ANDERSON. Mr. Bennett?

Senator BENNETT. No questions.

Senator BYRD. No questions, Mr. Chairman.

Senator ANDERSON. Thank you very much. We appreciate your testimony and your statement will be placed in the record.

(William P. Thompson's prepared statement, a resolution, and a policy statement follow:)

STATEMENT OF WILLIAM P. THOMPSON, STATED CLERK, UNITED PRESBYTERIAN CHURCH IN THE UNITED STATES

SUMMARY

Exemption of churches

The reference to "churches and associations and conventions of churches" in various places in H.R. 13270 are satisfactory and appropriate.

In particular, we approve ending of the exemption of churches from the 1950

tax on "unrelated business income", subject to certain safeguards outlined in the bill. However, we urge certain minor changes:

1. Exception of churches from the mandatory and public disclosure requirements;
2. Limitation of cure for Clay Brown abuses—at least for churches—to taxing debt-financed *rents* rather than all passive or investment income;
3. Definition of "unrelated business income" in such a way that it does not include any activity related to tenets and traditional functions of the church;
4. Taxation as income of the cash housing allowance paid clergymen in lieu of a parsonage or rectory.

Private foundations

Certain restrictions placed on private foundations would inhibit or eliminate some of the most creative social pioneering in our nation, which has been done by private foundations. Three elements of H.R. 13270 seem particularly punitive toward activities from which the nation benefits:

1. We oppose the restriction on support by foundations for nonpartisan voter-registration drives;
2. We oppose the restriction on foundation-financed studies, reports, or recommendations that might affect legislation;
3. We urge the elimination of the proposed tax of 7½% on investment income of foundations, and in its place a "user fee" of no more than 2% to cover cost of federal regulations.

Charitable contributions

In its commendable effort to eliminate tax shelters, H.R. 13270 over-corrects in the area of charitable contributions to the degree that it would seriously handicap the causes and institutions that depend on such contributions.

Large-scale capital funds campaigns on behalf of such causes and institutions depend for success upon "pace-setting" gifts which will make up 50% of the total raised. These large gifts will be seriously reduced or inhibited by the strictures in the bill, thus crippling the support of important humanitarian efforts in the private sector.

Therefore, it is urged in the testimony:

1. that the tax code be simplified, so that donors are not hindered by inability to understand the tax effect of their contributions;
2. that charitable contributionse be excluded from both the "allocation of deductions" and the "limit on tax preference", since they are unlike the other items in those classes;
3. that charitable contributions be claimable by those using Standard Deduction beyond whatever allowance is made for charitable contributions within that deduction;
4. that charitable contributions of appreciated property or of an interest in, or portion of, property be encouraged by exclusion from taxable income *or* deduction as a charitable contribution (at the option of the taxpayer), but not *both*.

STATEMENT

Mr. Chairman and members of the committee, my name is William P. Thompson. I am a lawyer admitted to practice before the Supreme Court of Kansas and the Supreme Court of the United States. After practicing law for 20 years, I was elected and now serve as Stated Clerk of the General Assembly of the United Presbyterian Church in the U.S.A. In this office I am the permanent officer of the highest legislative, judicial and administrative body of my denomination. I am a member of the General Board of the National Council of Churches of Christ in the U.S.A. and of its Executive Committee. I also serve as Chairman of the Council's General Planning and Program Committee. By virtue of this latter position, I am thoroughly familiar with the programs and operations of the National Council of Churches.

I appear before you today on behalf of the National Council of Churches, which is an association composed of thirty-three Protestant and Eastern Orthodox denominations. I do not purport to speak for these denominations, but rather for the General Board of the N.C.C., which is its policy-making body, made up of delegates selected by the member denominations.

Among the policies adopted by the General Board are several which bear on certain provisions of the Tax Reform Act of 1969, as passed by the House of

Representatives in H.R. 13270. Those policies form the basis of this statement, and their applicability is confirmed by a resolution on tax reform adopted by our General Board meeting in Indianapolis last week. Copies of these policies are appended to this statement, Mr. Chairman, and I ask that they be made a part of the record of this hearing.

The General Board of the National Council of Churches favors tax reform which would distribute the burden of public expenditures more equitably, so that all are taxed in proportion to their ability to pay and none of the affluent is able to avoid paying income tax completely by use of tax shelters and loopholes. We commend the Congress and this Committee, Mr. Chairman, for their attention to the subject of tax reform and for their efforts to make the nation's tax laws more equitable for all. We would suggest that, in addition to seeking equity, the Congress also strive to simplify the Internal Revenue Code so that it is no longer a mystery known only to experts, but a plain formula understandable to the average citizen.

However, while we support the basic need for tax reform and simplification, there are certain features of the Tax Reform Act of 1969, as passed by the House of Representatives, which in our judgment do not conform to, or contribute to, the achievement of those goals, or which, if consistent with them, have unfortunate side effects and must be examined in terms of the impact they would have upon voluntary agencies which are meeting needs of our society and all citizens of our nation. We therefore welcome this opportunity to express to this Committee our views on the proposed legislation you are considering.

TAX EXEMPTION OF CHURCHES

It may be helpful at the outset, Mr. Chairman, to outline briefly our basic position on the exemption of churches from *ad valorem* and income taxation. In our view, the impact of tax policy on the churches is of three kinds:

(1) There are certain central elements—the property essential to the free exercise of religion (such as the house of worship) and the contributions of the faithful—which we feel should be exempt from taxation.

(2) There are other resources and facilities which we feel should *not* be exempted from taxation, such as unrelated business income of churches and the cash housing allowance paid to clergymen by most church agencies.

(3) There are many auxiliary agencies of churches, such as schools and hospitals, which we think the law should treat in whatever way it treats similar nonprofit charitable institutions that are unrelated to churches.

UNRELATED BUSINESS INCOME

We do not approve, Mr. Chairman, of churches (or any other exempt organizations) selling their tax exemption to private businesses so that they enjoy a competitive advantage over tax-paying businesses. Thus, last Spring we joined with the United States Catholic Conference in a statement asking for revision of the Internal Revenue Code which would end the exemption of churches from taxation on income from commercial business activities which are unrelated to the exempt function of the churches. That statement, together with suggested revisions in the Internal Revenue Code which would accomplish that goal, is attached.

The House Ways and Means Committee took cognisance of our request and incorporated many of our proposals in the bill as passed by the House. We hope that this Committee and the Senate will also support these changes.

In their statement, the United States Catholic Conference and the National Council of Churches also supported the elimination of the so-called "Clay-Brown" loophole. While noting that we were unable to speak for other exempt organizations, we did suggest to the House Ways and Means Committee that with respect to *churches*, it was our opinion that the "Clay-Brown" problem can be cured by taxing debt-financed *rents* while preserving the present exemption of churches from taxation upon passive or investment income including interest, dividends, and royalties. The Ways and Means Committee did not accept this suggestion, nor some others which we made, such as amending the definition of Unrelated Business to insure that it does not include any activity related to the tenets and traditional functions of a church and providing for financial reporting by churches on a voluntary basis. Therefore, we urge this Committee to review and consider the suggestions we have made in this area.

FUNCTIONAL LIMITATIONS AND TAXATION OF PRIVATE FOUNDATIONS

If we may turn from matters directly affecting the churches, we would like to speak in behalf of a class of institutions whose well-being is more significant to the nation than their treatment in the present bill suggests—the private foundations. We realize that some foundations have been set up or utilized as tax shelters serving a taxpayer's own benefit rather than the public good, and we endorse the effort to correct such abuses.

However, the stringency of some proposed restrictions on private foundations strikes us as almost punitive in some respects. Much of the germinative experimentation and innovation which has taken place in our nation in recent decades has been made possible by private foundations, many of which seek to implement in our nation's life its highest ideals of quality and equality in education, health care, and political democracy. We would regret the Congress approving legislation which would hamper or prohibit such constructive experimentation—experimentation which sometimes is not possible for public agencies but often serves to point the way for broad-scale public programs.

Specifically, we are troubled by, and opposed to, the restrictions placed upon the efforts of foundations to encourage voter registration and the prohibition on activities which might affect legislation or public policy. While we agree that tax exempt and deductible funds should not be used for partisan purposes, we know that much of the important work in voter registration in many parts of the country, particularly in the South, would not have been accomplished without the support of public-spirited foundations, whose concerns have been manifest for the health of the democratic process and civil rights of disenfranchised populations and not for partisan advantage.

While it is true that ostensibly non-partisan voter registration drives can be a cloak for partisan objectives, we feel that the present bill overcorrects for this abuse by requiring foundation contributions to be spread over at least a five-state area and to be mingled with funds from at least five other foundations. The greatest strides in the enfranchisement of powerless populations are made in rather concentrated drives, where the possibility of reaching non-voters is stimulated by the exigencies of an imminent election. To require that the foundation resources which might contribute to such a drive be employed over a five-state area might spread them so thin as to render the effort ineffective.

In fact, we feel that the actual and possible abuses of voter registration have been, and are, so slight when weighed against the advantages of increased voter participation, that we favor the elimination of these restrictions on non-partisan voter registration drives assisted by foundations. Any restriction should and can be directed at barring partisanship in voter registration activities and prohibiting participation in political campaigns on behalf of any candidate for public office, rather than at voter registration itself.

The same thing may be said of foundation-financed efforts to affect public policy. When one thinks of the vast amounts spent by corporations to protect their interests against restrictive legislation and charged off as part of the cost of doing business, it is difficult to understand why foundations already subject to the "substantiality" test should be the object of such vigorous regulation. Even though "non-partisan analysis and research" would be permitted, the strictures against foundation activities bearing on public policy are so rigorous as to inhibit foundations from any activities which might be construed as influencing legislation.

The proposed restrictions will surely force foundations to back away from all but the most noncontroversial, *status quo* types of philanthropy. Since most recipients of foundation grants are engaged in one way or another with public concerns which sooner or later become the subject of some kind of legislation, it would also become difficult, if not impossible, for such recipients to develop funding for such projects.

Of course, it may be argued that freedom for imaginative and innovative foundations is likewise freedom for other foundations to advocate regressive and repressive policies. We feel this is a chance the republic can afford and must take. If foundation or recipient activities which may influence the development of legislation are open, public and identified as to source, we believe legislators and their constituents would be able to judge the positions set forth on their own merits.

The nation would indeed be poorer if foundations were not free to finance the important research and experimentation that provide needed data and example for legislation without worrying whether their efforts might be construed "partisan" by opponents. In short, we do not see the need to exclude private foundations from the "free marketplace of ideas," even when some of those ideas might affect legislation.

We would also propose, Mr. Chairman, the elimination of the proposed tax of 7½% on foundation investment income, and its replacement by a minimal "user fee" sufficient to defray the actual cost of federal regulation of foundations. A tax on foundation income is, after all, simply a tax on the beneficiaries of foundations—not on the foundations themselves.

CHARITABLE CONTRIBUTIONS

On the main subject of this Committee's hearings this week, we are deeply troubled by some aspects of the bill as it passed the House of Representatives, not only because they would seriously reduce the voluntary support of churches, colleges, hospitals and other charitable institutions, but because these aspects of the bill suggest an ominous shift in public policy.

Hitherto, private generosity for the public good has been encouraged by the tax code. U.S. Treasury publication 561 (3-68), "Valuation of Donated Property," states this point well:

> "Our Federal government recognizes that gifts to religious, educational, charitable, scientific and literary organizations have contributed significantly to the welfare of our nation, and our tax laws are designed to encourage such giving."

The new policy embodied in portions of H.R. 13270 does not encourage such giving, but makes it more difficult.

We understand and approve the general direction of this effort at tax reform. We are aware that some well-to-do taxpayers have used certain provisions relating to charitable contributions to improve their own financial condition without greatly benefitting charity, and we approve the effort to limit such abuses.

But we are troubled by the tendency in the bill to *over-correct* and almost to penalize the taxpayer with higher-than-average income for contributing to charity. This is not apparent so much in any one section of the bill as it is in the cumulative effect of many sections, such as those on "allocation of deductions" and on "limitation on tax preference," which not only make it more difficult for the philanthropist to be generous, but almost impossible to explain to him what the effect of his contribution will be on his tax position. The result is postponement of his gift, while he consults his tax attorney, and in too many cases "a gift postponed is a gift lost."

It is vital that this Committee should understand the place of large gifts in modern charitable fund-raising. The day when effective institutions of religion, education, medicine, etc. could depend on the "impulse giving" of individuals is past. Well-planned and organized campaigns are necessary to make potential contributors aware of their role in supporting the charitable causes they tend to take for granted. The level of their support is determined by the initial "pace-setting" gifts with which the campaign is launched, since most of the subsequent contributions will follow in direct proportion to the "pace-setting" gifts, and the campaign as a whole cannot rise above its "source" in the initial contributions.

In capital funds programs, for instance, our denominational fund-raisers depend on just 10% of the donors to subscribe 50% of the goal (since, whatever they subscribe, the other 90% of the donors will no more than match). If the initial donors are inhibited in giving, the result is felt all down the line. That is, if the goal is a million dollars, the pace-setters are expected to produce half, or $500,000. If they give only $300,000 the best that can be expected is an overall total of $600,000 from everyone. In other words, the total loss is not just the $200,000 short fall of the pace-setters, but $400,000 for the whole campaign! Although it is the large givers who are most strongly affected by changes in the tax law, their example causes those changes to be felt throughout the donor population.

Today, private eleemosynary institutions are especially vulnerable to fluctuations in their voluntary support, since inflation has reduced their purchasing power without increasing the rate at which donors are giving, and many churches and related institutions have had to make extensive program and staff

cutbacks for this reason. If their ability to raise funds is not augmented but *reduced* by the impact of changes in the tax law, their very survival is jeopardized. Certainly they will not be able to respond to human needs in the way that the nation has come to expect of them. If the nation depends upon efforts in the private voluntary sector to help keep it healthy, vigorous, educated, responsive, purposive, then the nation needs to safeguard the vitality of the nonprofit institutions by preserving in its tax laws a climate of encouragement for charitable giving.

Perhaps the difficulty stems from lumping "charitable contributions" with "tax preferences" and "personal deductions", when they are essentially different from the other members of those classes. Unlike excess depreciation, hobby farm losses, tax-free interest on municipal bonds, depletion allowances or untaxed capital gains, charitable contributions do not derive from undertakings entered into primarily for the benefit of the taxpayer, but for the benefit of *others*. If his charitable contributions are discouraged by tax law, the recipients are the losers.

Therefore, we urge that "charitable contributions" be *excluded* from both the "allocation of deductions" and the "limit on tax preference".

The same is true of the classification of charitable contributions among "personal deductions" for purposes of the Standard Deduction. Such contributions are not essentially *like* medical costs, taxes, interest, casualty losses, etc., which are involuntary or for the taxpayer's own benefit, or both. When they are all lumped together in the Standard Deduction, the taxpayer loses any incentive to claim above-average contributions to charity, or even to *make* the contributions he does not need to claim the Standard Deduction.

We favor the separation of charitable contributions from the Standard Deduction, so that taxpayers who do not (otherwise) choose to itemize their deductions may claim the total of their charitable contributions, a total they must be able to substantiate upon request, as deductible apart from the Standard Deduction. If allowance is made under the enlarged Standard Deduction for average charitable contributions, perhaps only contributions above that level—up to 2% of adjusted gross income has been suggested—should be claimable above the Standard Deduction.

In respect to certain other changes proposed by the House bill—the tax treatment of arrangements in which churches and charities are beneficiaries of the remainder of principal after payment of annuities or dividends to a donor, or his designee for life—we appreciate the effort to prevent a double benefit for donors in the name of charity. As the House Ways aand Means Committee said in its Report:

> "* * * a charitable contribution deduction is not to be allowed for an income interest given to charity in trust, unless the grantor is taxable on the income of the trust, or unless all the interests in the trust are given to charity. The effect of this is to deny the double benefit of a deduction and exemption from taxation which is available under present law . . . This double benefit is an unwarranted tax advantage which is not necessary to provide an inducement to charitable giving" (p. 61).

The abuse has been virtually eliminated by administrative ruling. But if you conclude that a change in the statute is required to assure this result, we would support such revision. However, we urge retention in the law of the encouragement of charitable contributions by one or the other of these tax benefits—either exclusion from taxable income *or* deduction as a charitable contribution (perhaps at the option of the taxpayer)—but not *both*.

Other provisions of the Bill related to such arrangements are so restrictive and burdensome that they will almost certainly discourage donors from entering into these arrangements at all. This will greatly reduce, and may eliminate, charitable giving by a large group of prospective donors who are advanced in years and comfortably situated but not wealthy. The net effect would be to deny this source of funds to churches and charities.

Gifts of appreciated property, whether by such arrangements or by outright gift, should be encouraged. A charitable contribution is not comparable to the *sale* of property, and the taxpayer who *gives* property to a charitable cause should not be taxed as though he had received consideration in the transaction. He always has the option of *keeping* the property rather than giving or selling it, and if that is what the tax code encourages him to do, the loser will be the charitable causes which might otherwise have benefitted.

The National Council of Churches is not asking in this testimony for more consideration than present law allows, or even for preservation of the *status quo*. What we are asking is that the Congress not injure the whole array of charitable, religious and philanthropic institutions which have played such an important part in shaping and maintaining our Nation's vitality and character.

In conclusion, I should like to quote a portion of the Resolution on Tax Reform adopted by our General Board last week (and ask that the full text be incorporated in the record):

> "Philanthropy is not a 'loophole' and it should not be treated as such. It is a voluntary act designed to help others, and the philanthropist should not be penalized for undertaking it.
>
> "Tax policy which reduces the incentives to charitable giving would do the most harm to those that benefit the most—the young, the poor, the deserving—rather than handicapping those who are the benefactors."

We therefore urge your Committee to help undergird rather than undermine the vitality of the private sector.

National Council of the Churches of Christ in the U.S.A. Resolution on Tax Reform

ADOPTED BY THE GENERAL BOARD SEPTEMBER 12, 1969

The General Board of the National Council of the Churches of Christ in the U.S.A. favors tax reform which would distribute the burden of public expenditures more equitably across the nation, so that all are taxed in proportion to their ability to pay, and none of the affluent is able entirely to avoid paying income tax by use of tax shelters and loopholes.

In particular, the General Board recommends the following directions which it hopes tax reform will take:

1. Simplification of the Internal Revenue Code rather than increasing complication, so that it is no longer a mystery known only to experts, but a plain formula understandable to the average citizen.

2. Tempering the proposed regulation of private foundations so that, while it prevents abuses for personal or corporate advantage, it does not inhibit the constructive social experimentation made possible by such foundations. The General Board particularly urges:

(*a*) Deletion of the proposed restrictions on expenditures by foundations to support nonpartisan voter registration drives;

(*b*) Deletion of the proposed restrictions on expenditures by foundations to conduct studies and projects which could influence legislation.

(*c*) Elimination of the proposed tax of 7½% on foundation income, and its replacement by a miminal "user fee" sufficient to defray the actual cost of federal regulation of foundations.

3. Encouraging charitable contributions through deductibility provisions that are readily intelligible and that permit "pace-setting philanthropy."

The proposed legislation would have the effect of inhibiting contributions to the constructive nonprofit undertakings in the private sector—colleges, hospitals, churches, etc.—which serve the nation's good as well as do public, tax-supported institutions.

Philanthropy is not a "loophole," and it should not be treated as such in tax policy. It is a voluntary act designed to help others, and the philanthropist should not be penalized for undertaking it.

Tax policy which reduces the incentives to charitable giving would do the most harm to those that benefit the most—the young, the poor, the deserving—rather than handicapping those who are the benefactors. Therefore, the General Board urges:

(a) Separate treatment of "charitable contributions" befitting their difference from "tax preferences" and "personal deductions", which are involuntary or mainly for the taxpayer's own benefit or both;

(b) Retention, insofar as compatible with elimination of palpable abuses, of existing tax policy in regard to benefactions.

4. Allowing deductibility of charitable contributions that can be substantiated (possibly above 2% of gross income) for those who claim the standard deduction rather than itemizing deductions, so that some incentive is offered such taxpayers for above-average giving.

JOINT STATEMENT BY THE NATIONAL COUNCIL OF CHURCHES AND THE U.S. CATHOLIC CONFERENCE TO THE WAYS AND MEANS COMMITTEE OF THE U.S. HOUSE OF REPRESENTATIVES, MAY 2, 1969

Under existing law many types of organizations are granted exemption from the income tax. Certain exempt organizations, including charitable, educational, and some religious organizations, labor unions, business leagues, etc., are nevertheless subjected to tax upon their incomes from any unrelated business; and rents derived from debt-financed property (under leases for periods *in excess of five years*) are included in unrelated business taxable income. The tax upon unrelated business taxable income does not apply to churches, or conventions or associations of churches.

Such exemption makes available to churches a potential advantage over taxpaying organizations engaged in commercial business activities. The National Council of Churches and the U.S. Catholic Conference favor elimination of the specific exemption of churches from taxation on income from *regularly* conducted commercial business activities which are unrelated to their exempt functions.

Ingenious tax planning on the part of some exempt organizations which are subject to the unrelated business tax has enabled them to purchase a business on credit, lease its assets to an operator for *five* years or less, receive the business profits as rent and use such rent to pay the purchase price. The operator pays little or no tax, the exempt organization pays no tax, and the seller reports his profit at capital gain rates. This is the so-called "Clay-Brown" loophole. Being exempt from the unrelated business tax, a church desiring to engage in commercial business activity has not needed to resort to this technique. The National Council of Churches and the U.S. Catholic Conference also favor elimination of the "Clay-Brown" loophole.

In order to close the "Clay-Brown" loophole, the Treasury recommends that *all* exempt organizations, *including churches*, be subjected to taxation upon dividends, interest, rents, royalties and capital gains to the extent that such income is derived from debt-financed property. That proposal goes far beyond a cure of the abuse involved. We cannot and do not speak for the other exempt organizations, but with respect to *churches*, the NCC and the USCC believe that the "Clay-Brown" problem can be cured by taxing debt-financed *rents*. In this connection, rentals from property acquired for expansion, within or without the church neighborhood, and held for a reasonable period (10 to 15 years) before conversion to church use should not be subject to taxation.

The changes to accomplish these policies should carry provisions to: (a) provide adequate procedural safeguards to prevent governmental involvement in the internal and financial affairs of churches; (b) preserve the present exemption of churches from taxation upon passive or investment income, including royalties, dividends, interest, gains from the disposition of property, and rents (not rents to be taxable to the extent necessary to eliminate the "Clay-Brown" loophole); (c) protect from taxation the traditional functions of churches, including, among others, the printing and distribution of religious publications, with or without advertising, and customary fund-raising activities; and (d) provide a five-year grace period for the divestiture of *existing* unrelated business activities.

There have been suggestions for compulsory filing of financial data by all exempt organizations, including churches. Financial reporting by churches should be on a *voluntary* basis. We do not consider that it is desirable or wise for Government to *compel* disclosure of financial information by churches. Only those churches which conduct an unrelated trade or business should be obliged *by law*, to file tax reports and then only with respect to such business activity.

Suggestions for technical revisions to accomplish these changes are appended.

TECHNICAL REVISIONS

1. Amend section 511 of the Code to permit imposition ofthe unrelated business tax on church entities by deleting from Section 511(a)(A): "(other than a church, a convention or association of churches . . .)."

2. Amend the definition of Unrelated Business (Section 513) to insure that it does not include any activity related directly or indirectly to the tenets and traditional functions of a "church, a convention or association of churches," including among others, cemeteries, institutions for the care and training of the unfortunate, the printing and distribution of religious publications with or

without advertising, customary fund raising activities, and sale under church auspices of religious articles, pamphlets, etc. etc.

3. Amend the definition of a business lease [Section 514 (b) (1)] to eliminate the 5-year lease rule with respect to churches so that the unrelated debt-financed rental income of churches (Clay-Brown loophole) will be subject to tax. Redefine the definition of "business lease indebtedness" to insure that an indebtedness must be directly connected with rental property owned by a church.

4. Amend section 514 to provide that the unrelated business tax would not apply to real property acquired for eventual exempt use by a church.

There would be no tax in any case if the real property were actually applied to an exempt use within 15 years. On the other hand, if the property were not so applied within 15 years or was sold or disposed of after 10 years but within 15 years, tax would be due for all years after the 10th year. A facility need not be demolished if converted to an exempt church purpose within the 15-year period. Any property acquired and operated primarily for the production of rental income shall not qualify for exemption under this provision.

5. Amend Section 512 (or 513) to provide that a church would not be subject to the unrelated business tax if its gross income from unrelated business activities, adjusted by Sec. 512 (b), does not exceed $5000 in the case of a single congregation or $50,000 in the case of a diocese or a convention or association of churches.

6. Amend subtitle F (subpart B, part III, subchapter A, chapter 61) to provide (for information returns from seller) that with appropriate enforcement penalties sellers be obliged to report all sales or rental income-producing property to any charity; (a) when the property was sold on credit of which the seller had knowledge; and (b) whenever the property sold had a value of more than $50,000.

7. Amend Sections 7602 and 7605 to provide that an examination of church books and records would be made only when the Secretary or his delegate (not lower than Regional Commissioner) has reasonable cause to believe that a church is liable for the tax imposed by Section 511.

8. The Code shall be amended to provide that churches shall be required to file only Form 990T and only with respect to unrelated business income.

9. Provide that the amended unrelated business tax provisions at least in relation to churches apply: (1) five years after date of enactment for existing business, and (2) as of date of enactment for newly-acquired unrelated business activities.

A Policy Statement of the National Council of the Churches of Christ in the United States of America, Tax Exemption of Churches

ADOPTED BY THE GENERAL BOARD, MAY 2, 1969

"The following policy statement is an attempt to deal in non-technical terms with a limited area of tax policy which has a limited effect upon the well-being of society. It is not an attempt to assess the wider and more important ranges of general tax policy, where glaring inequities and gaping loopholes call for moral scrutiny by the churches at the earliest opportunity.

"No brief outline of general principles can do justice to the many unique situations in which the churches seek to minister to minority groups or special populations. If the principles set forth below should have an adverse effect upon any small, struggling churches in the inner city, the rural parish or the Indian reservation, or if the changing nature of the mission of the church should necessitate changes in the traditional concepts of tax-exemption, these policies, like the tax-codes themselves, are subject to revision by subsequent actions."

Christians are advised in Gospel and epistle to pay their proper taxes to the governing authorities (Matthew 17: 24, 22: 19, Romans 13: 6). Their obedience to God normally includes the obligations to pay their just share of the cost of public order, justice and service which God has appointed the authority of government to provide. Since this advice applied to an imperial Roman regime, how much more apt it is in respect to a government in which the citizens have a voice in the imposition and disposition of their taxes. Although individual Christians for reasons of conscience sometimes refuse to pay a particular tax, in general we recognize and uphold the power of taxation as the necessary mechanism by which the resources of society are directed to the ordering of its life and the solution of its problems.

The New Testament does not deal directly with taxation of Christians in their corporate activities, but its recognition of government's right to tax has implications for the church as a corporate structure in the modern world.

1. *Churches should ask of government (for themselves) no more than freedom and equality.*—For all members of society, Christians expect government to establish and maintain justice, order, defense, welfare and liberty, recognizing that in a democracy they and all others share in the responsibility which government discharges. They can also ask that the tax laws be administered and enforced fairly, equitable and expeditiously for all. For themselves and their churches, however, Christians ask no more from government than freedom to proclaim and bear witness to the Gospel: to preach, to teach, to publish, to worship and to serve in obedience to the will of God as it is made known to them. They ask of government protection of this freedom rather than direct support of their activities. Churches can ask exemption from taxation only if it is essential to protect their freedom or to afford equal treatment among them.

2. *Tax exemption can be a safeguard of the free exercise of religion.*—In the United States, it has been a basic public policy since the founding of the nation to accord to freedom of religion, speech, press and assembly a "preferred position" at the head of the Bill of Rights. Christians support and affirm this healthful arrangement of the civil order, not solely or primarily for themselves and their churches, but for everyone. Citizens, whatever their beliefs, should likewise appreciate the policy of our society that the free exercise of religion cannot be licensed or taxed by government. Property or income of religious bodies that is genuinely necessary (rather than merely advantageous) to the free exercise of religion should likewise not be taxed. Except for cases where exemption is required to afford equality with other eleemosynary institutions, such exemption should be confined to the essential facilities of the church and to the voluntary contributions of the faithful for the operation of the religious organization.

Such exemption has usually been regarded as a benefit but not a subsidy (in the sense of a cash outlay). There is no doubt that an organization is financially stronger with a tax exemption than without it, but the exemption does not convey to the organization funds it has not already attracted from voluntary contributors on its own merits. That is, a church cannot be built with a tax exemption alone. It is built by the donations of its adherents because they believe in its purposes. Exemption from taxation merely permits full use of their gifts for these purposes without drawing off a portion for the purposes of the whole society, which the members already support directly through the taxes they pay as individual citizens.

3. *Government may encourage voluntary organizations through tax exemption.*—Society is stronger and richer for the voluntary associations in which citizens voluntarily band together for constructive purposes independent of government support and therefore of government control. Exemption from taxation is one way in which government can and does foster such voluntary groups.

Christians may agree with other citizens in the civic judgment that it is good public policy not to tax nonprofit voluntary organizations. Though they may view religious organizations (especially their own) as something more than "nonprofit voluntary organizations," they may concede that it is an appropriate category in which government may classify them. If religious organizations are so classified and so exempted, they do not thereby enjoy any "special privilege" that is not shared with a broad range of generally meritorious secular groups.

4. *Tax Exemption may entail conditions which Christians cannot accept.*—Society may extend exemption from taxation to religious organizations on the condition that they meet certain tests, such as subscribing to loyalty oaths or refraining from political activity. Whatever may be the civil merits of this policy, Christians must determine independently whether the acceptance of such conditions will hinder their obedience to the will of God, and, if so, dispute the conditions. If tax exemption will tend to curtail or inhibit their efforts to affect public policy, churches may want to set up non-exempt agencies for political activity, using contributions that are not deductible.

5. *Taxation on real property of religious organizations.*—Depending upon the exigencies of the total tax base, states and municipalities may be more or less

generous in exempting the property of religious and other nonprofit voluntary organizations from taxation. Parsonages and parking-lots are taxed in some localities but not in others, at the discretion of the legislature. Religious organizations have accommodated themselves to a wide range of such provisions over the centuries, and will continue to do so. They should not begrudge paying taxes on auxiliary properties to help defray the costs of civil government. Certainly no exemption from property taxes should be sought for property owned by religious organizations which is not used primarily for religious (or other properly exempt) purposes.[1]

Churches should be willing to pay their just share of the cost of municipal services which they receive, such as fire, police, and sanitation services. Some do this through voluntary payments "in lieu of taxes;" others might offer to pay service-charges for the particular services they use.

6. *Deductibility of contributions to religious organizations.*—At present, citizens may deduct from their taxable income certain gifts and contributions to a wide variety of "charitable" organizations—religious, scientific, literary, humane, educational, etc. Where it is public policy to encourage contributions to voluntary nonprofit organizations in this way, religious organizations need not be arbitrarily excluded from that classification, nor given preferential treatment. If it becomes public policy not to allow deductibility for contributions, religious organizations should not claim a special privilege of deductibility.[2]

7. *Taxation of employees of religious organizations.*—Employees or other functionaries of religious organizations—lay or clergy—should not enjoy any special privilege in regard to any type of taxation. A clergyman properly pays his income tax just as other citizens do. If he receives a cash allowance for housing, that amount should be taxed as part of his income, as it is for laymen. Likewise, if he owns his own home, he should not enjoy any reduction of property taxes which is not equally available to his unordained neighbor. In case of cash allowance, only the non-recoverable costs, which do not include payments on principal, should be included; if property taxes and interest are included in the allowance, they should not also be claimed as deductions.

Whether the value of housing provided a clergyman by his church should be taxed is a question that should be resolved as part of the broader category of all employees who occupy residences furnished for their employer's conveniences. Equity might be better served if the dollar equivalent of all such housing was taxed as income. In localities where parsonages are exempt from school taxes, provisions should be made by local churches for payment of tuition or the equivalent. Whatever the solution, churches should compensate their employees for any losses incurred through the elimination of special privileges from the tax laws. We favor legislation requiring payment by churches and church agencies of the employer's contribution to social security tax for both lay and clerical personnel (except those bound by a vow of poverty).

8. *Unrelated business income.*—Churches constitute one of the few categories of otherwise tax-exempt organizations which do not pay taxes on the income from business enterprises they own which are unrelated to their exempt purpose. Churches should not be in a position where they are tempted to "sell" their exemptions to businesses seeking a tax advantage over taxpaying competitors. Therefore we urge that federal tax law be revised so that any "church or convention or association of churches" which regularly conducts a trade or business that is not substantially related to its exempt function shall pay tax on the income from such unrelated trade or business.[3]

9. *Disclosures.*—If they engage in unrelated business enterprises, churches should be required to file full financial reports with respect thereto. Even if not so engaged or required, it is good policy for churches voluntarily to make available to the public a complete, audited annual report of income and expenditures, assets and liabilities so that there is no mystery about the nature and extent of their operations.

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[1] Property obtained for expansion or relocation of churches (and the income derived therefrom, if any) may be exempted for a reasonable period of time until the church can expand or relocate on it.

[2] An existing statement by the General Board of Feb. 27, 1963, supports the deductibility of charitable contributions and opposes a "threshold" on such deductions.

[3] This revision could best be made by deleting from Section 511 of the 1954 Internal Revenue Code the parenthetical expression: "(other than a church, a convention or association of churches)," and making suitable provision as to "business lease" rental income which is debt-financed.

Those changes would not affect dividends, interest, annuities, royalties, capital gains, or rents from real property (except as already indicated).

We would not object to a delay of up to five years in applying such taxes to businesses now held by churches, nor to a "floor" deduction large enough to permit trivial or transitory activities by churches which do not rise to the level of serious competition with taxpaying trade or business.

The definitions and descriptions of "trade or business" "regularly" "conducts," and "substantially related" in Treasury Regulations, Paragraph 3256, seem generally reasonable and equitable, and do not appear to threaten the legitimate exercise of religious freedom if applied to churches.

Senator ANDERSON. Mr. Consedine.

STATEMENT OF WILLIAM R. CONSEDINE, GENERAL COUNSEL, U.S. CATHOLIC CONFERENCE; ACCOMPANIED BY ROBERT F. HANNON, ATTORNEY; AND JOHN W. AHERN, ATTORNEY

Mr. CONSEDINE. Mr. Chairman, members of the committee, my name is W. R. Consedine. I am the general counsel of the U.S. Catholic Conference. The USCC is an agency of the Catholic Bishops of the United States.

Senator BENNETT. May I interrupt to ask the chairman a question? Are we going to go on through today? The Republicans have their regular policy committee luncheon at 12:30. If you are not going to break at 12:30 we might as well go on through, and I will be happy to stay here.

Senator ANDERSON. We will try to break at 12:30.

Senator BENNETT. Mr. Chairman, I think we can go on hearing this witness and as far as I am concerned, I can stay here beyond 12:30, but if we are going to break soon thereafter—under any circumstances, I think we should make a decision now as to whether we are going to break at 12:30. I think we should go on and hear the witness.

Senator ANDERSON. Go ahead.

Mr. CONSEDINE. As I indicated, I am general counsel of U.S. Catholic Conference, and I am appearing in their behalf.

The purpose of the U.S. Catholic Conference is to unify and coordinate activities of the Catholic people of the United States in works of education, social welfare, immigrant aid, civic education, communication, and public affairs.

I am accompanied by Robert Hannon and John Ahern, both attorneys who have been technical assistants in the preparation of our position and testimony.

We are deeply grateful for this opportunity to appear.

Our statement is based upon three general principles.

With respect of exempt organizations in general and of churches in particular, the positions that USCC takes in this testimony rest on three general principles.

(1) Tax reform must respect and reflect the principle of separation of church and state as it has been developed in this country.

(2) The objective of tax reform legislation should be the elimination of inequities and abuses, not the reduction of the income of exempt organizations, much less the reduction of the income of churches or the imposition of unnecessary burdens.

(3) The vitality of voluntarism in the social welfare field should be preserved.

Separation of church and state.—Churches and other religious organizations do not stand on exactly the same constitutional and public policy footing as other exempt organizations. Religion has been given special treatment by the Federal Constitution and by the legislative policies of Congress. The fundamental reason justifying and necessitating this special treatment is the separation of church and state. USCC is opposed to any weakening of this separation.

The history of our country shows that fiscal separation has always been considered one of the most fundamental aspects of church-state separation. Government does not finance the churches, and churches do not finance the Government. It is fundamental in our system that Government cannot finance or tax religious activities, or may Government become intimately involved in the internal affairs of churches.

Certain functions of churches may not be taxed to support Government. Other activities not themselves religious in nature, may be taxed. The Government's position must be one of neutrality in respect of religion.

Religious organizations should not be required to file annual information returns. Financial reporting by churches should be on a voluntary basis. We do not consider that it is desirable or wise for Government to compel disclosure of financial information by churches. Only those churches which conduct an unrelated trade or business should be obliged by law to file tax reports and then only with respect to such business activity.

This policy was emphasized by the preceding speaker and was emphasized in the joint statement on tax policy approved by the U.S. Catholic Conference and the National Council of Churches. A copy has already been introduced in the record and a copy is attached to our statement.

I might add that this is the first time in history that the two major Christian bodies in the country have arrived at a joint statement and it might also be interesting to know that it is probably the first time that any group has ever come to the Congress and asked you to take away one of our exemptions.

The House bill has a provision requiring an information return which strikes at the very freedom of churches and religious organizations from intimate, governmental, and financial scrutiny. Churches and religious organizations do not make general appeals to the public for contributions. Their appeal primarily is limited to their congregations. The reports that churches make voluntarily to their members are one thing; compulsory reports to the Government are quite a different thing.

In the past, respect for the privacy of church affairs has been an essential part of Government policy. There appears to be no sufficient reason why this policy embedded in sound principle should be changed.

Ordinary investment income of churches should not be taxed merely because it happens to be debt-financed.—We agree that the Clay-Brown loophole and the variations of it should be closed and hopefully they will be as a result of this legislation, but the closing of these loopholes does not necessarily require a tax on the endowment income of churches.

The definition of unrelated business income of churches should be clarified.—Churches should pay taxes on unrelated business income—

and we have agreed to this change in the law. However, it should be made clear by this committee that the tax does not include any activity related directly or indirectly to the tenets and traditional functions of a church, including operation of cemeteries, institutions for the care and training of the unfortunate, printing and distribution of religious publications with or without advertising, fundraising activities and the sale under church auspices of religious articles and pamphlets.

There are certain provisions of the tax bill in respect of the repeal of the unrelated business exemption of churches that we applaud. One is the provision of a period of time for churches to divest themselves of these activities, and the second one, and very important, is a limitation imposed upon the audit of church books.

We would also suggest a de minimis rule to avoid unproductive administrative problems for both the Treasury and the churches. We suggest that no tax be assessed in the event the unrelated business gross income does not exceed $5,000 in the case of a single congregation or $50,000 in the case of a diocese, religious order or convention or association of churches.

Acquisition indebtedness should be clarified.—H.R. 13270 defines this term in such a way as to make it difficult to determine whether a church is actually engaged in a transaction which involves acquisition indebtedness. The indebtedness should be directly connected with unrelated income-producing property owned by a church.

Real estate acquisitions present a special problem for churches.—We also applaud another provision of the House bill which permits acquisition of debt-financed land acquired by a church for expansion purposes with or without the church neighborhood and not to be subject to taxation if the land is converted to an exempt use within 15 years.

Private foundations should not be taxed on investment income. We view this provision of H.R. 13270 as an unfortunate precedent. It not only would reduce the income available for charitable purposes; the imposition of an income tax on funds derived from a charitable trust has a potential which could change the whole philosophy of the Government with respect to charitable organizations. Viewing H.R. 13270 as a whole there is some cause for alarm that a shift in policy may be taking place with regard to this Nation's traditional policy of encouraging private philanthropy.

Limit on tax references.—It does not seem to USCC that a charitable contribution deduction is truly an item of "income" to the donor. He has given away a portion of his wealth to charity; society has gained, and his wealth has been diminished. Accordingly, USCC urges that appreciation on contributed property should be deleted from the items of tax preference income that would be subject to the limit on tax preferences provisions in H.R. 13270.

Allocation of deductions.—For the same reasons stated above the appreciation on contributed property also should be deleted from the list of preferences which would reduce a donor's other itemized deductions. Additionally, if charitable contributions are to be subject to allocation, this should be done only to the extent such deductions exceed $10,000. This would help assure that low- and middle-income families would not be discouraged from continuing their gifts to charity.

There are other treatments in our longer statement on gifts of partial interest that I will skip. Gifts have been adequately covered by preceding witnesses and I can pass them over.

The increased standard deductions permitted by H.R. 13270 should include an incentive for charitable giving.—We think the substantial limitation placed on tax incentives for giving by famlies of wealth requires some added incentives for giving by low- and moderate-income families if our charitable institutions are not to suffer great damage. There should be a provision for charitable contributions outside the standard deduction. Families using the increased standard deduction should be allowed a deduction for gifts in excess of 1½ or 2 percent of adjusted gross income.

There are some additional statements on the minimum standard deduction but I heard the bell and I really don't have to read them. They are in our more extended statement.

The CHAIRMAN. You are well represented here. May I say your entire statement is in the record. You have summarized it. Our staff has summarized it for us and it is a very fine statement. So I think you would be well advised, just like I would be well advised back in my debating days, once my time is up, to bring it to a close because when you trespass on time it tends to hurt you with the judge.

But you have got some good opinions and they will certainly be considered.

Mr. CONSEDINE. Thank you.

(Mr. William R. Consedine's prepared statement follows:)

STATEMENT OF WILLIAM E. CONSEDINE, GENERAL COUNSEL, UNITED STATES CATHOLIC CONFERENCE

SUMMARY

My name is W. R. Consedine. I am the General Counsel of the United States Catholic Conference. The USCC is an agency of the Catholic Bishops of the United States. Its purpose is to unify and coordinate activities of the Catholic people of the United States in works of education, social welfare, immigrant aid, civic education, communications and public affairs. I am accompanied by Robert F. Hannon and John W. Ahern, both attorneys who have been technical assistants in the preparation of our positions and testimony.

GENERAL PRINCIPLES

With respect of exempt organizations in general and of churches in particular, the positions that USCC takes in this testimony rest on three general principles:

(1) Tax reform must respect and reflect the principle of separation of Church and State as it has been developed in this country.

(2) The objective of tax reform legislation should be the elimination of inequities and abuses, not the reduction of the income of exempt organizations, much less the reduction of the income of churches, or the imposition of unnecessary burdens.

(3) The vitality of voluntarism in the social welfare field should be preserved.

SEPARATION OF CHURCH AND STATE

Churches and other religious organizations do not stand on exactly the same constitutional and public policy footing as other exempt organizations. Religion has been given special treatment by the Federal Constitution and by the legislative policies of Congress. The fundamental reason justifying and necessitating this special treatment is the separation of Church and State. USCC is opposed to any weakening of this separation.

The history of our country shows that fiscal separation has always been considered one of the most fundamental aspects of Church-State separation.

Government does not finance the churches, and churches do not finance the Government. It is fundamental in our system that Government cannot finance or tax religious activities, nor may Government become intimately involved in the internal affairs of churches.

Certain functions of churches may not be taxed to support Government. Other activities not themselves religious in nature, may be taxed. The Government's position must be one of neutrality in respect of religion.

Religious organizations should not be required to file annual information returns.—Financial reporting by churches should be on a voluntary basis. We do not consider that it is desirable or wise for Government to compel disclosure of financial information by churches. Only those churches which conduct an unrelated trade of business should be obliged by law to file tax reports and then only with respect to such business activity.

This policy is emphasized in the Joint Statement on tax policy approved by USCC and the National Council of Churches of Christ in the U.S.A., a copy of which is appended to our formal statement.

The House provision requiring an information return strikes at the very freedom of churches and religious organizations from intimate, governmental, financial scrutiny. Churches and religious organizations do not make general appeals to the public for contributions. Their appeal primarily is limited to their congregations. The reports that churches make voluntarily to their members are one thing; compulsory reports to the Government are quite a different thing.

In the past, respect for the privacy of church affairs has been an essential part of Government policy. There appears to be no sufficient reason why this policy embedded in sound principle should be changed. (See pages 8–11).

Ordinary investment income of churches should not be taxed merely because it happens to be debt-financed.—We agree that the Clay-Brown loophole and the variations of it should be closed and hopefully they will be as a result of this legislation, but the closing of these loopholes does not necessarily require a tax on the endowment income of churches. (See pages 12 and 13).

The definition of unrelated business income of churches should be clarified.—Churches should pay taxes on unrelated business income—and we have agreed to this change in the law. However, it should be clear that the tax does not include any activity related directly or indirectly to the tenets and traditional functions of a church, including operation of cemeteries, institutions for the care and training of the unfortunate, printing and distribution of religious publications with or without advertising, fund raising activities and the sale under church auspices of religious articles and pamphlets. (See pages 13, 14, and 15).

Churches should have a period of time for adjustments.—The Senate should retain the provisions of H.R. 13270 which give churches until January, 1976, to dispose of an unrelated business or place it in a tax status. (See page 16).

Churches should be protected from unnecessary audits of their books.—The Senate should retain the provision of H.R. 13270 that a church would be subject to audit only upon determination by the Secretary or his delegate (not below the level of the Regional IRS Commissioner) of reason to believe that the church owes a tax (See page 17).

The present de minimis rule should be increased for churches.—To avoid unproductive administrative problems for both the Treasury and the churches, we suggest that no tax be assessed in the event the unrelated business *gross* income does not exceed $5,000 in the case of a single congregation or $50,000 in the case of a diocese, religious order or convention or association of churches. (See page 18).

Acquisition indebtedness should be clarified.—H.R. 13270 defines this term in such a way as to make it difficult to determine whether a church is actually engaged in a transaction which involves acquisition indebtedness. The indebtedness should be directly connected with unrelated income producing property owned by a church. (See page 18).

Real estate acquisitions present a special problem for churches.—The Senate should retain provisions in H.R. 13270 that rentals from property on debt-financed land acquired by a church for expansion within or without the church neighbrohood will not be subject to taxation if the land is converted to an exempt use within 15 years. (See page 19).

Private foundations should not be taxed on investment income.—We view

this provision of H.R. 13270 as an unfortunate precedent. It not only would reduce the income available for charitable purposes; the imposition of an income tax on funds derived from a charitable trust has a potential which could change the whole philosophy of the Government with respect to charitable organizations. Viewing H.R. 13270 as a whole there is some cause for alarm that a shift in policy may be taking place with regard to this Nation's traditional policy of encouraging private philanthropy. (See pages 20 and 21).

LIMIT ON TAX PREFERENCES

It does not seem to USCC that a charitable contribution deduction is truly an item of "income" to the donor. He has given away a portion of his wealth to charity; society has gained, and his wealth has been diminished. Accordingly, USCC urges that appreciation on contributed property should be deleted from the items of tax preference income that would be subject to the Limit on Tax Preferences provisions in H.R. 13270. (See page 23).

ALLOCATION OF DEDUCTIONS

For the same reasons stated above, the appreciation on contributed property also should be deleted from the list of preferences which would reduce a donor's other itemized deductions. Additionally, if charitable contributions are to be subject to allocation, this should be done only to the extent such deductions exceed $10,000. This would help assure that low and middle income families would not be discouraged from continuing their gifts to charity. (See pages 24 and 25).

Treatment of gifts of partial interest in property should be clarified.—If the Senate decides to abolish the deduction for gifts of the use of property (fair rental value), we ask that H.R. 13270 be clarified so present tax treatment is continued for gifts subject to a retained life estate and for gifts of undivided interest in property. (See pages 25 and 26).

Life Income Gifts should retain their present tax treatment.—A great many taxpayers, particularly elderly persons, are anxious to make charitable gifts during their lifetime, but cannot afford to give up the income earned by their property. Such gifts would be unduly restricted by H.R. 13270 by failure to make provision for *gift annuity, life income contract* and *charitable remainder trust* plans currently in use. The tax benefits for these traditional forms of deferred giving should be retained (See pages 27, 28 and 29).

The increased Standard Deductions permitted by H.R. 13270 should include an incentive for charitable giving.—We think the substantial limitation placed on tax incentives for giving by families of wealth requires some added incentives for giving by low and moderate income families if our charitable institutions are not to suffer great damage. There should be a provision for Charitable Contributions Outside the Standard Deduction. Families using the increased standard deduction should be allowed a deduction for gifts in excess of 1½ or 2% of adjusted gross income. (See pages 30 through 34).

The Minimum Standard Deduction should be increased as provided in H.R. 13270.—USCC heartily supports this provision, particularly the decision to end the "low income phase-out" after 1960. The Senate should provide for continued sharing of the poor in tax relief contemplated for 1972 and beyond. The $100 minimum standard deduction for each dependent should be retained and added to the basic allowance of $1,100 provided in 1971 and thereafter. The ceiling should be raised to $2,000 so large families get full benefit from the increased minimum standard deduction. (See pages 35 and 36).

STATEMENT

My name is W. R. Consedine. I am the General Counsel of the United States Catholic Conference. The USCC is an agency of the Catholic Bishops of the United States. Its purpose is to unify and coordinate activities of the Catholic people of the United States in works of education, social welfare, immigrant aid, civic education, communications and public affairs. I am accompanied by Robert F. Hannon and John W. Ahern, both attorneys who have been technical assistants in the preparation of our positions and testimony.

The history of our income tax laws demonstrates the necessity for periodic revision and reform. Economic and social conditions change, creating the need

for equitable adjustments in such matters as the standard deduction and the tax treatment of the poor and elderly. Other experience under existing law has demonstrated unforeseen and unintended results which make it necessary for Congress to take remedial action.

HR 13270 and other proposals for tax reform are currently pending before this Committee. Some of the proposed revisions of the tax law are of great interest to the USCC because they promise more equitable tax treatment for low and middle income families and for the elderly. Others are of interest to USCC because they would affect the income of exempt organizations in general and of churches in particular, and would impose unnecessary burdens.

The concern of the American Bishops for the poor and the elderly is the obvious basis for the support of more equitable treatment of these categories of taxpayers.

With respect of exempt organizations in general and of churches in particular, the positions that USCC takes in this testimony rest on three general principles:

(1) Tax reform must respect and reflect the principle of separation of Church and State as it has been developed in this country.

(2) The objective of tax reform legislation should be the elimination of inequities and abuses, not the reduction of the income of exempt organizations, much less the reduction of the income of churches, or the imposition of unnecessary burdens.

(3) The vitality of voluntarism in the social welfare field should be preserved.

In order to illustrate the magnitude of the interest of the American Bishops in these areas effected by the bill and other proposals and importance of the contributions by American churches to the general welfare, I would like to give a brief survey of the work of the Catholic Church in the United States.

At the present time the Catholic Church is operating 834 hospitals in the United States which contain 156,838 beds (approximately 30% of the bed capacity for general hospitals in the country). In 1967 these hospitals had 5,446,675 admissions. The school system is of comparable size. In 1967 there were 10,603 parochial schools enrolling 44,143,150 students and 2,356 secondary schools enrolling 1,098,756 students. Additionally, there are 308 colleges sponsored by the Catholic Church with an enrollment of 433,960 students.

The institutional system in the welfare field is likewise substantial. For example, in 1968 there were 103 protective institutions with 8,110 students; 142 special hospitals and sanitoria with a bed capacity of 11,578; 239 orphanages with 21,237 resident children. Additionally, there were 25,188 foster homes operated in connection with Catholic Charities. The Catholic Church maintains 420 homes for the aged with 37,966 residents.

Today, this institutional system is confronted with challenges in the fields of health, welfare, education, urban housing and civil rights—challenges which must be met. It will take a substantial amount of money in addition to contributed services of many volunteers and religious personnel adequately to respond to the increasing tempo of the social challenge.

The money to support the activities of this institutional system must come from a cross-section of the people. Certain types of institutions rely on gifts from taxpayers in relatively high brackets. On the whole, however, the Catholic Church in this country and its institutional system relies primarily on contributions of people with relatively small incomes. This has been the principal financial support of the Catholic Church in this country and will continue to be unless it is dried up at its source by an adverse tax policy. In this connection we wish to emphasize the importance of patterns of giving. Long-range financing of church projects for the institutional system of the Catholic Church takes into consideration established patterns of contributions. The experience of the Catholic Church indicates that the small giver follows a pattern which gradually results in substantial contributions after a period of time.

SEPARATION OF CHURCH AND STATE

Churches and other religious organizations do not stand on exactly the same constitutional and public policy footing as other exempt organizations. Religion has been given special treatment by the Federal Constitution and by the legislative policies of Congress. The fundamental reason justifying and necessitating this special treatment is the separation of Church and State. USCC is opposed to any weakening of this separation.

This history of our country shows that fiscal separation has always been considered one of the most fundamental aspects of Church-State separation. Government does not finance the churches, and churches do not finance the Government. The separation of Church and State does not, of course, preclude the Government from cooperating with the secular services of church-related institutions in such fields as education, health and housing on the same basis as the Government cooperates with other exempt organizations. Nevertheless, it is fundamental in our system that Government cannot finance or tax religious activities, nor may Government become intimately involved in the internal affairs of churches.[1]

USCC does not contend that all existing church tax exemptions are matters of constitutional right. Where the tax is imposed on property and not directly on religious activities, Government has wide discretion under our Constitution to impose or not to impose the tax. As a matter of sound public *policy*, this discretion should be exercised in such a way as to preserve the historic *fiscal* separation of Church and State.

Neutrality is one of the cardinal values enshrined in the First Amendment. In the field of taxation, it might be argued that neutrality is impossible. Taxation hurts; exemption helps. This argument, however, confuses abstention with aid. In itself, the exemption is worthless. You cannot buy a chalice or build a church with an exemption. You cannot maintain a synagogue or support a minister with an exemption. The exemption becomes valuable only after voluntary contributions by church members have made possible the acquisition of property and services necessary for religious purposes. Without periodic voluntary contributions from their members, and without prudent management of those contributions, the churches would be penniless.

USCC firmly believes that continuation of most of the existing *exemptions* for churches and religious organizations is one of the best possible expressions of governmental neutrality towards religion. The aid that results to churches from such exemptions is a by-product of a policy of abstention, not the fruit of Federal favoritism. As the Supreme Court has indicated in its most recent Church-State decisions, indirect and collateral help or hurt to religion does not destroy the constitutionality of otherwise valid secular governmental programs.[2] It may seem paradoxical, but tax exemptions of churches have served the highest secular purpose: to keep the Government itself secular, neutral, and uninvolved with the internal affairs of churches.

OBJECTIVES OF TAX REFORM LEGISLATION

The objective of tax reform legislation should be the elimination of inequities and abuses, not the reduction of the income of exempt organizations, much less the reduction of the income of churches, or the imposition of onerous and unproductive burdens.

Exempt organizations, including churches, have not been paying taxes, but they have been saving the American people hundreds of millions of tax dollars every year. In the educational, medical, welfare, housing and social services they perform, churches and other exempt organizations make contributions to the general welfare that would cost billions of tax dollars to replace. Since many exempt organizations, and especially churches, have dedicated personnel working at well below the market value of their services, a dollar in the hands of these organizations can and does produce much more benefit to the public than a dollar in the hands of a Government compelled to purchase everything in the market place. It follows that any substantial diversion of exempt income used for governmental purposes represents a loss to the general welfare, not a gain. USCC is opposed to all tax reform proposals that have as their objective the substantial reduction of the income of exempt organizations.

MAINTENANCE OF VOLUNTARY EFFORT

One of the invaluable and laudatory characteristics of Federal tax legislation is the underlying philosophy designed to encourage charitable contributions to

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[1] *Murdock* v. *Pennsylvania* (1943), 319 U.S. 105; *Everson* v. *Board of Education* (1942), 330 U.S. 1, 15, 16; *People ex rel McCollum* v. *Board of Education* (1947), 333 U.S. 203, 210, 211; *Zorach* v. *Clauson* (1952) 343 U.S. 306, 312, 314; *School District of Abington* v. *Schempp* (1961), 374 U.S. 203, 222, 229; *Board of Education* v. *Allen* (1968), 392 U.S. 236.

[2] *McGowan* v. *Maryland* (1961), 366 U.S. 420, 442.

voluntary agencies. In the various amendments to our tax law, Government has never deviated from this salutatory principle. As a result of this philosophy, private agencies have played a significant role in the social welfare field. It has not been left to the sole province of Government. This dualism must be maintained for the benefit of welfare and for the benefit of our country. Accordingly, the USCC strongly urges that the Congress refrain from taking any action which would deviate from or minimize the philosophy of voluntarism.

SEPARATION OF CHURCH AND STATE; APPLIED TO H.R. 13270

Several provisions of H.R. 13270 as passed by the House are inconsistent with the principle of separation of Church and State.

1. INFORMATION RETURNS

Section 101(d) of the House measure (p. 57) would amend Section 6033 of the Internal Revenue Code which presently exempts religious organizations as well as certain other nonprofit institutions from the duty of filing information returns. The amendment would require that churches and all nonprofit institutions file an annual information return which would be made public. The returns would include such information as the organization's gross income, expenses, disbursements for exempt purposes, accumulations, balance sheet and the total amount of contributions and gifts during the year. In addition, the return would have to show the names and addresses of all substantial contributors, directors, trustees and the salaries of managers and highly compensated employees. The Secretary of the Treasury could exempt certain classes of organizations but such action would be within his discretion. Also, the Secretary would have discretion to require that such additional information be incorporated in the information return as the Secretary or his delegate may require. A penalty of $10 a day would be imposed for late returns. Additional penalties would be assessed for failure to file.

This proposed change in the law is contrary to our testimony in the House and to the Joint Statement of National Council of Churches and the United States Catholic Conference which was filed with the Ways and Means Committee of the House. A copy of this statement is attached hereto.

It should be emphasized that this provision has not been suggested by either the present or the past Administration.

There was no notice by the House Ways and Means Committee that it was under consideration during its deliberations on the bill.

There is no basis on which Congress can judge its desirability or feasibility as a matter of Government policy nor its impact on churches as a practical matter.

There is no knowledge of the extent it would intrude government into the internal affairs of churches.

There is no evidence of the extent the requirement will interfere in the internal voluntary relationship of church entities such as those between dioceses and religious orders.

The reports may be of doubtful legality under the taxing power.

There is no assessment of the expense to the churches in order to comply and no relationship to any valid recognizable governmental purpose.

We have already noted that churches and other religious organizations do not stand on exactly the same constitutional and public policy footing as other exempt organizations. Religion has been given a special treatment by the Federal Constitution and by the legislative policies of Congress. The reason is the constitutional separation of Church and State.

Financial reporting by churches should be on a *voluntary* basis. We do not consider that it is desirable or wise for Government to *compel* disclosure of financial information by churches. Only those churches which conduct an unrelated trade or business should be obliged *by law* to file tax reports and then only with respect to such business activity.

The House provision requiring an information return strikes at the very freedom of churches and religious organizations from intimate, governmental, financial scrutiny. Churches and religious organizations do not make general appeals to the public for contributions. their appeal primarily is limited to their congregations. The reports that churches make voluntarily to their members are one thing; compulsory reports to the Government are quite a different thing.

Inherent in this requirement is the principle of Government supervision which has always been inconsistent with a harmonius relationship between Church and State. In the past, respect for the privacy of church affairs has been an essential part of Government policy. Consequently, churches have not had to make reports to Government concerning their financial status. There appears to be no sufficient reason why this policy embedded in sound principle should be changed.

The Catholic Church, for example, with its varying modes of tenure of property, its complex corporate structure, its familial financial arrangements between dioceses and parishes, its complex arrangements between religious orders and diocesan properties, its unique solutions of a commingling of autonomous entities under internal canonical concepts of control and discipline, poses monumental tasks both for the Government and the Church.

Government regulation in this respect would affect more than reporting--it must, in many instances, affect the interrelationship of various entities within the Church. A highly complex and workable structure would have to be altered to conform to a regulatory mold imposed by the Federal Government.

Additionally, the reporting requirements impose a direct financial burden on churches. A substantially sophisticated system of accounting would have to be developed in order to comply with the minimal demands of the law. Such a system would involve considerable expense, an expense which would have the same financial burden as a tax. Both the sanction and the burden would be present.

Of course, if a church engages in unrelated business activities it should make the appropriate report with respect to these activities. In such a case it implicitly waives the immunity. Where this element is not present the exemption of religious organizations presently contained in Section 6033 of the Internal Revenue Code must be retained. Sound constitutional and practical considerations dictate such a position.

2. UNRELATED BUSINESS INCOME

a. Tax on debt financed passive income

Another aspect of HR 13270 which deeply involved the Church-State relationship is the imposition of an unrelated business tax on such debt financed income as interest, dividends and royalties.

The National Council of Churches and the United States Catholic Conference specifically requested that the exemption of churches from the unrelated business tax be eliminated but at the same time we also contended that the unrelated business tax should not be imposed on ordinary investment income of churches merely because it happened to be debt financed. (See attached copy of the NCC-USCC statement).

We agree that the Clay-Brown loophole and the variations of it should be closed and hopefully they will be as a result of this legislation, but the closing of these loopholes does not necessarily require a tax on endowment income of churches.

Originally, this proposal contained in the 1965 Treasury Report was based on the concept that exempt organizations should be kept dependent for income on annual contributions and the management of debt free resources that they already possess. (Note: Page 26, Tax Reform Studies).

USCC rejects the premise on which this proposal is based. Government should favor the growth of exempt organizations generally and certainly should not interfere unnecessarily with the growth of churches. Credit is an essential part of American economic life, and the House Bill would severely restrict churches in their proper use of credit. The abuses inherent in the Clay-Brown [8] type of situation can be cured. USCC is heartily in accord that they should be cured. The pending proposal, however, goes beyond a solution of those abuses and unnecessarily intrudes on internal affairs of churches. Accordingly, we urge that ordinary investment income of churches be exempted from this portion of the bill whether or not debt financed.

c. Definition of unrelated business income

The Joint Statement of the National Council of Churches and the United States Catholic Conference contained a request the unrelated business income be defined in such a way that it does not include any activity related directly

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[8] *Commissioner of Internal Revenue v. Clay-Brown* (1965), 380 U.S. 568, 85 S. Ct. 1162, 14 L. Ed. 2d 75.

or indirectly to the tenets and traditional functions of a church including especially cemeteries, institutions for the care and training of the unfortunate, printing and distribution of religious publications with or without advertising, fund raising activities and the sale under church auspices of religious articles and pamphlets. The definition of the term "unrelated business" has been developed in a context which would not include churches and their traditional functions since they have been exempt from the unrelated business tax under the terms of Section 511. Nevertheless, it is our position that Congress should provide definite guidelines or standards so that there will not be an uncritical application of the term "unrelated business" as it applies to functions that are and have been intimately associated with churches. Such guidelines would eliminate an area of uncertainty and would also foreclose an administrative definition of religion and its legitimate functions. This is a real danger in the field of unrelated business activities, a situation which has certain critical First Amendment implications.

For example, in justifying the need for extending the tax on unrelated business income to include churches, the House Committee report, on page 47, cites as an example of a business activity of a church, the operation of a chain of "religious bookstores." We submit that the printing, distribution and sale of religious publications is a related function of a church. The mere fact that a profit making, non-religious corporation may be engaged in the same activity in competition with a church does not alter the fundamental fact that a church which seeks to spread religion and the Word of God through the printing and sale of religious books is truly engaged in a related, religious function. Accordingly, we urge this Committee to include in its report on H.R. 13270 appropriate guidance and restrictions for the Treasury Department.

c. Advertising income

Another area which should be given more attention if the church exemption is deleted is the section in this Bill on advertising. (Section 513(c) as added by Section 121(c), see page 93). This section is designed presumably to support the Treasury regulation issued two years ago which defines as unrelated business income the income of an exempt organization from the sale of advertising space or services even though the advertising is related to the exempt purpose of the organization and whether or not the publication itself is related. The Treasury regulation was adopted at a time when churches were exempt from unrelated business activities. But under the terms of the House bill, religious publications, as indicated above, would be included even if all the advertising relates to such subjects as church vestments and other items used only in churches. Admittedly, under present Treasury regulations, the publication must show an overall profit before the tax applies. This would mitigate the impact, but it still would leave a possible situation where the Federal Government might be levying a tax on, and collecting money from a church which through the printing press is engaged in a religious purpose. Even though there may be no tax impact, the accounting cost to demonstrate that fact would be burdensome. Accordingly, it is urged that all church publications which carry out a religious purpose exempted under Section 501(c)(3), should continue to be exempted from the provisions of the tax on advertising.

Finally, the new Section 513(c) would provide that "for the purpose of this section the term 'trade or business' includes any activities which are carried on for the production of income from the sale of goods or the performance of services." Moreover, it is stated that an activity does not lose its identity as a trade or business merely "because it is carried on in a larger aggregate of similar activities or within a larger complex or other endeavors which may or may not be related to the exempt purposes of the organization."

This language is so broad that it is impossible to determine what would be the limits of the Treasury's power. There is no doubt about the application of the language to advertising but certainly it could apply to many other areas of activity. We strongly urge that this language be revised with a view towards clarifying the precise meaning of this section. Otherwise churches and other church related organizations could be subjected to a tax merely on the basis that their activity involves a "performance of services or sales of goods" which may or may not involve a trade or business.

Other Unrelated Business Provisions

1. MORATORIUM FOR CHURCHES

In the case of a church the unrelated business tax will not apply for taxable years beginning before January 1976 (Sec. 121(B)(2)(C) amending Sec. 512(b) for a trade or business if such trade or business was carried on by such organization prior to May 27, 1969. Unrelated business acquired after May 27, 1969 will be taxable on acquisition. We urge that this provision, be retained for a period of adjustment is necessary in order to enable churches to make an appropriate accommodation to the law.

2. LIMIT ON AUDITS OF CHURCHES

The House Bill also contains a special provision to protect churches from unnecessary audits (Sec. 7605, as amended by Sec. 121(f), p. 108)). The books of a church would be subject to audit only upon the determination by the Secretary or his delegate (not below the level of the Regional IRS Commissioner) or reason to believe that the church owes a tax. The church would have to be notified in advance. This provision recognizes the status of a church and its proper relationship to Government.

3. CERTAIN PASSIVE INCOME TAXED

A new section (Section 121(b)(2)(c), p. 90) modifies Section 513(b) of the Internal Revenue Code to close an existing loophole by taxing interest, annuities, rents and royalties (but not dividends) derived by an exempt organization from a controlled corporation (80% or more of stock owned by the exempt organization). If this provision is interpreted strictly in accordance with Section 368(c) of the Code to which it makes reference for the purpose of defining control, it will not adversely affect many churches or charitable organizations.

4. DE MINIMUS RULE

The imposition of the unrelated business tax on churches may affect them in ways which they currently do not anticipate. Moreover, churches undoubtedly have at various intervals income from activities which might be designated as unrelated business. It is suggested no tax be assessed in the event the unrelated business gross income does not exceed $5,000 in the case of a single congregation or $50,000 in the case of a diocese, religious order or convention or association of churches. At the present time, the law provides an exclusion for all exempt organizations up to $1,000 of unrelated business gross income. That figure was adopted in 1950. It is no longer realistic. In view of the extension of the unrelated business tax to new organizations and of the limitation on exclusions in Section 512, the above mentioned figures of $5,000 and $50,000 would seem to be more realistic both from the standpoint of Treasury and the individual church.

5. ACQUISITION INDEBTEDNESS

Though the USCC and NCC have supported in substance the proposed legislation to close the Clay-Brown loophole, there is an area of concern with respect to the definition of the term "acquisition indebtedness." This term was defined (p. 100 of the bill) in such a way as to make it difficult to determine whether a church is actually engaged in a transaction which involves acquisition indebtedness. We are of the opinion that the definition should be clarified to insure that an indebtedness must be directly connected with income producing property owned by a church and to insure that related indebtedness would not be attributed to acquisitions of unrelated property. The House bill provides that there is acquisition indebtedness if the "indebtedness incurred after the acquisition or improvement of such property if such indebtedness would not have been incurred *but for* such action or improvement and the incurrence of such indebtedness was reasonable at the time of such action or improvement." The concept of *reasonably foreseeable* is not a satisfactory test and could involve an investigation into the motives of church officials with respect to the incurrence of an indebtedness. For example, if a church should purchase an apartment for cash and two years later borrows money, Treasury officials might contend that there is a relationship between the incurring of the indebtedness and the purchase of the apartment. This

may or may not be true. It is therefore suggested that a more precise test be adopted.

6. FIFTEEN-YEAR RULE RELATING TO REAL ESTATE ACQUISITIONS

The House bill includes a provision that rentals from property on debt financed land acquired by a church for expansion within or without the church neighborhood will not be subject to taxation if the land is converted to an exempt use within 15 years. It is further provided that if buildings are on the said property there must be an intention to demolish them for the purpose of the church use. We urge that it be retained as churches frequently must purchase property substantially in advance of actual use. The mobility of people, industrial development, real estate values and many other factors influence these decisions.

PRIVATE FOUNDATIONS

The House Bill establishes a new category of 501(c)(3) organizations (religious, charitable and educational) to be known as "private foundations." Among other things a tax of 7½% on annual investment income would be imposed. The net gain to the Treasury from this tax is estimated at 65 to 75 million dollars. It is not clear whether this tax is designed to raise revenue primarily or is intended as a regulatory measure. Nevertheless, it is a tax on income and, as such, it is the first time that the Federal Government has imposed a direct tax on the income of a tax exempt organization. We view this as an unfortunate precedent.

The imposition of an income tax on funds derived from a charitable trust has a potential which could change the whole philosophy of the Government with respect to charitable organizations. Viewing H.R. 13270 as a whole, there is some cause for alarm that a shift in policy may be taking place with regard to this Nation's traditional policy of encouraging private philanthropy. When the Congress shifts its emphasis from corrective legislation to the imposition of a tax on charitable income, then it is time to take a second look at the legislation to determine whether we are undergoing a major shift in the Government attitude toward philanthropy. As we stated at the outset, the underlying philosophy of Federal tax to encourage voluntary effort in the solution of social problems is not only in the national interest but one of the essential strengths of democracy.

We trust that the whole question of the proposed tax on foundations will be resolved in light of this philosophy, and that the Senate will reject the tax imposed by H.R. 13270.

In his testimony of September 4, the Secretary of the Treasury proposed that the 7½% tax in H.R. 13270 should be reduced to 2% and considered in the nature of a service, or regulatory assessment. We do not agree. A 2% tax on investment income of a private foundation is just as surely a tax on funds and income permanently set aside for a tax exempt charitable purpose as would be a 7½% levy or a 10%, or 50% levy. Regardless of the rate, the result is the same. The Federal Government would be placing a direct tax on charitable income.

CHARITABLE CONTRIBUTIONS

The provisions in the income tax law for the deductibility of charitable contributions have proven of great assistance to the fund appeals of all exempt organizations, including the churches. Tax deductibility has become an important part of the psychology of giving. As a result, USCC is greatly concerned with the Treasury proposals and the provisions of H.R. 13270 that would alter existing deductibility provisions.

It is recognized that a tax reform program which seeks to eliminate opportunities for personal gain from the use of present personal income tax deductions for charitable gifts may result, as a by product, in a reduction of income for tax-exempt charitable organizations. USCC does not object to this so long as care is taken to insure that it is the opportunity for personal gain that is being eliminated and not the opportunity for charitable giving. In this context, and for the purpose of emphasis, it is well to repeat what we have said earlier—*USCC is opposed to all tax reform proposals that have as their objective the substantial reduction of the income of exempt religious, educational and charitable organizations.*

We do not consider such a reduction to be the objective of H.R. 13270 in the repeal, over a period of years, of the provisions for unlimited charitable deduc-

tions. We agree that repeal of this provision should be accompanied by an increase in the maximum deduction for charitable contributions from the present 30% to 50% of adjusted gross income (or contribution base). This should encourage increased charitable giving by a significant portion of the population and perhaps offset the loss to charity from repeal of the unlimited deduction provision.

In 1966 apaproximately 41,000 taxpayers made contributions in excess of 30% of adjusted gross income. The Treasury estimates that the higher ceiling would affect 48,000 taxpayers in 1969, Thus, H.R. 13270 contains a positive incentive to increased charitable giving; but it also contains certain provisions which suggest that certain forms of giving are to be discouraged in the future. We shall discuss some of the provisions in more detail.

LIMIT ON TAX PREFERENCES

The concept that all individuals who enjoy substantial total income should pay a tax on at least one-half of that income, even though derived entirely or in part from otherwise tax exempt sources is one that has met with great popular approval. USCC has no desire to oppose such a policy, whether it takes the form of a "minimum income tax" or a "limit on tax preferences." We do, however, seriously question the items of "tax preference income" included in H.R. 13270. It does not seem to USCC that a charitable contribution deduction, allowed by the tax code, is truly an item of "income" to the donor. He has given away a portion of his wealth to charity; society has gained, and his wealth has been diminished. Thus, USCC joins Secretary Kennedy in urging that charitable contribution deductions for gifts of appreciated property be deleted from the items of "tax preference income" that would be subject to the limit on Tax Preferences in H.R. 13270. Any tax shelters which presently may result from gifts of appreciated property would be adequately curbed by other provisions of H.R. 13270 which, (1) abolish unlimited charitable deductions; (2) place a limitation of 30% of adjusted gross income on the deductibility of gifts of appreciated property; (3) other limitations on deductions for gifts of appreciated property; and (4) require that personal deductions be allocated between taxable and non-taxable income.

ALLOCATIONS OF DEDUCTIONS

The Treasury has reported that some wealthy individuals with large amounts of tax-free income have been able to avoid all, or nearly all, tax liability by charging all of their personal deductions, including charitable contributions, against taxable income. Surely, this was not the intent of Congress in making provisions for charitable contribution deductions. USCC would agree that tax justice requires some remedial action. Care must be exercised that remedial action does not have an unintended result of destroying recognized, socially desirable tax incentives for charitable giving. We fear that may occur in the provisions of H.R. 13270 for Allocation of Deductions.

H.R. 13270 seeks to correct the situation of high-income individuals who pay little or no tax by disallowing a portion of certian personal deductions when an individual has "tax preference income" in excess of $10,000. As with the limit of Tax Preferences, the list of tax preference items includes charitable contribution deductions attributed to appreciation in value of property given to charity. Again, USCC would contend that such gifts do not represent tax-free income to the donor. They should not be included in "tax preference income" for either limit on Tax Preferences or Allocation of Deductions. Additionally USCC is concerned that the inclusion of *all* charitable contributions in the list of allocable deductions may have a severe adverse effect upon charitable giving in cases where charitable deductions are not the reason why an individual is able to avoid tax liability. Therefore, it is suggested that if charitable contributions are to be made subject to allocation, this should only be done to the extent such deductions exceed $10,000. Such a provision would help assure that low and middle income individuals would not be discouraged from continuing their contributions to charity.

GIFTS OF PARTIAL INTEREST

H.R. 13270 (Sec. 201 (a)-(8). Page 121) provides that where a taxpayer makes a contribution of less than his entire interest in property to, and not in trust for, a charitable organization a deduction is not to be allowed under

Sec. 170(b) for the said contribution. The Committee report makes special reference to the contribution of the use of property for a period of time.

This language could be interpreted to deny a charitable deduction for a gift of real estate subject to the donor's retention of a life estate. Also the language could be interpreted to deny a deduction for a remainder interest gift in real property, as well as a gift of a divided interest in real or personal property.

Presumably, the intent is to deny a charitable deduction for the fair rental value of property which a donor allows a charity to use rent free. If the Senate decides to abolish the deduction for gifts of the use of property (fair rental value), we ask that H.R. 13270 be clarified so that present tax treatment is continued for gifts of real property subject to donor's retained life estate and for gifts of undivided interest in property.

LIFE INCOME (DEFERRED) GIFTS

A great many taxpayers, particularly elderly persons, are anxious to make charitable gifts during their lifetime to institutions and causes to which they have a special attachment. Many of these individuals cannot afford to relinquish the income earned by their property, so that they have followed a practice of giving their securities and other property to charity while retaining a life interest. On their death, the securities and property are owned outright by the charity. This is the area of giving known as life income gifts (so-called deferred giving) which a growing number of organizations have solicited and have come to depend upon.

The experience of one national Catholic agency which has been active in this field discloses that its program is definitely used by the middle income group in our society. For example, during the year 1969, gift annuities to this agency, funded by appreciated securities, had an average fair market value of only $15,000. We cite this example merely to impress upon the Congress that restrictions contained in H.R. 13270 in regards to life income gifts will have an adverse effect upon people of relatively modest means and there is more involved in this area than persons of extreme wealth.

There are three types of life income gifts which we fear will be restricted unduly and will be unnecessarily discouraged by the provisions of H.R. 13270. These are: charitable remainder trusts, life income contracts and charitable gift annuities.

(1) *Charitable Remainder Trusts*—Present law provides there is no capital gain on the transfer of appreciated property to fund a charitable remainder trust; nor is there a capital gain if the property transferred is later sold by the trust and the gain permanently set aside for charity. We ask that these rules be retained.

Abuses in the investment policies of these trusts are rare and means are now available to curb any such abuses. Certainly, the ordinary responsibility imposed by law upon trustees should serve as sufficient assurance that the Corpus of a charitable remainder trust would be adequately conserved for the charitable beneficiary.

H.R. 13270 allows no *estate tax* charitable deduction for a charitable remainder interest in a trust, unless it is a "unitrust" or "annuity trust." This change in the estate tax would apply to trusts created before the Bill's enactment. Thus, the estate of a donor who created an irrevocable trust years ago, but who dies after the Bill's enactment, would lose the estate tax charitable deduction under the types of trust currently in common usage.

We believe this provision of H.R. 13270 would result in great hardship. The retroactive effect is so harsh that we believe that any such change in the law should only apply to charitable remainder trusts, life income contracts, and remainder real estate gifts made *after passage* of the Bill.

Where a new trust format is adopted, as contemplated by H.R. 13270, or the traditional charitable remainder trust is retained, we propose that the charitable deduction for gifts of appreciated property be based on the fair market value at the time the trust is created, rather than requiring the donor to base his deduction upon his cost or to pay a capital gain if he elects to use the fair market value. We also propose that capital gains incurred by the trust and permanently set aside for charity not be taxed, as present law provides. To tax the capital gains of such a trust amounts to taxing the charity because the tax would come out of the trust principal.

(2) *Life Income Contracts*—H.R. 13270 makes no provision for life income contracts. Additionally, no charitable deduction is to be allowed for life income contracts created after April 22, 1969, even though there was no adequate warning that H.R. 13270 would impose such a deadline.

The life income contract makes charitable remainder gifts available to a donor of modest means who cannot afford to fund a separate trust. This is accomplished by placing a donor's irrevocable gift in a pooled fund maintained by the charity. The donor receives as life income his appropriate share of the earnings of the pooled fund. We ask that present law covering life income contracts be retained. To tax the capital gains incurred by existing life income contract pooled funds would create great difficulties in administration and be unfair to the many thousands of charitable individuals of modest means who have chosen this method of making their gifts.

(3) *Charitable Gift Annuities*—When a donor transfers money or appreciated property to a charity in exchange for a promise to pay him a fixed income for life, the donor makes a substantial gift since the rate of return is lower than that offered by a commercial insurance company. Therefore, we ask that present tax treatment be continued when money or property is contributd for a charitable gift annuity.

Under H.R. 13270, we fear that transfer of appreciated property for a gift annuity could be treated as a "bargain sale." That may not be the intent of H.R. 13270 in the provisions regarding "bargain sales." To avoid any doubt, we ask that any provisions in the area of "bargain sales" specifically provide that the transfer of appreciated property in return for a gift annuity is not to be treated as a "bargain sale."

INCREASED STANDARD DEDUCTION

As a measure of tax relief for low and middle income families, and as an effort to simplify tax reporting and administration, the increased standard deduction contained in H.R. 13270 is to be commended.

When an increase in the standard deduction was first proposed by the Treasury, recognition was given that the resulting shift of a large number of low and middle income families from itemization of deduction to the standard deduction would have an adverse effect on charitable contributions since some of the tax benefit which accrues to those who itemized their deductions is not available to those who use the standard deduction. To offset this effect, the Treasury proposed to permit those who use the standard deduction to claim deductions for charitable contribution in excess of 3% of adjusted gross income. USCC is disappointed that this feature of a charitable deduction outside the standard deduction is not included in H.R. 13270. We think there is an even greater need for it as a result of the substantial limitation placed on tax incentives for charitable giving by families of wealth and high incomes. If our charitable institutions are not to receive as much support from the wealthy, then we must increase the incentives for giving by low and middle income families.

In its Tax Reform Studies and Proposals of February 5, 1969, the Treasury indicated that 53% of the taxpayers use the regular standard deduction and that if the standard deduction is increased to 14% of adjusted gross income, 80% of the taxpayers will use this method. The House Committee report estimated that the proposed increase to 15%, with ceiling of $2,000, will result in 70% of taxpayers using this method. Both reports agree that the shift of itemizers to users of the standard deduction will be concentrated in the under-$15,000 income group which includes the great bulk of American families.

It is precisely this group of families upon whom the churches rely for contributions. Certainly, the group of taxpayers who are the main sources of financial support for the Catholic Church and its institutions, particularly the parochial schools, are to be found among those who will be shifting from itemized deductions to standard deductions. Such a development obviously would interfere with the established psychology of giving.

Admittedly, it is difficult to estimate with any degree of precision the loss of income to charity which will result from an increase in the standard deduction. Tax deductibility is not the only motive of charitable contributors. In its report of February 5, the Treasury estimated that its program could, on balance, reduce charitable contribution by an amount of $100 million to $300 million. We believe this estimate to be extremely conservative, much too low. In any event, H.R. 13270 does not incorporate all of the proposals of the Treasury in its February 5

report. H.R. 13270 does incorporate several such recommendations which would, by Treasury's own statement, reduce charitable contribution, and only one (increase of allowable deductions from 30% of A.G.I. to 50% of A.G.I.) which is designed to increase the incentive for giving.

The major omission on the side of *deterrents* to giving is the 3% threshold on deductibility of itemized charitable contributions. USCC applauds this decision by the House.

The major omission on the side of *incentive* to charitable giving is the contribution outside the standard deduction (COSD). USCC deplores this omission and warns that H.R. 13270 as it passed the House is heavily weighted toward reduction of incentives for charitable giving.

Accordingly, USCC renews the request made in our testimony before the House Committee—the proposed increase in standard deduction should be accompanied by an allowance for deductions outside the standard.

The Treasury report of February 5 suggested allowing deductions outside the standard deduction for contributions in excess of 3% of adjusted gross income. At the same time the Treasury admitted that users of the standard deduction currently allocate to contributions an average of 3% of *after-tax* income. Thus, the Treasury proposal could be virtually meaningless at the 3% figure.

USCC has suggested, and now repeats, that the restrictions on charitable giving by the wealthy incorporated in H.R. 13270 should be accompanied by a meaningful, positive incentive for the less-well-to-do. These families using the increased standard deduction should be allowed a contribution deduction for gifts in excess of 1½% or 2% of adjusted gross income. Without such an incentive, H.R. 13270 could result in disaster for the American concept of voluntary, private charity.

In the case of the Catholic Church, the already severe financial burden of maintaining its parochial school system would be increased. It is a well-documented fact that one out of every seventeen elementary school children is in a non-public school and that 90% of the children in these schools are in Catholic parochial schools.

It is also a well-known fact that due to the increased costs, teachers' salaries and other related items, it is becoming more difficult to maintain these schools, for they are supported primarily by contributions. The level of the contributions must be increased in order to provide the best possible education for those attending the parochial schools, otherwise a large number will be enrolling in the public schools and will therefore substantially increase the local tax burden. For example, from the school year 1967–68 to the school year 1968–69 there was a decrease of 4.6% enrollment in Catholic high schools and a decrease of 2% in elementary schools. Most of the children transferring from the parochial schools are enrolled in the public schools with a consequent increase in the tax burden. This situation will continue because of the increasing cost of operating a parochial school. During the current school year 44.4% of the total teaching staff in parochial and elementary schools consisted of lay teachers. In high schools 40.9% of the teaching staff were laymen. Additionally, the lay teachers in our school systems are now getting substantially the same amount of money which their counterparts receive in the public school system. Accordingly, any change in the tax structure which discourages contributions certainly will make it extremely difficult to support the parochial school system at its current level.

Finally, your attention is called to the fact that throughout the Nation there have been various fund drives to support projects sponsored by the Catholic Church. Many people have pledged to give certain amounts. The fulfillment of these pledges is conditioned on the assumption that the tax laws with respect to contributions will remain relatively stable.

MINIMUM STANDARD DEDUCTION

USCC is particularly pleased with the increase in the minimum standard deduction which promises to halt the reprehensible practice of levying a tax on individuals and families with income below the poverty level.

H.R. 13270 would change the present *minimum standard deduction* to a *low-income allowance* amounting to $1,100. The purpose is to remove from the tax roles those families and individuals with incomes below the "poverty level" and to reduce the tax liability of those individuals and families in the under-$7,000 annual income level who are fighting a losing battle against the rising cost of living.

USCC heartily supports this provision of H.R. 13270, particularly the decision to end the "low-income phase-out" after 1970. We were not satisfied with the Treasury proposals of February 5, nor with the revision made by the new Administration. H.R. 13270 is a decided improvement over both Treasury suggestions, and its provisions should be retained by the Senate.

In addition, the Senate should make provision for a continued sharing of the poor in the tax relief contemplated for 1972 and beyond by H.R. 13270. This can be done by continuing the present provision of a $100 extra minimum standard deduction for each dependent of a low-income taxpayer. This can be done by providing that in 1972 and thereafter the minimum standard deduction will be $1,100 for each taxpayer, plus $100 for each dependent up to the maximum $2,000 which will be allowed by the increased standard deduction. Most of this additional tax relief would be given to families with income of $7,000 a year or less. Surely, no group is more in need or more deserving, of tax relief than the "working poor." Failure to make this change in H.R. 13270, or adoption of the Treasury's revised "low-income phase-out" along with President Nixon's welfare reform could result in the strange situation of the Federal Government supplementing the income of a poverty-stricken family, while at the same time taxing the family on its earned income.

Head of the household treatment for single persons

There is a significant number of single persons (aside from widows and widowers) who have children under their care and custody but who may not under the terms of the current law claim head-of-the-household treatment since the children have not been adopted or do not have a close blood relationship. Nevertheless, they perform an important social function which should be recognized. An appropriate recognition would be the extension of the head-of-the-household treatment to them so that they would receive the same benefits as other taxpayers in comparable situations.

CONCLUSION

In conclusion, the USCC urges the Congress in its deliberation of tax policy to be ever mindful of the special constitutional dispensation accorded to churches and religious organizations. It is important to emphasize this constitutional separation of Church and State which includes as an essential ingredient a fiscal separation. Certain functions of churches may not be taxed to support Government. Other activities, not themselves religious in nature, may be taxed. The Government's position must be one of neutrality in respect of religion.

We view with deep concern the proposals that churches be required as a matter of law to file detailed financial information returns. Government, for considerations of constitutional law and sound public policy reflected by an historical consensus, ought to avoid involvement in the internal affairs of churches or detailed attempts to define religion or religious activity. The reports that churches make voluntarily to their members and to the general public are one thing; compulsory reports to the Government are quite a different matter. Financial information reporting should be limited to activities subject to tax. But Government should avoid tampering with the traditional functions of churches.

The Church recognizes that the tax structure as it currently exists contains certain areas in which absolute tax equality among the various taxpayers is not achieved. Moreover, it is obvious that the law currently authorizes certain deductions and exclusions of income from taxation which deprive the Government of revenue. Admittedly some of these provisions are difficult to administer, but this should not be the determining factor. From the very beginning of this country our law has formulated a tax policy which has recognized the significant role which religion together with related charitable institutions plays in society.

A political and social consensus has developed, reaffirmed by law and judicial decision throughout the last two hundred years in which Government has specifically recognized the place of religious institutions not only in the lives of the individuals but in the service of the community.

One of the most important recognitions of this consensus is our tax policy. This policy should not be so substantially altered that it would dry up the basic sources of income which churches currently enjoy.

The CHAIRMAN. Our next witness will be Mr. Leonard S. Silk, president, the National Assembly for Social Policy and Development, Inc.

STATEMENT OF LEONARD S. SILK, PRESIDENT, THE NATIONAL ASSEMBLY FOR SOCIAL POLICY AND DEVELOPMENT, INC.; ACCOMPANIED BY WILLIAM G. REIDY, DIRECTOR, WASHINGTON OFFICE; AND STANLEY S. WEITHORN, COUNSEL

Mr. SILK. Mr. Chairman, members of the committee, I am Leonard S. Silk, senior economist at the Brookings Institution, formerly an editor of Business Week magazine and currently the unrecompensed president of the National Assembly for Social Policy and Development.

With me today I have Bill Reidy, who is the director of our Washington office, whom I am sure many of you know, and Mr. Stanley Weithorn, who is a legal expert on problems of taxation and who is our counsel.

We would like to thank you for this opportunity to testify on H.R. 13270.

Mr. Chairman, the National Assembly may or may not be a meaningful entity to members of this committee. Its composition and objectives are set forth in our written testimony. There is no question, however, but that you do know and I am sure know favorably many of the more than 35 voluntary organizations for whom we are specifically authorized to speak today.

The list of those organizations is appended to our written testimony as schedule A. Since it was presented to you on Monday as requested by your committee, other organizations have asked to subscribe to our statement and I respectfully request that their names, which I have here, be added to those on our schedule A as previously submitted.

The additional names are those of the Goodwill Industries of America, the National Urban League, and the National Conference of Catholic Charities.

Mr. Chairman, if you will glance at that list, you will know the kind of organizations for whom the National Assembly testifies today. It includes the Young Women's Christian Association, the Young Men's Christian Association, and the American Jewish Committee. Also the Big Brothers of America, the Camp Fire Girls and the Child Welfare League are included. So, too, is the National Association for Mental Health, the National Association for Retarded Children, the National Council on the Aging, the National Council on Crime and Delinquency, the Salvation Army, and the Volunteers of America.

The United Community Funds and Councils of America, who will testify in their own behalf following my own testimony, also subscribe to our position.

These and other fine organizations——

The CHAIRMAN. May I say there, Mr. Silk, the record will show these organizations for which you speak, and they are a very fine group of organizations, each one of them a very meritorious organization, and we highly approve of all of them and the fine work they are doing. We wish we could have heard all of them.

I am sure you can see our problem. We have been committed to report this bill by October 31 and there is no way we can do this and hear all the fine people we want to hear.

Mr. SILK. Thank you, sir. I would like to point out certain common characteristics these organizations have. They are all voluntary organizations. They all try to cope with specific problems afflicting all of our society but problems which differ from community to community. They are organizations that are adapted to dealing with local community conditions. They all meet needs which, if these organizations cease to exist, would either go unmet or have to be met by Government, probably not as well, probably more extensively, more rigidly, and through greatly increased taxation.

These organizations are dependent on philanthropy.

Senator BENNETT. May I interrupt you to add one other common characteristic? They all seek funds in public fundraising programs, drawing on the strength of the whole community rather than on a few individual wealthy givers.

Mr. SILK. That is right, Senator.

The CHAIRMAN. Well now, that just brings up one more point that concerns me. You see, most of this problem comes up because of a tax loophole or two, or the foundation problem. Otherwise, I don't think there would be anything in this House bill to concern your organizations at all.

Now, of course, I see that you do oppose the tax on the investment income of foundations. Here is what concerns me about the foundation problem more than anything else. I fear that some of these foundations are making a lot of money without putting that money into organizations such as yours. If they were giving it to your organizations and the money was being promptly funneled through or if not promptly, without too much delay, then I would feel better about that as one who has to vote on this matter.

Mr. SILK. Well, of course, we could not agree more that we would like these worthy foundations to give their money to us rather than less worthy——

The CHAIRMAN. How about the foundation who just takes the money, keeps the money in the foundation, has a declaration of a worthy purpose but never does anything about it? Don't you think we ought to do something about that?

Mr. SILK. Yes. We fully agree that is an undesirable thing to permit to happen. Foundations should certainly be required as the bill proposes to spend all of their income or to spend a sum that would be equal to 5 percent of their assets, whichever is larger, and we fully agree that the sequestering of funds for whatever purpose is not a wise act of public policy, important public policy, to permit. So we are quite agreed on that.

However, I did want to make the point in response to what Senator Bennett said, that is would be a mistake to suppose that all these organizations receive money only from great numbers of small individual contributors. The foundations do in very many cases play an important role in supporting our constituent members and the National Assembly itself. Many grants are made which serve exactly the same purposes that an individual wishes to advance when he contributes

to his Community Chest or Camp Fire Girls or Salvation Army, or whatever.

These are broad-based organizations but at the same time they do depend heavily on foundation contributions and in many cases the contributions of wealthy individuals. I think we ought to be clear about that, that they are affected and that this law touches them.

Therefore, I hasten to say that there are many provisions in the bill and in the philosophy underlying it that we are concerned about. At the same time, there are many parts of the bill which we thoroughly approve and for which we want to give you our full support.

For example, we applaud the decision to remove millions of people living at or below the poverty level from the Federal tax rolls. We certainly want you to approve those provisions of the bill designed to close loopholes through which some taxpayers avoid paying their fair share of the cost of government and thereby force others of us to pay more than our fair share.

I could list many more items which we consider to be in the public interest but the time afforded us is understandably brief, and I must use it to point up those matters in H.R. 13270 which we consider to be against the public interest, potentially disastrous to the voluntary sector of our society, and a reversal of our Government's long-established pattern of encouraging the solution of social problems through voluntary means rather than by Government.

Mr. Chairman, as the summary before you indicates, there are five specific provisions in the bill which we would like to ask you to remove or to change. The reasons for each suggestion are spelled out in our written testimony. Let me therefore concentrate on the basic principle involved which each of these provisions would negate to a greater or lesser degree.

Our basic concern, Mr. Chairman, is with the effect which these provisions would have on philanthropy in America, on that voluntary self-determined, non-rigid, locally controlled and managed mechanism through which voluntary organizations involving millions of our people cope with—and I think cope magnificently with, in many cases—our diverse social problems.

We believe that there has never been a time in our history when there has been a greater need for the Congress to do all that it can to stimulate that sort of philanthropic giving and doing on which our voluntary organizations depend and on which many individual Americans depend for help.

Never has there been greater need to strengthen their ability to complement—I insist on complement, not supplement merely—that is, to work together with what Government is trying to do, to do it in some cases a different way, a more pointed way, than Government which is in many cases, especially the Federal Government, far removed from the local scene.

This is the philosophy of the way we are going in this country and it would be a very grave mistake in this important instance to go in an opposite direction.

It has never been so obvious that, to resolve our many problems, we have to devise such combinations of governmental and voluntary actions as can best be adapted to the different conditions in our local

communities and produce locally effective solutions to the social problems.

As I have mentioned, those who write our tax laws must be aware of the fact that should our churches, private colleges and voluntary organizations be deprived of adequate financing, either we will let festering problems go unsolved or Government will have to cope with them and raise our taxes to finance its efforts.

It seems obvious that our objective should be to strengthen rather than to weaken incentives to voluntary and philanthropic giving. Yet, Mr. Chairman, we do find ourselves and groups we represent confronted with a paradox. The administration and all the individual Members of Congress to whom we talked assure us that they believe what I have just said, and that they are strong supporters of the voluntary way and that the Congress most certainly does not intend to weaken our efforts.

Nonetheless, at least five provisions of H.R. 13270 can have disastrous effects on philanthropy.

There is a great deal of testimony that can be read not only in hearings but in the newspapers. The Wall Street Journal had a long article on September 12, on reports done by its own staff covering what the concerned organizations and charitable institutions, universities, colleges, research centers, and so on, had to say. I think that that kind of reaction deserves very, very careful attention lest the Congress do what it has no intention of doing.

If these provisions are enacted into law it will mark a radical shift in public policy and a reversal of our Government's long continued policy on voluntary giving. Our written statement details the history of that policy, Mr. Chairman. Let me just say it was this committee and the Senate of the United States which in 1938 successfully defended that policy when it struck from the House-passed bill a proposal to tax gifts of appreciated property.

That same sort of proposal is contained in this bill. We hope that you gentlemen will reaffirm the statement made by this committee in 1938, that "charitable gifts generally are to be encouraged," and that you will amend this bill in accordance with our recommendations so as to assure the continuance of this historic policy.

The continued effectiveness of our voluntary organizations depends upon it.

The thousands of local organizations which make up the groups joining in this statement and the many, many thousands of individuals who volunteer their services to these organizations are aware of the threats to their continued viability that are contained in H.R. 13270. We hope you gentlemen will remove these threats.

Senator BENNETT. Mr. Silk, you have taken your 10 minutes and past, and I wonder if in the interests of time, if it wouldn't be well to put the rest of your statement in the record now. There are only three of us here.

Mr. SILK. Yes, sir.

Senator BENNETT. And we have got seven more witnesses whom we must hear.

Mr. SILK. Well, I will be glad to do as you say, Senator. I would like to take, if I might, 1 minute longer just to summarize these five points that I have alluded to.

The CHAIRMAN. I might say for the benefit of you and the other witnesses, you waste a lot of time coming up here telling who you are and who you speak for. It is all here. We read that before you ever show up. Then, you talk about your general philosophy and the fine work you do. We know that and our staff knows that.

After your time is about up, then you proceed to get to the point that you came to testify about. Now, I would suggest that hereafter, for our future witnesses, please don't tell us who you are. We know who you are and what you are trying to do. That is right here in the record. We understand that.

And I wish that future witnesses would stress the point that needs to be made that hasn't yet been made. If we have already heard it six times this morning, there is no particular point in you saying it for the seventh time. We know that. And this will be considered. If you didn't show up at all, it would be considered.

The main thing you ought to do, is to hit those points you think ought to be made.

May I say to all witnesses, as far as who you are, from Mr. John D. Rockefeller on down, you don't need to tell us who you are. We know who you are. Just tell us the points.

Mr. SILK. I am sorry, Senator. I was carried away.

The CHAIRMAN. We would be glad to sit here and listen to you all morning explain who you are except that we are limited for time just as you are. The Senate has a noose on our necks as perhaps we have a gag on you. We have to get on with this thing and arrive at conclusions and report a bill out here on October 31 whether we are ready or not.

Mr. SILK. Yes, sir. I do appreciate the advice.

Since there are just these few specific points, I would like permission to just finish very quickly.

The first one is that we do believe that charitable contributions should not be grouped or considered with all deductible items in the tax bill. These others are deductions approved by the Congress as reflecting bites out of a taxpayer's income which he cannot avoid, State and local taxes, interest payments on his mortgage. The deductions in every one of these other cases benefit the taxpayer.

Charitable contributions, on the other hand, are voluntary on the taxpayer's part and redound not to his benefit but to the community's. Therefore, charitable items should be deleted from the House bill.

Second, the proposal to limit gifts of future interest and appreciated property will eliminate a major source of financial support for charitable organizations. It was not considered during the hearings of the House and has not been related to any tax abuse.

Third, we believe that both the limitation of the tax preference and the proposal to allocate deductions are highly meritorious.

However, the inclusion of charitable gifts of appreciated property in those provisions is uncalled for. It could do serious damage to our fundraising drives and its value to the Treasury is miniscule. The Treasury itself has said so.

Fourth, there is no valid reason for limiting the deduction of charitable trust income. Again, the Treasury has taken exactly the same position.

Fifth and finally, we strongly oppose the proposal to tax the invest-

ment income of foundations, first on principle, and second, because it would be in reality a tax on the beneficiaries of the foundation grants, a tax on organizations that the Congress believes should be tax exempt.

I am going to wind up there, Senator, but I will be delighted to try to respond to any questions if there are some.

The CHAIRMAN. May I just ask that the record show that the summary is here. We are trying to move as expeditiously as we can. I am sorry we have to move as rapidly as this with this measure and that a witness representing all the fine organizations you represent has to be asked to quickly summarize his position, but that is the only way we are going to be able to consider what all the people have to say and take it all into account when we vote on this.

May I say, even though we don't have many Senators here, when we go into executive session on this bill, we people who have read your testimony, summarized it, considered it, drafted alternative language to what is in the House, to do what you are urging us to do in the event we agree with you, they will be in that room explaining what your position is as well as these other witnesses and these other fine organizations who have testified parallel to what you said right here.

Thank you very much.

Mr. SILK. Thank you, sir.

(Mr. Silk's prepared statement follows:)

STATEMENT OF LEONARD SILK, PRESIDENT, THE NATIONAL ASSEMBLY FOR SOCIAL POLICY AND DEVELOPMENT

My name is Leonard S. Silk and I am President of The National Assembly for Social Policy and Development, Inc. I am accompanied by William G. Reidy, Director of its Washington Office, and Stanley S. Weithorn, Esq., an attorney practicing in the field of Federal taxation in New York City, and our counsel. I speak for The National Assembly and for the more than thirty-five organizations associated with The National Assembly whose names are listed on Schedule A, attached to and made a part of the written record of my testimony.

The National Assembly for Social Policy and Development is an independent organization of individuals representing a broad spectrum of citizen and organizational interest and concern. Its primary purpose is to contribute to the development of sound national social planning, policies, and programs; to develop strategies for action and implementation in both governmental and voluntary sectors; and to strengthen citizen participation in such activities. The scope of its concern is broadly defined to encompass the major social problems and issues.

The National Assembly, which has 300 individual corporate members, has associated with it some 77 national organizations and 400 state, regional and local health and welfare planning and fund raising organizations. It is a non-profit organization supported by contributions from affiliated organizations, some 425 local communities through united funds, community chests or welfare councils, grants from foundations and gifts from business, industry and individuals.

We wholeheartedly endorse the efforts of the Congress and in particular those of the Committee on Ways and Means in the House and the Committee on Finance in the Senate to reform and, we hope, simplify our tax laws.

We are altogether in favor of your efforts to produce equity and to close any loopholes in the tax structure through which some members of the community escape the obligation to pay their fair share of the costs of government and thereby force others of us to pay more than a fair share.

We particularly approve of those provisions in the bill which would relieve millions in woefully low income families of the necessity to pay direct federal taxes. We would point out that even with this proposed relief such families—and they are the ones with whom our associated agencies have closest contact—will still be paying taxes; they do it every time they buy food or clothing or pay the rent.

THE TAX BILL AND PHILANTHROPY

Before getting to those specific items in H.R. 13270 which are of concern to us and which we believe you will want to change, we would like to make the following brief background comments.

We believe that there has never been a time in our history when there has been a greater need for the government to do all that it can to stimulate the sort of philanthropic giving which enables voluntary associations of citizens to help cope with the social problems that beset us. Never has there been a greater need to strengthen voluntary organizations as a complement to the role of government. Never has it been so obvious that to resolve our problems we have to devise such multi-faceted approaches, combining governmental and voluntary efforts, as can adapt to the conditions in our local communities and result in locally planned, locally run and locally effective programs.

Recognizing this, we must also be aware of the fact that should our churches, private colleges, and voluntary organizations be deprived of adequate financing, either we will leave these festering problems unsolved or government will have to assume full responsibility and incidentally raise taxes to do so. It is obvious that our objective should be to strengthen rather than to weaken incentives to voluntary philanthropic giving. The paradox that confronts us today lies in the fact that while the Administration and all the individual members of the Congress to whom we talk assure us that they agree with all that I have just said, nonetheless, certain provisions of the bill now before us could have disastrous effects on the voluntary sector. Those provisions, if enacted into law, would mark a reversal of our government's past attitude toward philanthropy. Since this would represent a radical shift in public policy, it most certainly should not come about inadvertently. If it is to be done, the Congress should know what it is doing. Therefore, let me briefly sketch the historical background of the charitable contribution deduction in American law before focusing on those specific provisions of the bill which would impair tax incentives for charitable giving.

BASIS OF THE CHARITABLE CONTRIBUTION DEDUCTION

Proposals to place further limitations on contribution deductibility are steps away from the historic position which government has hitherto taken in relation to voluntary educational, religious, and cultural organizations. From the earliest days of the Nation, our federal and state governments have adhered consistently to the principle of tax exemption for charitable organizations. Contribution deductibility is an inherent aspect of tax exemption since without it most of our tax exempt institutions would cease to exist.

The concept of governmental assistance to charitable organizations through tax exemption originated in the Middle Ages and the famous Statute of Charitable Uses in England. The American colonists brought this tradition with them and incorporated it in the laws of the various states.

Even where no specific exempting legislation was passed, custom and common understanding dictated the practice of tax exemption for charitable organizations.

By the mid-nineties almost all of the American states were granting tax exemptions in favor of religious, educational and charitable institutions. Often the exemption appeared in the charters granted institutions and these charter exemptions were held by the Supreme Court of the United States to be contractural in nature and thus within the constitutional prohibition against the impairment of contracts by states.

The first federal corporate income tax was imposed during the Civil War, but only on certain types of corporations. In 1894 Congress enacted the first law which taxed the income of corporations generally, and in doing so it specifically exempted charitable organizations. A similar exemption has appeared in every federal income tax law since, including the Revenue Act of 1913 which was adopted after the Sixteenth Amendment to the Constitution.

The charitable contributions deduction was first enacted in 1917, almost simultaneously with the imposition of the income tax. (Prior to that time, government at all levels was financed primarily by custom duties, excise and property taxes, so that it was unnecessary to provide for contribution deductibility.) It applied to individuals only, and was limited to 15% of income. In 1935, however, deductibility was extended to corporate contributions. The evidence is overwhelming in the records of the congressional hearings that the underlying policy which impelled the adoption of contribution deductibility was identical with that which

had historically inspired tax exemption. Further, when the House passed a bill, in 1938, to tax gifts of appreciated property, it was rejected by the Senate Finance Committee because "The Committee believes that charitable gifts generally are to be encouraged."

It is clear that charitable organizations have been measurably assisted by these provisions either by being directly relieved of the burdens of taxation or through the stimulus to generosity that they provided potential contributors. Thus, it is not surprising that legislators and courts have been consistent in their position that the concept of tax exemption is justified not only by the saving of expenses to the government resulting from the operations of charitable organizations but also because of our belief that voluntary action is often more desirable, more effective, and less expensive than governmental action in meeting social needs.

SPECIFIC RECOMMENDATIONS

I. Distinction between charitable contribution deductions and others

The point that I would most like to emphasize is the wholly erroneous thrust of any legislative proposals that group the tax benefits of charitable giving with the multiplicity of other special tax provisions or "loopholes" (as some have been called) available to individual taxpayers. The vast majority of those other provisions which permit the exclusion of particular items from income and all of the other provisions which authorize itemized deductions have their place in the Internal Revenue Code essentially for one reason. That reason is the Congressional realization that specific economic burdens falling on certain taxpayers should be given recognition in the allocation of tax burdens.

Obviously if all of the provisions of the Internal Revenue Code relating to deductions for long-term capital gain, interest payments, State and local taxes, extraordinary medical expenses, casualty losses, and the like were repealed, individuals still would invest their capital in the hope of seeing it appreciate, and still would pay their doctor bills and the interest on money that they borrow, the only difference being that personal financial pressures would be heightened by an increase in tax liability.

In all of these cases involving transactions which give rise to particular tax benefits, the concern is for the taxpayer and not for any other party to the transaction. The distinction between those tax benefits and the charitable contribution deduction is all-important. The underlying motive for the charitable contribution deduction is not to soften (for individual income taxpayers) the post-tax economic consequences of certain events. Charitable giving is a voluntary act on the part of an individual, the consequences of which can be mostly avoided by the simple expedient of not giving to charity; this effect makes it clearly distinguishable from all of the outlays previously discussed. The most significant effect of the taxation of charitable contributions will be to hurt the non-profit organizations and local community undertakings and, far more importantly, the intended beneficiaries of their programs.

Contribution deductibility is the means by which the Federal government supports the American pluralistic approach to meeting social needs.

II. Inclusion of charitable contributions within "allocation of deductions" provision

Section 302 of H.R. 13270 entitled "Allocation of Deductions" creates a new I.R.C. Section 277 entitled "Limitation on Deductions for Individuals." This provision, which requires that an individual allocate his personal deductions between his taxable income and his tax preference items (to the extent that the latter exceed $10,000) is most meritorious because it endeavors to infuse equity into our tax laws. However, in listing those deductions subject to allocation, that provision includes charitable contributions in the same category as interest, taxes, casualty losses, and the like. As I have stated before, and for the same reasons, the discretionary charitable contribution is not comparable to the expenditures comprising the balance of the itemized category. Thus, while the concept of allocation of deductions is endorsed, it is imperative, in the view of The National Assembly, that the charitable contribution deduction be deleted from those items subject to allocation. This could be accomplished by deleting the phrase reading "section 170 relating to charitable contribution", which is designated as I.R.. Section 277 (c) (1) (A) (iv).

An example of the prospective impact of this provision should serve to illustrate the problem. Assume that an individual has $100,000 of ordinary taxable in-

come and $100,000 of tax perference income (after adjustment for the $10,000 allowance provided for in H.R. 13270) and that, in 1970, such individual contributes $60,000 in *cash* (rather than appreciated property) to charitable organizations. Despite the fact that his contributions were entirely in the form of cash, that individual would be subject to a charitable contribution disallowance of $30,000 simply because of his tax preference income.

Faced with the prospect of such a result, it is improbable that individuals now counted on by publicly supported organizations for "leadership gifts" would be in a position to continue to make substantial commitments on a timely basis. That is so because our hypothetical contributor, if approached during the early or middle portion of the year, is unlikely to know how large his tax preference income will be as compared with his ordinary taxable income. Based upon that lack of knowledge, he surely will be disinclined to commit himself for $60,000 in cash contributions at a time when he cannot determine whether he will be able to deduct the entire $60,000, or $30,000, or some lesser amount.

As indicated in this example, it is important to recognize that this far-reaching consequence exists when only cash is being contributed. The result can become even more distressing when contribution is made in the form of appreciated property.

III. Limitation of gifts of future interests in appreciated property

Section 201(c)(1) of H.R. 13270, entitled "Chritable Contributions of Appreciated Property", amends I.R.C. Section 170(e) to provide that, in certain cases of contributions of appreciated property to publicly supported organizations, the taxpayer either must treat the appreciation of such property as taxable gain or must limit his contribution deduction to the tax basis of the property. One area to which this rule would apply is the contribution of future interests in appreciated property.

In essence, the enactment of such a provision would significantly hamper or, possibly, totally eliminate the deferred giving programs which have become so important to a considerable number of religious, educational, and charitable organizations. As it is, those programs would be subject to substantial alteration in any event, because of the provision in H.R. 13270 relating to "Charitable Remainder Annuity Trusts", so that a further limitation requiring (as a practical matter) that all future contributions made under such programs be in the form of cash would be disastrous.

Interestingly, this provision was not among any of the proposals dealt with in the Hearings held by the House Ways and Means Committee, nor is it in an area which has been related, in any way, to tax abuse.

There does not appear to be any reasonable basis for this limitation, and it is respectfully suggested that it be deleted from the basic provision relating to contributions of appreciated property. This can be accomplished by the elimination of what is the now newly proposed I.R.C. Section 170 (a) (2) (C), reading "a future interest in property."

IV. Inclusion of appreciated property contributions within limit on tax preference and allocation of deductions

Two of the provisions designed to bring the tax liability of high income individuals in line, on a relative basis, with the tax liability of low and middle-income individuals relate to a "limit on tax preference" and an "allocation of deductions." Both of these provisions and the ends which they are designed to achieve, are meritorious and must be supported in principle.

However, the limit on tax preference and, similarly, the tax preference items included in the allocation of deductions provision, in addition to "recapturing" significant items of excluded income also include the appreciation in value of property contributed to charity. To include such appreciation in this computation will substantially depress the level of many charitable contributions which now are relied on as "leadership gifts" in major fund-raising drives by publicly supported organizations.

The National Assembly was pleased to note that the Administration is in agreement with us on this point. Members of the committee will recall that the statement presented you by the Honorable Edwin S. Cohen included the following proposal:

"It appears that the inclusion of gifts of appreciated property to charity as a tax preference item will reduce the benefit of the contribution and, thus, unduly

restrict public charitable institutions. For this reason the Administration proposes that this item be deleted from the Limit on Tax Preference and Allocation of Deductions provisions."

V. Limitation on contributions of appreciated tangible personal property

H.R. 13270 sharply limits the prospective contributions of appreciated tangible personal property to publicly supported charities by requiring that the donor either realize taxable gain to the extent of the appreciation or that he limit the amount of his contribution deduction to the tax basis of the property. With respect to this area, The National Assembly strongly recommends that the limitation imposed on the deduction of appreciated tangible personal property be deleted from Section 201 of H.R. 13270 by striking what is intended to be the new I.R.C. Section 170(e)(2)(B). We agree that in past years gifts of tangible property gave rise, in limited instances, to serious problems regarding the valuations placed on such gifts and that some individuals may well have taken undue advantage of the law. It would appear that those problems have now been resolved quite satisfactorily and that there is no reason now to treat gifts of tangible property any differently than gifts of appreciated securities.

Again, we are happy to learn that the Administration agrees with our position on this matter and we subscribe fully to the rationale therefor as set forth on page 25 of Assistant Secretary Cohen's statement to this committee.

VI. Limitation of deduction on charitable trust income

Of major interest to many of our voluntary organizations are those provisions in present law which permit the division of property interests between charitable and noncharitable beneficiaries through the use of a trust. H.R. 13270 would seriously restrict the use of such a mechanism for assuring the income beneficiary a certain return on such trust assets. We urge the committee to accept the Administration's suggestion which was set forth by Assistant Secretary Cohen as follows:

"The bill restricts the availability of the charitable contribution deduction where, by the use of a trust, property interests are split between charitable and noncharitable beneficiaries. On reconsideration, we believe the bill is unduly stringent in permitting a deduction for the value of a charitable income interest only where the income is taxable to the grantor under other rules. The donor should be allowed a deduction for the value of any longterm income interest to charity which is in the form of a guaranteed annuity or a unitrust. Under the bill a unitrust is a trust in which the income beneficiary is entitled to a return equal to a fixed percentage of the value of the assets of the trust each year, thus assuring the income beneficiary a certain return irrespective of the investment policies of the trust."

VII. Tax on investment income of foundations

The National Assembly would like to make it crystal clear that we do not oppose those provisions of the bill addressed to real and specific problems involving self-dealing, accumulation, unrelated business, and other such abuses which were reported as involving a small number of foundations. In fact we regard those provisions as sound and decidedly in the public interest.

However, we do take strong exception to the proposal to tax foundation income whether that tax be 5 percent, as originally proposed, 7½ percent, as the bill now calls for, or one tenth of one percent.

We object primarily as a matter of principle. This Congress should preserve the historical principle that churches, educational institutions, foundations and other charitable institutions are ax-exempt. If the Congress imposes a tax of 7½ percent or of two percent on one such institution, why not on all? If 7½ percent this year, why not 10, 20, or 50% in later years? And if the Federal government levies such taxes, why should not the states, counties and municipalities? We object, too, because such a tax would be, in reality, a tax on just those institutions and organizations which the House of Representatives, and, presumably, this body specifically intends to exempt from taxation. A tax of 7½ percent on foundation income means, in fact, that churches, schools, hospitals, and voluntary organizations which receive foundation grants would receive 7½ percent less. The tax would be the same as a 7½ percent sales tax on gifts to such organizations. And, since foundation grants are often the basis of matching grants, the adverse effect on foundation beneficiaries would be compounded.

We understand that the foundations are willing to accept the imposition of an

annual filing or audit fee sufficient to defray the cost of federal supervision. If so, of course, we could have no objection. But, if this is done, we would assume it should apply not just to foundations but to all organizations which require federal oversight to insure the proper discharge of the obligations they assume in seeking preferential tax treatment. In any case, such a charge should not be called and should not be a "tax."

In this connection, we should like to express our concern and register our objections to those added limitations on foundation activities which are in this bill but were not in the original proposals of the Department of the Treasury. We understand that the foundations will be testifying on these matters in detail on their own behalf and therefore will reserve our comment.

In closing, Mr. Chairman, we would like to express our appreciation to you and the other members of the committee for this opportunity to present our views on this most important legislation. Our comments have been carefully considered and reflect the serious concerns of the many organizations, well and favorably known to all of you, which have authorized us to append their names to this statement. We urge you to remove from the bill those provisions which will adversely affect philanthropy and to champion our cause before the Senate and in conference with the House. We believe that members of this committee share the view that people should receive every encouragement to resolve their problems through voluntary action and to turn to government only when they must. When that principle was threatened in 1938, this committee successfully defended it. We ask you to do so again.

Thank you.

SCHEDULE A

The organizations listed below have specifically authorized The National Assembly to advise the Senate Committee on Finance that they concur in the views expressed above and join in requesting the Committee to amend H.R. 13270 as suggested.

American Council for Nationalities Service
American Foundation for the Blind
American Jewish Committee
American Social Health Association
Big Brothers of America
Camp Fire Girls
Child Study Association of America
Child Welfare League of America
Council on Social Work Education
Family Service Association of America
Florence Crittenton Association of America
International Social Service, American Branch
National Association for Mental Health
National Association of Hearing and Speech Agencies
National Association for Retarded Children
National Association for Social Workers
National Committee on Employment of Youth of the National Child Labor Committee
National Conference of Social Welfare
National Council of Jewish Women
National Council of the Young Men's Christian Association of the U.S.A.
National Council on Alcoholism
National Council on Crime and Delinquency
National Council on the Aging
National Federation of Settlements and Neighborhood Centers
National Public Relations Council of Health and Welfare Services
National Recreation and Park Association
National Society for the Prevention of Blindness
The Salvation Army
Social Work Vocational Bureau
The Volunteers of America
Travelers Aid Association of America
United Community Funds and Councils of America, Inc.

United Hias Service
United Health Foundations
United Seamen's Service
United Service Organization
Young Women's Christian Association of the U.S.A.

The Boy Scouts of America join in the representations made with respect to provisions affecting life income and gifts of appreciated property.

The CHAIRMAN. Now, the next witness is Mr. Walter H. Wheeler, Jr., president of the United Community Funds and Councils of America.

STATEMENT OF WALTER H. WHEELER, JR., PRESIDENT, UNITED COMMUNITY FUNDS AND COUNCILS OF AMERICA; ACCOMPANIED BY CHARLES SAMPSON, ASSOCIATE EXECUTIVE DIRECTOR, AND HENRY WEBER, DIRECTOR, WASHINGTON OFFICE

Mr. WHEELER. Mr. Chairman, gentlemen, I am chairman of the executive committee of a company called Pitney-Bowes. I am president of the United Community Funds and Councils of America, and I am accompanied by Mr. Charles Sampson, associate executive director, who handles technical matters for our national association, and Mr. Henry Weber, director of our Washington office.

In a sense, we are the organization that does the fundraising and the budgeting and the planning for the large majority, I think, of the organizations that Mr. Silk, who just testified, represents. We represent 31,500 local, State, and national health and welfare agencies, supported by some 18 million United Way volunteers, 32 million individuals, groups, and corporations contributing assistance to some 28 million American families. In 1968, $755 million was raised but because of our critical community needs and—in view of the administration's request for increased voluntary action in health and welfare, the United Funds are seeking to raise much more money.

Our objective is a billion dollars in United Way voluntary givings, local voluntary campaigns are now starting in some 2,200 communities throughout the Nation. We are deeply concerned by the somewhat discouraging directions in which some of the proposals for new tax legislation seem to be taking us. It seems to me that this great country of ours is suffering from a pollution of the spirit brought about by sophistication, complexities in modern life, suffering more from that perhaps than from any other cause. And what we need more than anything else is a restoration of the spirit of individual responsibility on the part of all American citizens.

In recent years, business and industry have well begun to recognize the sense of responsibility to help solve social problems which is in their own long-range interests. Tax incentives have played a large part in this as they do with individuals. We are moving together in the Government-private partnership toward curing our ills. At this moment it would be catastrophic to take any action which would in any way discourage this. Rather, it should be encouraged.

We are in favor of tax reform, which would remove the burden of taxes from the poor, give relief to the middle-income taxpayer, and require everyone to pay his fair share of taxes. I believe in our zeal to

plug every single possible loophole of tax evasion, we are in danger of burning down the barn, or at least a part of it, for the sake of killing a few mice. We can have no more absolute protection than we have in many other areas without danger of encroaching on individual freedom and other desirable aspects of the American way of life.

We oppose tax revision proposals which would curtail, lessen, or discourage charitable contributions. We do not believe it right or necessary to realize tax reform at the expense of the poor and needy or at the expense of expanding voluntarism among our citizens. We believe that Government encouragement of voluntary action in meeting health and welfare needs should be increased and strengthened by retaining the present and adding more incentives for charitable contributions.

We believe that H.R. 13270, as presently drafted, contains provisions which would result in reduced charitable contributions. We recommend that no tax be levied on foundation income. There are instances where the whole foundation income goes to the United Fund and many cases where large parts of it are so donated, both directly and indirectly. Tax on foundation income would inevitably and seriously cut into the United Funds income.

We recommend that no charitable contributions be included in an allocation of deductions. Charitable contributions should remain protected against tax. We further believe that the definition of a private foundation as contained in H.R. 13270 is ambiguous and should therefore be clarified. It could include some United Funds agencies, as now written.

We believe that no tax should be levied on gifts of appreciated property. The real value of the gift is its current value, not some lesser amount. Gifts of appreciated property are a sizeable source of income to United Funds. We had an instance in one of our United Funds just last week where an old chap of about 85 or 90 years walked in and handed us $275,000 in securities. This is not uncommon.

We favor the increase in the allowable deduction from 30 percent to 50 percent of the individual contributor but believe that its income-producing potential for charitable organizations is minimal and would in no way make up for the harmful effects of other provisions in H.R. 13270.

The CHAIRMAN. May I ask you one question?

I read your statement and also the summary. May I just ask you one question.

Suppose we amended the House law this way, to say that anybody who had a private foundation, if he is ready to give the money right now to the united funds, to the community chest, to the orphan children's home or to a university or home for crippled children or home for the blind, if he wants to give it now, no tax. In fact, we will add 10 percent to it, give him a 10 percent tax credit over and above that so he pays nothing and gets the bonus, closes out the foundation, and gives the money away. Would you object to that?

Mr. WHEELER. This would certainly meet our objection.

The CHAIRMAN. Now, further having done that, we say if you don't want to make that money speedily available to charity, keep it in your

own possession and have it to yourself and postpone indefinitely the time this good will become available to the public, then you just pay us some tax money on it and we with the tax money will do some of the same good you don't feel like doing for the time being. How does that appeal to you, for us to say, all right, Mr. Foundation, if you want to give this money to charity or education, go ahead, and we will give you a tax advantage, but if you don't want to give this, if you want to hold it and invest it and postpone to some future date doing the good we hope you will do some day, if you want to postpone that for the future, pay us a tax for the privilege of postponing that.

Senator BENNETT. May I ask a question?

Mr. WHEELER. That sounds to me like an original——

Senator BENNETT. My question is, here is a charitable foundation which has $5,000 to give to a community chest but it has $100,000 in assets. Do you want that $100,000 in 1 year or wouldn't the community chest rather have $5,000 a year indefinitely?

The CHAIRMAN. That question is directed toward me. My thought is if you have in mind doing somebody good, doing some good for somebody, the sooner the better. It is just that simple.

Senator BENNETT. Having been chairman of a community chest I know the problems created when you get one single gift one year and have to go back in preceding years and try to make it up.

Mr. WHEELER. That is right.

Senator BENNETT. You are killing the goose instead of preserving the opportunity for the future, so it isn't quite as simple, Mr. Chairman, as you may feel at the moment.

The CHAIRMAN. Well, the reason that all this matter came up to begin with is that some of those geese are not laying any eggs to begin with.

Senator BENNETT. I think that is another problem.

Mr. WHEELER. Just to summarize, Mr. Chairman, I have been in this kind of work all my life, locally and nationally, and I am tremendously impressed with it and I really believe what I say, that the greatest salvation of this country is increasing the individual's sense of responsibility to carry his full share, and I just don't want to see anything done which will discourage that, particularly if it is done hastily, and I am inclined to think that it might be a good thing if you segregated all of these questions that have to do with charitable contributions from the rest of the bill and looked at them separately.

The CHAIRMAN. Yes, sir.

Well, I am completely in accord with the fine work you are trying to do with your group and the organizations you represent. I have contributed to some of them, and may I say when I contributed, I didn't contribute to make money out of it. I have tried to amend the law with regard to some people who claim they have got a right to make money out of contributing to charity. I think you ought to have a little bit of desire to benefit somebody else when you give. Otherwise I don't see what reward you expect to get in Heavan if you get a 50-percent profit from doing it.

My only thought is that I would just like to see it handled in such a way that we continue to give whatever incentive can be justified. The House bill actually increases from 30 percent up to 50 percent,

what can be deducted for gifts to your organization; is that not correct? And I think that is good.

I think that we ought to continue to provide an incentive for people to make donations for charitable purposes. And yet where this has been abused by people who for their own selfish means have been able to avoid paying their fair share of taxes and haven't done what was intended to be done here at all, that shound be stopped.

Mr. WHEELER. That is perfectly true.

The CHAIRMAN. I think in the last analysis——

Mr. WHEELER. But please don't burn down the barn, or any big part of it.

The CHAIRMAN. If I have my way, we won't, but sometimes we have to light a big fire in order to illuminate the atmosphere and see what is going on.

Mr. WHEELER. Thank you very much.

(Walter H. Wheeler's prepared statement follows:)

STATEMENT BY WALTER H. WHEELER, JR., PRESIDENT, UNITED COMMUNITY FUNDS AND COUNCILS OF AMERICA

SUMMARY

1. We are in favor of tax reform which will:
   (a) remove the poor from the tax rolls:
   (b) give relief to the middle-income taxpayer: and
   (c) require that everyone pay his fair share in taxes.
2. We are opposed to tax revision proposals which would curtail, lessen or discourage charitable contributions.
3. We do not believe it right or necessary to realize tax reform at the expense of the poor and needy.
4. We believe that government encouragement of voluntary action in meeting health and welfare needs should be increased and strengthened by retaining the present and adding more incentives for charitable contributions.
5. We believe that H.R. 13270 contains provisions which would result in reduced charitable contributions, and therefore recommend:
   (a) that no tax be levied on foundation income;
   (b) that no tax be imposed, either directly or indirectly, on appreciated property contributed to charity; and
   (c) that no charitable contributions be included in "Allocation of Deductions".
6. We believe that the definition of a private foundation as contained in H.R. 13270 is ambiguous and should therefore be clarified.
7. We favor the increase in the allowable deduction from 30% to 50% for the individual contributor, but believe that its income producing potential for charitable organizations is minimal, and would in no way make up for the harmful effects of other provisions in H.R. 13270.
8. We recommend that those provisions of H.R. 13270 which relate to philanthropy, because of their complexities and in view of their injurious, though perhaps unintended, effects on charitable contributions, be removed from the Bill and referred for further study.

Mr. Chairman and Members of the Committee:

I am appearing before you as volunteer president of the national association of United Funds, Community Chests, United Crusades, etc., and the Community Health and Welfare Councils.

These United Community Campaigns are now in progress throughout the country. They provide support for 31,500 local, state and national health and welfare agencies. These voluntary organizations provided assistance to 28 million American families in 1968.

Last year $755 million was raised. This year, because of our critical community needs, and in view of the President's request for increased voluntary action in health and welfare, United Funds are seeking much more money. Our near-term objective is to raise the level of annual United Way voluntary giving to the billion dollar level.

I have come here today because we are deeply concerned by the undesirable direction in which some of the proposals for new tax legislation seem to be taking us.

In behalf of the 18 million United Way volunteers who freely give of their time and talents and the 32 million individuals, groups and corporations who voluntarily contribute their money, we wish to register our concern that no harm shall be done to the traditional policy of encouragement by the government of the United States for voluntary humanitarian service, as carried on by these United Way Funds and agencies.

It has always been the policy of our government to encourage charitable giving by providing incentives to donors. For the first time in the history of our country, it seems that government is turning its back on private philanthropy and is considering the establishment of impediments to charitable giving.

I wish to make it completely clear that we applaud the desire of the Congress to remove millions of the poor from the tax rolls, to lighten the burden of the hard pressed middle-income tax payer, and to make sure that no one escapes paying his fair share for the support of his government.

We are for all these benefits. But we do not think it should be necessary to realize such benefits at the expense of health and welfare services which benefit the poor and all our citizens. We wish to make sure that the voluntary financial support for meeting the community's social needs is not undercut.

Certain provisions of the Tax Reform Act of 1969, H.R. 13270 as passed by the House, would have the immediate effect of reducing gifts to United Funds. The ultimate result would be a cutback in rehabilitation work with the handicapped, fewer children of working mothers cared for by day nurseries, less recreational centers for the aging and reduced opportunities for disadvantaged people of all ages, in the central city, and in the entire community. Eventually, this would lead to demands by the needy upon government as the last resort for their assistance.

There are other aspects of H.R. 13270 which appear to nibble away at reducing the vitality of the voluntary sector. Because of the complexity of some of these items, and because of the great many issues contained in the House Bill which do not relate to philanthropy, we recommend that those provisions which do affect philanthropy be set aside from the present House Bill and referred for further study as to their implications upon charitable giving and their effect upon the voluntary heritage of the American people.

We are especially concerned with the following items contained in H.R. 13270:

1. One of the provisions which would result in direct loss in United Fund contributions is the 7½% tax on foundation income. There are instances where United Funds have been receiving some or all of the income realized annually by foundations as a regular contribution to their yearly campaign. Any tax on foundation income would be a direct cut for the United Fund and the dependent human care services.

We strongly feel that no tax be made on the income of foundations. Not only would such a tax be taken out of charitable contributions, but it would set a precedent violating the traditional attitude of our government toward the encouragement of philanthropic effort.

2. We believe that no tax should be levied on charitable contributions of appreciated property. The donor of such property voluntarily foregoes receipt of such gain for his personal benefit and the value of the property to the charitable organization is its current value, not some lesser value. To give the donor credit for the full value of his donation is an important means of encouraging greater support for charitable activities.

In regard to H.R. 13270, we recommend that the provision which would include appreciation of such property in the Limit on Tax Preferences and the Allocation of Deductions be deleted. It is inconsistent with the fact that the H.R. 13270 exempts direct tax on gifts of appreciated property to United Funds and member agencies.

3. Another provision in H.R. 13270 which would tend to hinder rather than to encourage donations to charity is one which requires the inclusion of charitable contribution deductions as items subject to allocation under the "Allocation of Deductions" procedure. The charitable contribution, is not comparable to the mandatory expenditures comprising the other itemizations and we urge its deletion. This could be accomplished by deleting the phrase reading, "Section 170

relating to charitable contributions" which is designated as I.R.C. Section 277 (c) (1) (A) (iv).

4. The definition of a private foundation in H.R. 13270 is so broad and of such ambiguity as to raise questions whether or not some publicly supported, operating charitable organization such as United Funds and their member agencies would be classified as private foundations. We recommend that this definition be clarified or revised so that United Funds and their member agencies are clearly excluded from the definition of private foundations.

5. We commend the intent to encourage donations to charity indicated by that provision of H.R. 13270 which increases the limit on the deductibility of individual charitable contributions (subject to certain limitations) from the present 30 percent to 50 percent of a taxpayer's contribution base.

In the Report of the House of Representatives Ways and Means Committee on H.R. 13270, it is stated that, "It is believed that the increase in the limitation will benefit taxpayers who donate substantial portions of their income to charity and for whom the incentive effect of the deduction is strong."

However, the Internal Revenue Service statistical reports on individual income tax returns indicate that the total of all contributions to charity for which deductions were claimed represented an average of 3.1 percent of adjusted gross income. Individuals with incomes from $20,000 to $50,000 averaged 2.8 percent in donations. In the $50,000 to $100,000 income group, the percentage of itemized charitable contributions averaged 3.3 percent. Even for individuals with incomes exceeding $500,000, the average of charitable contributions amounted to only 10.7 percent. This is far short of the 30 percent presently allowed. Therefore, we do not believe that an increase to 50 percent in the ceiling of allowable deduction credit would result in any immediate substantial increase in United Fund income. Since this provision has been cited by some as a balancing factor to compensate for the losses in contributions income to charities, we wish to state our belief that in no way would this provision make up for the harmful effects of the provisions to which we object.

In conclusion, I wish to thank the Chairman and Members of the Committee for giving us this opportunity to express our views on this important matter.

The CHAIRMAN. Now, the next witness is Kyran McGrath, director of the American Association of Museums. At this point in the record, let me insert a letter addressed to Senator Fannin by Mr. Edward Jacobson. He asked that it appear as the committee begins to hear witnesses representing the museums.

(The letter referred to follows:)

PHOENIX, ARIZ., *September 12, 1969.*

Re: Relationship of proposed changes in Federal Income Taxes to small museums

Senate Office Building,
Senator PAUL FANNIN,
Washington, D.C.

DEAR SENATOR FANNIN: On behalf of the two Phoenix Museums (the Phoenix Art Museum and the Heard Museum of Anthropology and Indian Art), I want to express serious concern over two proposed changes in Federal Income Tax Laws as they relate to small museums. Those changes are: (1) the 7½% tax on a museum's investment income and, even more importantly, (2) the application of the income tax to gifts to museums.

SUMMARY

The effect, especially of proposal (2), will be to keep the great art and anthropological treasures of our culture in private hands and away from the public, and, to seriously cripple or prevent the growth of the collections of smaller museums.

To understand why these results are inevitable, there are a few MUSEUM FACTS and a few TAX FACTS which must be understood.

MUSEUM FACTS

1. The Phoenix Art Museum operates on a total budget of less than $200,000 a year and the Heard Museum of Anthropology and Indian Art operates on a

total budget of less than $100,000 a year. In both cases, most of the budget goes for salaries and maintenance. In neither case are there more than pennies (if any) for acquisitions. I understand this to be the situation existing in most small museums in the country.

2. The budgets for our two Museums are raised by small contributions averaging less than $50 apiece from private citizens in the Phoenix area.

3. Rarely can small museums afford to make significant additions to their collections by purchase. Thus, over 98% in value of the present collections of both Phoenix museums is the result of gifts from private donors. If these collections are to grow, this same pattern (gifts) will have to continue in the future.

4. Both museums are attempting to build endowment funds which will generate some operating monies for future years. At this point both funds are small and the income therefrom is minuscule.

TAX FACTS

5. *Under present tax laws*, if you purchased an Andrew Wyeth painting many years ago for $10,000 now worth $40,000 and chose to give it to the Phoenix Art Museum, you could get a $40,000 tax deduction as the result of your gift.

6. *Under the proposed tax laws*, you would have three choices:

(*a*) You could give the painting to the Phoenix Art Museum deducting only your cost of $10,000 and pay no tax. Thus you would lose the benefit of $30,000 of appreciated value.

(*b*) You could give the painting to the Phoenix Art Museum taking a charitable deduction for its true market value of $40,000, *but*, the $30,000 increase in value would be added to your income for income tax purposes.

(c) You could will the painting to the Museum or to a relative or friend. If you took the latter course, after you died, the relative or friend would acquire the painting by inheritance at its market value ($40,000). The relative or friend could then give the painting to the Phoenix Art Museum, take the full $40,000 charitable deduction and pay no tax.

From the Museum's point of view and from the point of view of the public who would like to see that painting, the unfortunate result is that the gift at least would be delayed and, perhaps, might never be made.

7. *Under present tax laws*, if many years ago you purchased a block of Valley Bank Stock for $10,000 which today is worth $40,000 and you would like to give it to the Museum, you could take a $40,000 charitable deduction and pay no tax on the appreciated value of the stock.

8. *Under proposed tax laws*, you could still make the gift and take the deduction and suffer no tax consequences, *provided* at least 50% of your income was subject to taxation. In computing the 50%, however, the $30,000 appreciation in that stock would be considered as income. Again, however, you could will that stock to the Museum or to a relative or friend. And, in the latter event, that relative or friend would inherit the stock at its true market value ($40,000) and would be able to make the gift to the Museum, taking the full $40,000 deduction and paying no tax.

Once again, the result is obvious, and, from the point of view of small museums, disastrous. The gift, at least, will be postponed, and, may never be made.

CONCLUSION

Under the proposed revisions, the owner of art or stock still could take advantage of the appreciated value without changed tax consequences. But, to do so, his gifts to museums either would be seriously delayed (until his death), or, perhaps, never made. It will be the museums, and, therefore, the public who will suffer.

It is respectfully submitted that this is not a reasonable approach.

Sincerely,

EDWARD JACOBSON.

Senator CURTIS. Mr. Chairman I have a statement by Mr. James B. Shaeffer, chairman of the Nebraska Museums Conference, that I would like placed in the record at this point.

The CHAIRMAN. Without objection.

(The statement of Mr. Schaeffer follows:)

PREPARED STATEMENT OF MR. JAMES B. SHAEFFER

The Mountain Plains Museum Conference of which the Nebraska Museum Conference is a member has recently held discussion on the provisions of the tax reform bill HR 13270, which was passed by the House and is pending in the Senate, as it affects museums. In turn, the executive committee of the Nebraska Museum Conference has met and discussed this legislation as it will affect the 100 or more museums in Nebraska.

The Nebraska Museums Conference feels that the provisions of the Tax Reform Bill HR 13270 in its present form which requires all donations of tangible property to be assessed a capital gains tax on appreciated value will undermine private support of all museums in Nebraska. Its effects will be especially harmful to the majority of museums in Nebraska which are small historical society museums supported solely by private donations of land, buildings and operating funds. While all museums operate under very restrictive financial limitations, the smaller museums are generally ineligible for grants, or other forms of public support to the extent that they depend mostly on local private donations. Most museums get their start by a donation of land, an old building and the collections of local persons. Under the present bill, if these relatively small gifts become taxable, the incentive for such donations will evaporate. To a greater or lesser degree this situation applies to all museums in the state.

Of concern to the larger museums is the effect of this fiscal policy in the matter of their collections. The large collections amassed by individuals and the rare, expensive, and unusual items collected by individuals usually have, in the past, ended in museums. The present bill in effect taxes this foresightedness of collectors and will force them or their estates to put these objects on the open market and auction them to the highest bidder in order to offset the capital gains tax on their appreciated values. Museums generally do not have sufficient acquisition funds to successfully compete in public auctions.

The situations cited apply to all types of museums, art museum, science museums, and history museums. The proposed legislation revises a tradition as old as the Constitution wherein private support of cultural institutions, both public and private had been sought and encouraged.

The present provisions in HR 13270 are punitive to donors, to museums, and to cultural institutions in general and is not the type of legislation to encourage public giving. More incentives, not less, are needed to encourage private donors to support cultural institutions. The Nebraska museums are therefore opposed to the present provisions of HR 13270 as they affect donations to publicly used cultural institutions.

The CHAIRMAN. Mr. McGrath.

STATEMENT OF KYRAN M. McGRATH, DIRECTOR, AMERICAN ASSOCIATION OF MUSEUMS

Mr. MCGRATH. Thank you, Senator. I will try to be brief.

I am here to testify and provide information regarding the effects of the Tax Reform Act of 1969 on museums in three principal areas—the appreciated value of donated, tangible, personal property; the 7½-percent tax on private foundations as they relate to privately supported museums; and third, the charitable contribution limits for privately supported museums as compared to publicly supported museums.

As to the tax on appreciated tangible, personal property, the more valuable the public interest is in an object, the more reason it should be brought into the public museums where it will be properly cared for and properly exhibited to the public. Ninety percent of the museums in America are barely able to operate with their expenses, much less have funds left over for acquisitions.

Last year, museums received over 560 million visits from the public. This indicated they are very much in the minds of the public, very much in the public forum, and we hope in the public interest to have them continued and expanded.

The CHAIRMAN. Mr. McGrath.

As to the 7½-percent tax being applied to private foundations, the definition contained in H.R. 13270 would include a number of privately supported museums as private foundations. This would then apply the 7½-percent tax on the endowment income of these privately supported museums. Ninety percent of the museums don't have money left over, and a 7½-percent tax, even a 2-percent tax as indicated by the administration, would be quite a burden to them and would result in a commensurate decline in the services to the public.

The charitable contribution limits for privately supported museums as compared to publicly supported museums work a hardship on those museums which by nature of the private nature of that support are unable to qualify under 107(b). of the existing code. The difference at present is between 20- and 30-percent deduction limitation. The difference under H.R. 13270 would go up to 50 percent or a total of 30 percent distinction.

We would hope that the committee would consider that if a museum is privately supported and otherwise unable to meet the definition of 170(b), at least if it would qualify as an operating foundation devoting substantially all of its assets to operating the museum, open to the public and on a regularly schedule basis, that then this distinction between 20 and 50 percent would be removed. This really contains the body. I could go on at length, but I won't.

Museums will drown in their own success and the public will suffocate them unless the public is willing to assist them through public appropriations or tax support.

Mindful of the patience and hunger that is stalking all of us at this time, and unless you have further questions, I will conclude.

Senator BENNETT. May I ask one question?

Would you feel that the distinction between private and public museums should be removed and that museums should be so defined that they all fall in the same class?

Mr. McGRATH. Yes. This would be the ideal, of course. The value to the public is identical and the public can't tell when they walk into one museum or another whether or not its financial support comes from private or other resources. The test should be in the service to the public.

Senator BENNETT. The definition should be based on its availability to the public rather than on the source of its income.

Mr. McGRATH. Yes.

Senator BENNETT. Aren't there some public museums that are also privately supported?

Mr. McGRATH. There are some public museums that because they have obtained or have been the recipients of, say, in one shot, a very valuable contribution, let's say one person donates or leaves in his will a bequest, a lot of money, that amount of money may be so high that it can throw the proportion or the formula for its meeting the 170(b) formula out of kilter and it will then fail to qualify as a publicly supported charity, whereas it did the year before.

Senator BENNETT. No further questions.

The CHAIRMAN. Thank you very much for a good statement.

(Kyran M. McGrath's prepared statement follows:)

Prepared Statement of Kyran M. McGrath

Mr. Chairman, I am happy to appear today and provide information regarding the effects the Tax Reform Act of 1969 would have on museums, as you requested in your letter of August 26, 1969, in three principal areas:

1. The appreciated value of donated, tangible, personal property.
2. The 7½% tax on private foundations as they relate to privately supported museums.
3. The charitable contribution limits for privately supported museums as compared to public supported museums.

As a brief introduction, the American Association of Museums was formed in 1906 as a national organization to represent museums and promote them as cultural and educational centers in the United States. Over 1,065 museums belong to the Association. They represent the three major disciplines within the museum profession: art, history, and science, as well as children's museums, university and college museums, planetariums, and general museums which combine operations among these disciplines.

APPRECIATED VALUE OF DONATED, TANGIBLE, PERSONAL PROPERTY

H.R. 13270 applies a tax consequence on the appreciated value of donated, tangible, personal property. According to the August 2, 1969 accompanying report issued by the House Committee on Ways and Means, donations of paintings and other objects were cited as some of the items frequently given to charities and that some of these items had appreciated in value. True, and usually the appreciation was due to the public acceptance of the item as something of artistic, historic, or scientific value. The more valuable, the more the public interest in it and the more reason it should be brought into the public forum such as in a museum where it will be properly cared for and adequately exhibited. As I indicate below, 90% of museums are barely able to meet operating costs and have no funds left over for acquisitions. These museums depend on donations and gifts for acquisition of the objects exhibited to the public.

Two weeks ago, I attended the annual meeting of the Mountain Plains Museums Conference in Canyon, Texas. Professional museum personnel from Montana to Texas met in the Panhandle Plains Historical Museum. That museum has excellent, valuable exhibits on American history as it unfolded on the Plains states. The director, C. Boone McClure, told me every item in that museum had been donated and that no funds existed in his budget, past or present, for acquisition. The value of exhibits like that are not in the dollar amount they may bring in the open market. The value in that case is in the object itself, as an object of historic importance. H.R. 13270 appears to treat such objects as of commercial value only, requiring the donor to choose between deducting the cost to him or the fair market value provided he include the appreciation in his income.

Last year museums received over 560 million visits from the public. These visits were made to view the exhibits on display and learn from them. Exhibits consist of 1) objects of art, such as paintings and sculpture, 2) objects of historical significance ranging from tools and equipment used by our forefathers, to the restoration of buildings notable in our national heritage, and 3) objects of scientific value such as systematic collections involving biological specimens, anthropology, zoology, botany, to more singular scientific exhibits such as those depicting heart transplants, space technology, and basic principles of physics. The objects exhibited in American museums have become extremely popular to Americans, as evidenced by the skyrocketing attendance figures in recent years. The demand of museum visitors for more and more cultural and educational value in exhibits has placed a tremendous burden on museums to improve upon the quality of exhibits. This means that museums are constantly seeking new acquisitions to meet these demands and further extend the educational value of the displays and the quality of exhibits.

THE 7½ PERCENT TAX ON PRIVATE FOUNDATIONS WOULD APPLY TO MANY PRIVATELY SUPPORTED MUSEUMS

The bill, in its present form, would apply a tax of 7½% to private foundations. The definition of a private foundation, contained in section 509 (page 15 of the bill) would include many museums. The Museums which would be included are

those which do not qualify under section 170(b) as publicly supported charities and which receive most of their income from private endowment income. I cannot speak with knowledge on the private foundations, but I can state that many of the museums in America were established by wealthy individuals who wanted to benefit the public in their communities by building a museum to serve the cultural and educational needs of the people living there. These museums are non-profit, open to the public on a regular schedule, professionally operated, and exist to serve the public. The fact that the generosity which created them outstrips the formula expressed on pages 15 and 16 of the bill should not deny their value to the public.

A tax of 7½%, or even 2% as proposed two weeks ago by the Administration, on the investment or endowment income of these museums would work a very severe hardship. This is a critical matter. Up to 90% of museums are barely able to meet their increasing costs and do not have money left over for acquisitions. This bill, as it now stands, would apply a 7½% tax on their already inadequate endowment incomes. The result will have to be an equal reduction in operations and services to the public at a time when the public demands on museums are skyrocketing.

Those museums which are publicly supported or which can otherwise meet the formula in section 509 of the bill would not be affected by this new tax. But those museums which receive more than one third of their income from endowments would be affected. We are concerned that the test applied by the House looks to the source of funds for museums rather than to the educational and cultural services they offer the public.

Congressman Brademas said August 7, 1969: "Mr. Chairman, the test for equitable tax treatment of America's museums by the Federal Government should not rest on the source of funds so much as on the museum's service to the public. By treating museums for tax purposes like private foundations, this bill will add further to the burdens of museums located in cities which are not able to afford financial assistance for museum operations. So I ask the questions, Mr. Chairman: Is the museum a qualified, non-profit institution, professionally staffed, making its exhibits available to the public on a regular schedule? If so, then it should be treated as a public charitable institution and specifically included in the appropriate provisions of H.R. 13270."

THE CHARITABLE CONTRIBUTION LIMITS FOR PRIVATELY SUPPORTED MUSEUMS AS COMPARED TO PUBLICLY SUPPORTED MUSEUMS

The bill as it passed the House of Representatives provides different treatment regarding charitable contributions between publicly supported museums which qualify under section 170(b) (1) (B) and privately supported museums which do not qualify. At present, 170(b) museums (publicly supported charities) are able to offer individual contributors a charitable deduction up to 30% of adjusted gross income. H.R. 13270 would increase this to a total of 50%. Also, at present, those museums which do not qualify under section 170(b), usually by reason of their private support, are only able to offer up to 20% to a prospective donor on a charitable contribution.

This distinction in limitations discriminates against privately supported museums. If anything, it places them in a handicapped position in the competition for private donations. These museums must compete with universities, colleges, hospitals, as well as publicly supported museums. Privately supported museums can only offer a donor a 20% charitable contribution, whereas, the other categories can offer up to 50%. If there is concern that some individuals might use such a museum to shelter personal income, and until a professional and proven system of museum accreditation is in effect, perhaps the fact that a privately supported museum might be able to meet the qualifications for an operating foundation under section 4942(j) (3) of the bill (p. 33) would suffice to assure that the organization is otherwise functioning for the public good and thereby entitled to the full 50% standing regarding charitable contributions. However, it is not at all clear as the definition of operating foundation now stands, that many privately supported museums would be able to qualify. This confusion centers on what definition is given the term "assets", under 4942(j) (3) (B) (i) and whether more than half of a total endowment or the endowment income must be devoted to the specified activities.

The service to the public may be and in many cases is identical: the museum is open to the public; it is answerable to a board of trustees responsible for seeing

that it is operated for the cultural and educational advantages of the public; and it provides a genuine public service. One other item is usually identical with publicly supported museums: both types of museums are invariably desperate for money, and in 90% of the time, are totally dependent upon private donations for acquisition.

The concern that taxpayers will escape any taxation by way of such donations would be met by the House action to remove the unlimited feature of the charitable contribution provision to assure that at least 50% of a person's income would be included in his taxable income.

This is a very serious question to the entire museum profession, and especially to those privately supported museums. There are many of them in practically every state, and they are dependent, totally dependent upon private donations for their continued existence.

RISING COSTS OF OPERATION HAVE ERODED FINANCIAL STABILITY OF MUSEUMS

For years, the public was complacent that museums were operating quite well on their endowment incomes. But this complacency was shattered with the report submitted to the Federal Council on the Arts and the Humanities last November: *America's Museums: The Belmont Report. The Belmont Report* described the effects of inflation and increasing attendance demands for more service. Operating costs had climbed much higher than endowment incomes were able to meet. Additional revenues had to be found from both public and private sources. This would be a weak argument if only a small segment of the public was concerned. But the United States Office of Education figures confirm 560,000,000 museum visits last year in the United States, indicating a large percentage of our public is involved. This study also showed that of 2,889 museums surveyed, 1,419 were wholly financed by private contributions. If there is doubt that the privately supported museums were not substantially involved in these 560,000,000 visits, more than 264,000,000 visits were made to privately supported museums.

Museums will drown in their own success, the public will suffocate them unless the public is willing to assist them directly through public appropriations or indirectly through tax encouragement of private support.

The CHAIRMAN. We will next hear from Mr. H. Stewart Dunn, Jr., on behalf of the Longwood Foundation.

Mr. Dunn, I am sorry that we cannot put in the record——

Senator BENNETT. Didn't Mr. Rathbone come? He is the next in line.

The CHAIRMAN. I am sorry. There has been a mistake here.

May I offer you my apologies, Mr. Rathbone. In checking off the list here, I jumped over you.

Will you please take the stand.

Please excuse me, Mr. Dunn. I called you prematurely. I have been looking over your brochure for your foundation work.

I would like to place in the record at this point a letter from Mr. James Biddle, president of the National Trust for Historic Preservation. He supports your position Mr. Rathbone.

NATIONAL TRUST FOR HISTORIC PRESERVATION,
Washington, D.C., August 26, 1969.

Senate Committee on Finance,
New Senate Office Building,
Washington, D.C.

DEAR SIRS: As President of the National Trust, I wish to register my support of the position taken by Perry T. Rathbone, President of the Association of Art Museum Directors, in his letter to you of August 21, 1969.

The Trust and its member organizations, which are concerned with the preservation of historic and cultural sites, structures, and objects, are greatly concerned with the adverse effect certain provisions of H.R. 13270, as passed by the House Ways and Means Committee will have on future gifts of historic and cultural objects to the historic and cultural museums, as well as the art museums, of this country.

This letter will also confirm Mr. Rathbone's statement that the National Trust is joining with the Association of Art Museum Directors and others in consolidating its oral testimony in opposition to the above described portions of H.R. 13270.

Sincerely,

JAMES BIDDLE,
President.

STATEMENT OF PERRY T. RATHBONE, PRESIDENT, ASSOCIATION OF ART MUSEUM DIRECTORS; ACCOMPANIED BY DR. SHERMAN E. LEE, DIRECTOR, CLEVELAND MUSEUM OF ART; AND THOMAS P. F. HOVING, DIRECTOR, THE METROPOLITAN MUSEUM OF ART, NEW YORK

Mr. RATHBONE. I appear on behalf of the Association of Art Museum Directors. This is a non-profit educational corporation representing 66 major art museums situated all over the United States. I am president of that organization and director of the Museum of Fine Arts at Boston. I also have the pleasure of representing the College Art Association of America, a non-profit educational organization representing the departments of art and art history in over a thousand colleges and universities and their museums situated across the United States. Finally, I also represent the National Trust for Historic Preservation, a non-profit educational corporation supported by public contributions dedicated to the saving of great historic shrines. I have with me Dr. Sherman E. Lee, director of the Cleveland Museum of Art, former president of the Association of Art Museum Directors and a member of the Internal Revenue Service Art Advisory Panel, and Thomas P. F. Hoving, director of The Metropolitan Museum of Art in New York City and chairman of the Finance Committee of the Association of Art Museum Directors. We appreciate this opportunity to appear before the committee because it gives us the proper and responsible forum to underscore our firm belief that the continuing beneficial growth of the collections of thousands of the art museums in this country will be severely damaged by proposed section 201(c) of H.R. 13270 insofar as it would add section 170(e)(2)(B), which proposes a tax on gifts of tangible personal property to non-profit institutions, to the Internal Revenue Code.

You have heard from other organizations, and in particular the American Association of Museums, regarding the proposed tax legislation. I would like to say that all three of us are members of the American Association of Museums and totally and vigorously support their stated position.

I. BACKGROUND

The visual arts have played a long and honorable part in the history of the United States. From Copley's portraits of the prerevolutionary New England great, through Trumbull and Stuart with their record of battle and of the faces of the patroits, especially of Washington, through the record of the American wilderness by the "Hudson River School", through Winslow Homer and his record of the Civil War, to the rise of American art to levels of international recognition and respect, the visual arts have been an integral part of American life.

Historic shrines such as Mount Vernon, Monticello, and the Alamo have shared in producing this cultural heritage.

It is a singular fact among nations that this artistic heritage has been preserved by private patronage and private enterprise. The Federal Government has consciously and historically encouraged private patronage of arts ad letters rather than directly subsidizing these activities. The first museums in this country in Philadelphia, Baltimore, Hartford, Boston, and New York were the result of private responsibility and individual generosity. In great part, this was possible because of the large incomes and fortunes that were granted before the introduction of the income tax in 1913. One needs only to cite the name of J. P. Morgan and the size and quality of his great collection, amassed in the early 20th century and then given to museums and a library in New York and Hartford for the education and enjoyment of the American people, to understand the enormous scope for the collector-philanthropist before the coming of the income tax.

With this tax, one might have expected the flow of works of art into collections and then into the public domain to decline, even to cease altogether. Such was not the case, for the wisdom of the government has provided, since 1917, that incentives for private giving to the public domain be a part of the tax structure, as it has also since 1909 provided for the free entry of works of art imported into this country. The basic concept was to encourage the taxpayer to give to institutions serving the general public by being able to deduct the value of his gift, whether of cash, intangibles or tangible works of art, from his income for purposes of tax calculations. This enlightened policy proved to be a much needed boon to the museums and other educational institutions of the United States. The tremendous achievements in education and the growth of the collections of American museums have been a direct result of this policy.

II. THE MUSEUM WORLD TODAY—THE UNITED STATES VERSUS EUROPE

These results are well known and much envied by the state-controlled and state-supported museums of Europe, which do not enjoy comparable private philanthropic support. To many of the world-renowned museums of Europe the prospect of tax incentives for art donations would be greeted with jubilation. Indeed, several years ago the French Ministry of Culture initiated the first steps to provide such a structure of giving, citing at length the example of America. Look at the record of history. The great museums of Europe—the Louvre in Paris, the Prado in Madrid, the Uffizi in Florence, the Hermitage in Leningrad—performed the vast majority of their collecting much more than a century ago by nationalizing private, princely, royal or imperial collections. Since that initial gathering together, their collecting has been far, far less than that of museums in the United States. There is indeed no comparison in the growths of the collections of Europe and those of America in the last 50 years. One of the incontrovertible and readily self-evident reasons for this extraordinary flourishing in America as opposed to the dormancy of Europe is the beneficial government support of our museums by tax incentive concerning works of art. This system—rooted in democratic principles and in the system of free enterprise—must not be jeopardized.

There is no denying that the growth of the collections of our museums and historic shrines from the time of the First World War to the present has been the admiration of the world. The majority of works in the museums of Washington, New York, Chicago, Fort Worth, Tulsa, Los Angeles and the vast majority of other such institutions throughout the country are seen by the public because of private giving encouraged by the past income tax laws. Purely disinterested giving is admirable but must be supplemented by other incentives. Just as other giving involving the public good, such as the donation of securities, needs fiscal incentives, so does the giving of cultural property. It makes little sense to permit the full deduction of a gift of an historic house and securities for its maintenance when no provision for such deduction is made for its equally important contents. But this is just what the bill prescribes.

The very institutions that legitimately receive these gifts are largely privately supported through longstanding endowments or continued giving during the life of the donor. Such notable art museums as those in Boston, the Frick Collection and the Morgan Library in New York, the Cleveland Museum of Art, the Toledo Art Museum, the Nelson Art Gallery in Kansas City and the Huntington Library and Art Gallery in southern California—as well as the more than 1,000 historical societies throughout the country, all members of the National Trust for Historic Preservation—are completely dependent on gifts and private support without direct government subsidy. But these institutions are all open to the public and present extensive exhibitions and educational programs, all without direct expense to the municipality, State or Nation.

Museums such as the Metropolitan Museum of Art, the Art Institute of Chicago, the Philadelphia Museum of Art, the Dallas Art Museum, the Los Angeles County Museum and the Seattle Art Museum, while they receive local government support to some degree, rely primarily on private funds and gifts for their continued services and development, and entirely on private sources for their acquisitions.

Indeed, there is no more fitting example of public and private cooperation than our own great National Gallery. This is maintained by the Federal Government, but even this great institution would exist as an empty shell were it not for the private gifts of works of art adorning its walls, which were given by a relatively small number of public-spirited citizens. Though only 35 years of age, the National Gallery has already taken its place as an institution in which every citizen can take justifiable pride, largely because of private giving of tangible property, works of art, high in quality and large in number.

III. THE PROPOSED BILL AND THE DAMAGE THREATENED

It is now proposed in the current bill, H.R. 13270, to cancel the existing tax incentives to giving works of art. At the same time, tax incentives to gifts of intangible property—stocks, bonds, securities—would be preserved and reaffirmed. Thus, while quite properly preserving the lifeblood of universities and colleges, the lifeblood of equally deserving educational institutions, museums, is summarily cut off. In the world of art and culture, the damage will be prolonged and

catastrophic, out of all proportion to the relatively small fiscal return to the Federal Government.

The official figures, cited by Mr. Edwin Cohen, Assistant Secretary of the Treasury,[1] tell the story. In 1966, $9 billion, including tangible and intangible property, was given to all tax-exempt institutions. Of this amount, appreciated tangible property accounted for about $760 million, or approximately 8 percent. Of this 8 percent, the IRS estimates that not more than $50 million involved the giving of works or art, or about 7 percent of the 8 percent of the whole; in other words, about one-half of 1 percent of charitable giving.

While one cannot accurately estimate the actual tax realized by the Government, it would surely be small in Federal terms. The importance of the cultural value to the American people represented by this giving, on the other hand, is immense. Indeed in most cases this giving represents nothing less than the continued life and growth of the museums' permanent collections open to the general public. In 1968, for example, over 60 percent of the acquisitions of the Metropolitan Museum of Art were by private gifts given during the lifetime of the donor; at the Museum of Fine Arts in Boston, the figure was 42 percent. One of the most dramatic instances of this preponderance of private giving is that of the two museums in Phoenix, Ariz., the Art Museum and the Heard Museum of Anthropology and Indian Art: over 98 percent of the value of their collections is accounted for by private gifts.

It requires no extraordinary imagination to envisage what will happen, if this tradition is destroyed, to the collections of existing museums. They will stagnate and, once dormant, will become less and less capable of betterment. If this should occur, future generations will pass harsh judgment upon us. The situation will be even worse for the younger museums, many of them being built by public funds, such as the new art museums of the State University of New York at Purchase, the Museum of the University of Nebraska, or those just finished in Oakland, Calif., and the University of Wisconsin in Madison. Some will not even have the opportunity to stagnate, since their collections will not be given the chance to begin to grow.

Even graver consequences may follow. Works that might have entered the public domain by gift will inevitably appear on the world market, some to be sold abroad without hindrance since, unlike most European countries, the United States does not regulate the exportation of cultural property. Increased state subsidies for museums in England and France, for example, pose an immediate and concrete threat to America's position among those nations participating in the art world.

We, as museum directors, feel it our responsibility to point out that nations have later only looked back with regret on those periods in their histories when short-sighted policies have alienated their cultural life; on the contrary, nations cite with pride those moments when commerce and a vital cultural life have flourished together. The Florence of the Medicis and France of the 18th century are two well-known examples.

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[1] Remarks delivered before the American Bar Association, section on taxation, August 9, 1969.

IV. WHY CHANGE THE LAW?

The pragmatic orientation of the American character has often been noted, and often with approval. From De Tocqueville on, foreign and domestic commentators have noted our practicality and our genius in engineering, technology, and manufacture. Nevertheless, we find it very difficult to account for the peculiar discrimination built into the present bill. Stocks and bonds may be given and their full value deducted; but tangible personal property, including works of art, may not be given at full market value. IBM risen to 340 is acceptable; but the fortunate man who inherits or buys Rembrandt or Homer or Wyeth becomes an unfortunate giver since he can deduct fully only his cost. Where is the logic and consistency of principle in this unfair and particular discrimination?

It is objected that stock values are readily verifiable and that the values of paintings or antiques are not. In the words of the House Committee's Report, works of art are "very difficult to value." We beg to differ. Works of art are just as susceptible to valuation, by those who have spent a professional lifetime in their study, as are stocks. We point with pride to the endorsement by the Treasury Department and the Internal Revenue Service of the Advisory Panel on the Evaluation of Works of Art to the IRS. We helped develop the panel and have continued to assist in manning it with professionally distinguished personnel. The panel has been in operation for 2 years, so successfully that its life has been extended for another 2 years by the Secretary of the Treasury. In its still brief history, the panel has aided the IRS in identifying and controlling the minority of abuses that have given the donation of works of art an occasional bad press, an ill-deserved reputation which deeply concerns the profession and one which has already received corrective attention.

Indeed it should be noted that all of the abuses cited in support of the present discriminatory tax measures occurred before the operation of the panel. The IRS has informed us that the abuses have decreased notably in the last 2 years and, further, the opinions and findings of the panel have yet to be questioned by the complainant taxpayer. This is a fine example of the government working in close cooperation with the private sector in a self-policing operation. Thus, continued existence of this panel is proper and sufficient means of minimizing the kind of abuses that led to the framing of this section of the bill—without incurring the incalculable loss to the American people should the present vital flow of works of art into American museums and historic places be cut off.

V. RECOMMENDATIONS

In brief, we submit that there should be no difference between tangible and intangible property so far as the tax law is concerned. The abuses giving rise to illusory differences are the appropriate subject of regulation, not legislation.

If the words "(B) tangible personal property" are removed from proposed section 170 (e) (2), the result will be to continue the vital encouragement essential to the growth of the museums of the United States. It should be particularly noted that if this is done, gifts of tan-

gible personal property with full deduction of the current market value will be possible only to "operating foundations" or "publicly supported institutions", and not to private non-operating foundations. Thus the encouragement implicit in the change accompanies the elimination of the device of giving such property to a private non-operating foundation to hold for the future outside the public domain.

It should also be noted that nothing in this recommendation affects other provisions of the bill involving tangible property which would normally be treated as ordinary income under proposed section 170 (e) (2) (A). It is gratifying to know that the statement of the Secretary of the Treasury supported our position in this matter.

VI. OTHER ASPECTS OF THE BILL

The tax reform bill also contains other proposals which can adversely affect the world of art, education, and culture in this country. One particularly has to do with the tax treatment of private foundations. The foundations themselves are presenting their own arguments. These, insofar as they affect foundation-supported museums operated for the public benefit, have our support. The taxes that foundations will have to pay under the new legislation will, in many cases, reduce the amount of funds that otherwise would be available to cultural institutions. The administration's recommendations in this matter offer a clear and reasonable solution to these vexing problems.

We are also concerned with some technical problems in that the proposed definition of private foundations for purposes of the new tax provision may inadvertently cover many organizations which should not be treated as private foundations. Many deserving organizations may fail to meet the second exception provided for determining what organizations are not private foundations because of the requirements: (1) that gifts from substantial contributors (*i.e* those who contribute more than $5,000 in any year) cannot count toward the required one-third public support test; (2) that related income receipts from any person in excess of 1 percent of total support likewise do not count towards one-third public support; and (3) that one-third of total support cannot come from gross investment income. This last test should be dropped, since investment income already is included in the denominator but ont in the numerator of the fraction used to measure whether more than one-third of total support is derived from gifts, contributions, membership fees, or related income. Moreover, the third exception has a number of technical defects. It certainly could not have been intended o penalize a trust which now must be operated entirely for charitable purposes simply because as originally constituted part of the income was required to be distributed to private annuitants for a term of years or for their lives. It also should be made clear that organizations with defective charters may amend them to satisfy the "organized" test. Finally, there is no reason why a separate organization which is operated "in connection with" two or more qualified institutions, rather than one such institution, should not be protected under the third exception to the definition of a private foundation.

It is clear that those sections of the bill having to do with the "limit on tax preferences" and the "allocation of deductions" will inevitably

result in reduced, not increased, private financial support of cultural and educational institutions. For this reason, we support the administration's recommendation to delete the appreciation element from the limit on tax preferences and the allocations of deductions sections.

VII. CONCLUSION

Three hundred million people visited American museums and historic sites last year—these are the men and women who will be directly affected by the provisions of this bill. We are confident that the Senators now considering this tax reform bill will study our arguments with a care and sympathy equal to the magnitude of the effect this part of the bill would have on the public, national, and regional cultural heritage.

The CHAIRMAN. Let me just ask you a question if I may because your time has expired. I want to get this thing straight. I want to ask you basically the same question I asked the witness a few moments ago, Mr. Wheeler.

That is this: As between two situations, one where a man gives to a museum of art, or to this National Museum down here on Pennsylvania Avenue, and the other as to where he gives to a private foundation which simply keeps it, would you favor an approach whereby we would give better tax treatment to it if he gives it to the Government to put up here alongside that Mona Lisa when we had it on exhibition with 100,000 Americans standing in line for it, rather than give it to some private foundation that puts it over somewhere where nobody can see it for a long time to come; which way would you favor?

Mr. RATHBONE. I think the gifts to the public domain should receive preferential tax treatment and that is what our recommendation would accomplish.

The CHAIRMAN. I am in favor of the fine work you people are doing. I am just against tax cheaters who find some way of taking advantage of you people to try to beat Uncle Sam out of some tax money, and that is what we are concerned about. Congress passed a very fine law some years ago—at least it looked good on the face of it: A Philadelphia nun—she joined a Catholic order and took a vow of poverty—and so then we passed a law to say that inasmuch as she was the beneficiary of a spendthrift trust, set up by a very wealthy relative, she could proceed to give her share of the money to charity, that religious order, without having to pay a big tax on it which she was in no position to pay.

It made all the sense in the world and the only difficulty was that we drafted that language too broad so that some of the finest, most professional tax dodgers in America all took to being Philadelphia nuns. But they hadn't taken that vow of poverty that she had.

Now, if we can draft this thing so we achieve our purpose and help you obtain the fine works of art and fix it up so that it is more advantageous for somebody to hang it up in the Metropolitan Museum there where everybody can see it rather than lock it up for their own advantage, then I think we may achieve a worthy objective and that is what some of us have in mind.

Mr. RATHBONE. We devoutly hope you can. That is all we seek to accomplish by our proposal.

Senator BENNETT. I have two technical questions. Could you explain to the committee how the existence of the Art Advisory Panel protects the IRS against unrealistic valuation of art?

Mr. RATHBONE. I am fortunate to have on my right Dr. Lee, who is a member of that panel and has been since its inception. I think he can better answer that question than I can.

Senator BENNETT. Dr. Lee.

Dr. LEE. Senator, the panel was set up 2 years ago after a meeting with the IRS. It is a very expert panel of about 12 to 14 people representing museums, universities and the art market. The Association of Art Museum Directors and the IRS jointly initiated this new approach. The purpose of the panel is this, simply. It reviews the gifts of works of art to museums and institutions in this country as presented by the IRS. It then advises the Internal Revenue Service as to whether the gift in question has been valued properly—whether, if it is an estate tax, it is too low; or, if it is an income tax case, it is too high—and where, if further investigation is required, they can go to get the accurate and expert advice that is required to firmly establish the value.

The panel has been in existence 2 years. It is being extended for at least another 2 years. We have many letters and verbal opinions from the IRS that the panel has achieved a great deal, not only in terms of specific savings to the Government in correcting some of these improper tax deductions but psychologically in terms of the general approach in the whole field, because the IRS has said that there has been a signal decrease in the attempts to do this kind of thing. It is also, I think, quite noteworthy that the two or three cases that have come up and have been very much in the news, as in the testimony of the House Ways and Means Committee, occurred before the existence of the panel. So the panel has effectively stopped this practice and is continuing to do so.

Senator BENNETT. Mr. Rathbone, when he and I had a private conversation, told me that it was his impression that the values placed on this art had been reduced approximately 25 percent by the panel.

Dr. LEE. Yes. That is correct.

The figure is an overall figure. There are one or two bad examples which may have added significantly.

Senator BENNETT. But the overall figure is about a 25-percent reduction.

Dr. LEE. Correct.

Senator BENNETT. Would you care to predict what will happen to the future of appreciated art in gifts to museums if we go on with the present law or if this bill is passed?

Mr. RATHBONE. Senator Bennett, that is a very serious question, one that concerns people in my position and my colleagues' position very gravely. I think that no one would be more seriously affected by such a development than my colleague on my left, Mr. Hoving. Perhaps you would like to answer that.

Mr. HOVING. Well, sir; I think what it would do is simply this. As far as the figures are concerned, the annual figures of the Metropolitan Museum of Art show that of all the works of art that come into the Metropolitan each year, which is a great national encyclopedia for

cultural things, over 60 percent are gifts of works of art made during the lifetime of the donor.

I think that there will be a long lasting and extremely serious reaction to this proposal. I think I will just stand on that—that is as emphatic a statement as I can make.

Just yesterday somebody who came into my office, a person who wanted to sell us a work of art from abroad, spoke specifically about the fact that if this particular section of the bill is passed, he won't be making as many visits to the United States, because people would not be as interested as they are now in buying things. He said it is funny. In Europe we have recognized for a long time that you people in the United States have an enormous advantage, that your museums are growing in the treasures that the people see. We have been trying for years to come up to having the same thing. He said it is funny that your Congress is considering changing your favored position.

Senator BENNETT. Well, isn't one possible effect the end of that growth substantialy if this bill is passed in its present form?

Mr. HOVING. I would think that if the bill is passed in its present form, growth of U.S. museums would be very, very seriously affected. Very seriously.

Senator BENNETT. That is all.

Thank you, Mr. Chairman.

Mr. RATHBONE. May I just add to Mr. Hoving's remarks about the ultimate fate of works of art which would normally be given to American museums in the forthcoming years? They would not enter the public domain. They would remain in their owner's possession and his disposition would be simply to sell them and take what profit he could from what might have been a very good investment. Then those works of art would find their way not into American museums, necessarily, but into the international markets. I think we are not aware enough yet in this country of the tremendous rivalry that Europe offers American museums today. This is a two-way street. There was a time when works of art only flowed westward across the Atlantic. Such is not the case any more. I can cite the rather dramatic purchase a couple of months ago by the British Parliament of a painting by Tiepolo at a cost of nearly a million dollars.

This is the kind of money Europe is prepared to spend today on works of art. But Americans won't spend such money on American-owned works of art unless we can continue the law that permits us to give tax advantages to donors.

The CHAIRMAN. It occurs to me it works. They have got a law that you cannot carry a work of art out of this country without getting their approval. My wife when she wanted to bring something in had all the difficulty in the world getting it approved. It works both ways. But you have to have some sort of approval and they have to agree on it and I don't know why, if they are going to do it, why shouldn't we?

Mr. RATHBONE. Well, we have no such laws as of now, no protective laws.

The CHAIRMAN. Don't you think it would be a fair starting point to say with regard to any country that has any law impeding the outflow of their works of art to us, that we ought to have a law with similar restraints on our works of art flowing to them? I see you nodding.

Dr. LEE. Amen.

The CHAIRMAN. I heard one of your group say "Amen." It seems to me it has got to work both ways. We don't want them coming over buying ours away. They will be more valuable as time goes on. We all know that. We I think are seeking to obtain the same objective. I am one of those that just don't want to have some fellow who doesn't have in mind benefiting humanity at all or benefiting the public at all getting a big tax advantage for giving something away. It is just about that simple.

We will try to work this thing out to where it achieves your objective and helping us obtain works of art by making some of those people, not the Metropolitan Museum or the National Museum or anything else, conduct themselves as though they are what they are rather than being something that they are not.

Thank you very much.

Mr. RATHBONE. Thank you.

(The committee subsequently received the following letter from the Internal Revenue Service, relative to the preceding discussion.)

INTERNAL REVENUE SERVICE,
Washington, D.C., October 10, 1969.

Mr. TOM VAIL,
Chief Counsel, Committee on Finance,
U.S. Senate, Washington, D.C.

DEAR MR. VAIL: Your letter of October 3, 1969, requests a report on the Advisory Panel on the Evaluation of Works of Art presently used by the Internal Revenue Service.

The Commissioner's Art Advisory Panel was established November 24, 1967, under Executive Order No. 11007, dated February 26, 1962, and approved by the Secretary of the Treasury in a letter to the Commissioner of Internal Revenue dated November 24, 1967. The first meeting of the Art Advisory Panel was held in February 1968.

The creation of the Art Advisory Panel was suggested by the Association of Art Museum Directors. The purpose of this panel is to assist the Internal Revenue Service in the valuation of works of art for Federal tax purposes.

The panel consists of ten prominent representatives of the art world from major art museums, universities, and art dealers. It meets several times a year in Washington, D.C. These panel members are not paid for their services, except for travel expenses in accordance with standard government travel regulations. The panelists are appointed by the Commissioner of Internal Revenue for a period not to exceed three years on the basis of their prominence in the art world and their intimate knowledge of art markets and prices. Panelists may be reappointed. The panel operates under the chairmanship of a full-time employee of the Internal Revenue Service. All members of the panel are subject to security and tax clearance.

At its meetings the panel considers works of art having a claimed value of $10,000 or more which have been submitted for their valuation under instructions issued to all Internal Revenue examiners.

In the five meetings which have been held to date 229 separate tax cases have been considered, involving the valuation of over 1,000 objects of art. The attached schedule shows the dollar amounts of changes effected.

Over the years there has been a considerable amount of tax abuse in this area of art valuation as it affects both deductions from taxable income for contributions to charitable organizations and valuations for estate and gift tax purposes. The Internal Revenue Service does not have as regular employees the necessary experts in these various specialized areas of art valuation and it would be impracticable to attempt to maintain such a staff. The Art Advisory Panel has filled this gap admirably, based upon our experience during the first two years that it has been in existence. The decisions of this panel of experts have been well received by the public, as evidenced by the dearth of complaints or exceptions to its findings.

We believe that this Art Advisory Panel is performing a most helpful and valuable function. However, it is emphasized that the function of the panel is limited to the valuation of works of art under existing law pursuant to which a deduction for a charitable contribution of property is allowable to the extent of fair market value irrespective of basis. The panel is not concerned with the propriety of the deductibility of the spread between cost and fair market value.

With kind regards,

Sincerely,

WILLIAM H. SMITH,
Acting Commissioner.

Enclosure.

STATISTICS OF COMMISSIONER'S ART ADVISORY PANEL MEETINGS

Meeting date	Individual taxpayer cases	Total value claimed	Total value recommended	Difference	Estate tax cases	Total value claimed	Total value recommended	Difference
February 1968	28	$4,500,000	$3,000,000	$1,500,000				
June 1968	57	5,000,000	3,800,000	1,200,000	(1)	(1)	(1)	(1)
October 1968	63	10,500,000	8,150,000	2,350,000				
March 1969	35	3,375,000	3,008,000	[2] 367,000	5	$387,000	$989,000	[2] $602,000
September 1969	46	6,015,500	4,180,800	[3] 1,834,700	13	2,178,160	4,594,670	[3] 2,416,510
Totals	229	29,390,500	22,138,800	7,251,700	18	2,565,160	5,583,670	3,018,510

[1] No breakdown these meetings.
[2] March 1969 Individual Taxpayer donations overvalued by an amount of $367,000. Estate and Gift Tax donations undervalued by an amount of $602,000.
[3] September 1969 Individual Taxpayer donations overvalued by an amount of $1,834,700. Estate and Gift Tax donations undervalued by an amount of $2,416,510.

(Mr. Perry T. Rathbone's prepared statement follows:)

SUMMARY

Ten-point summary of statement of Mr. Perry T. Rathbone, President of the Association of Art Museum Directors, speaking on behalf of the College Art Association of America and the National Trust for Historic Preservaton, for presentation to the Senate Finance Committee hearings on tax reform legislation, H.R. 13270, September 17, 1969.

I. The visual arts, museums and the preservation of historic sites are an integral part of the history of the United States.

II. Credit for the preservation of this country's cultural heritage can be given in large measure to the traditional encouragement by the government of private giving for the public good through tax incentives.

III. This enlightened policy has fostered a phenomenal growth of American museums; the envy of similar institutions throughout the world.

IV. With the exception of the Smithsonian Institution the Federal Government in this country does not assume responsibility for the operating support of public museums. Occasionally museums are assisted by City or local governments; in all cases acquisitions of works of art and the contents of historic houses are procured through private means.

V. The proposed bill discriminates, without justification, between the tax treatment of securities and that of gifts of works of art and historical objects—to the detriment of museums and institutions engaged in the preservation of historic sites.

VI. Museums and the public will be damaged heavily by the removal of traditional tax incentives for giving works of art. It will be extremely difficult for new and smaller museums to build collections; the primary source of the development of more mature organizations will be cut off—all this to produce a minimal addition to the Federal income.

VII. Under the proposed bill major works of art which might otherwise be given to museums could be sold and, since the United States has no law to the contrary, national treasures could begin to flow out of the country.

VIII. The I.R.S. panel on the evaluation of works of art, with the cooperation of distinguished members of the museum world, has operated successfully, identified and reduced abuses, and earned the endorsement of the Secretary of the Treasury. It is pointed out as an excellent example of how self-regulation can operate to control a few abuses without the need for heavy-handed legislation which would result in great cultural loss to the public.

IX. The Association of Art Museum Directors, the College Art Association of America and the National Trust for Historic Preservation recommend the elimination of the discriminatory provisions of the proposed tax reform bill related to gifts of works of art which have appreciated in value. It is gratifying to know that the Statement of the Secretary of the Treasury supported our position in this matter.

X. Other aspects of the bill, including the technical definition of a private foundation, will have a restrictive effect on giving to nonprofit institutions and can serve only to harm rather than help the museums and other institutions engaged in the preservation of the nation's heritage.

Statement of Perry T. Rathbone on Behalf of the Association of Art Museum Directors, the College Art Association of America and the National Trust for Historic Preservation

Mr. Chairman:

I appear on behalf of the Association of Art Museum Directors. This is a non-profit educational corporation representing sixty-six major art museums situated all over the United States. I am President of that organization and Director of the Museum of Fine Arts at Boston. I also have the pleasure of representing the College Art Association of America, a non-profit educational organization representing the Departments of Art and Art History in over a thousand colleges and universities and their museums situated across the United States. Finally, I also represent the National Trust for Historic Preservation, a non-profit educational corporation supported by public contributions dedicated to the saving of great historic shrines. I have with me Dr. Sherman E. Lee, Director of the Cleveland Museum of Art, former President of the Association of Art Museum Directors and a member of the Internal Revenue Service Advisory Panel, and Thomas P. F. Hoving, Director of The Metropolitan Museum of Art in New York City and Chairman of the Finance Committee of the Association of Art Museum Directors. We appreciate this opportunity to appear before the Committee because it gives us the proper and responsible forum to underscore our firm belief that the continuing beneficial growth of the collections of thousands of the art museums in this country will be severely damaged by proposed Section 201(c) of HR 13270 insofar as it would add Section 170(e)(2)(B), which proposes a tax on gifts of tangible personal property to non-profit institutions, to the Internal Revenue Code.

You have heard from other organizations, and in particular the American Association of Museums, regarding the proposed tax legislation. I would like to say that all three of us are members of the American Association of Museums and totally and vigorously support their stated position.

I. Background

The visual arts have played a long and honorable part in the history of the United States. From Copley's portraits of the pre-revolutionary New England great, through Trumbull and Stuart with their record of battle and of the faces of the patriots, especially of Washington, through the record of the American Wilderness by the "Hudson River School", through Winslow Homer and his record of the Civil War, to the rise of American arts to levels of international recognition and respect, the visual arts have been an integral part of American life. Historic shrines such as Mount Vernon, Monticello and The Alamo have shared in producing this cultural heritage.

It is a singular fact among nations that this artistic heritage has been preserved by private patronage and private enterprise. The Federal Government has

consciously and historically encouraged private patronage of arts and letters rather than directly subsidizing these activities. The first museums in this country in Philadelphia, Baltimore, Hartford, Boston and New York were the result of private responsibility and individual generosity. In great part, this was possible because of the large incomes and fortunes that were gained before the introduction of the income tax in 1913. One needs only to cite the name of J. P. Morgan and the size and quality of his great collection, amassed in the early twentieth century and then given to museums and a library in New York and Hartford for the education and enjoyment of the American people, to understand the enormous scope for the collector-philanthropist before the coming of the income tax.

With this tax, one might have expected the flow of works of art into collection and then into the public domain to decline, even to cease altogether. Such was not the case, for the wisdom of the government has provided, since 1917, that incentives for private giving to the public domain be a part of the tax structure, as it has also since 1909 provided for the free entry of works of art imported into this country. The basic concept was to encourage the taxpayer to give to institutions serving the general public by being able to deduct the value of his gift, whether of cash, intangibles or tangible works of art, from his income for purposes of tax calculation. This enlightened policy proved to be a much needed boon to the museums and other educational institutions of the United States. The tremendous achievements in education and the growth of the collections of American Museums have been a direct result of this policy.

II. THE MUSEUM WORLD TODAY—THE UNITED STATES VERSUS EUROPE

These results are well known and much envied by the state-controlled and state-supported museums of Europe, which do not enjoy comparable private philanthropic support. To many of the world-renowned museums of Europe the prospect of tax incentives for art donations would be greeted with jubilation. Indeed, several years ago the French Ministry of Culture initiated the first steps to provide such a structure of giving, citing at length the example of America. Look at the record of history. The great museums of Europe—the Louvre in Paris, the Prado in Madrid, the Uffizi in Florence, the Hermitage in Leningrad—performed the vast majority of their collectiong much more than a century ago by nationalizing private, princely, royal or imperial collections. Since that initial gathering together, their collecting has been far, far less than that of museums in the United States. There is indeed no comparison in the growths of the collections of Europe and those of America in the last fifty years. One of the incontrovertible and readily self-evident reasons for this extraordinary flourishing in America as opposed to the dormancy of Europe is the beneficial government support of our museums by tax incentive concerning works of art. This system—rooted in democratic principles and in the system of free enterprise—must not be jeopardized.

There is no denying that the growth of the collections of our museums and historic shrines from the time of the First World War to the present has been the admiration of the world. The majority of works in the museums of Washington, New York, Chicago, Forth Worth, Tulsa, Los Angeles and the vast majority of of other such institutions throughout the country are seen by the public because of private giving encouraged by the past income tax laws. Purely disinterested giving is admirable but must be supplemented by other incentives. Just as other giving involving the public good, such as the donation of securities, needs fiscal incentives, so does the giving of cultural property. It makes little sense to permit the full deduction of a gift of an historic house and securities for its maintenance when no provision for such deduction is made for its equally important contents. But this is just what the bill prescribes.

The very institutions that legitimately receive these gifts are largely privately supported through long-standing endowments or continued giving during the life of the donor. Such notable art museums as those in Boston, the Frick Collection and the Morgan Library in New York, the Cleveland Museum of Art, the Toledo Art Museum, the Nelson Art Gallery in Kansas City and the Huntington Library and Art Gallery in Southern California—as well as the more than one thousand historical societies throughout the country, all members of the National Trust for Historic Preservation—are completely dependent on gifts and private support without direct government subsidy. But these institutions are all open to the

public and present extensive exhibitions and educational programs, all without direct expense to the municipality, state or nation.

Museums such as The Metropolitan Museum of Art, the Art Institute of Chicago, the Philadelphia Museum of Art, the Dallas Art Museum, the Los Angeles County Museum and the Seattle Art Museum, while they receive local government support to some degree, rely primarily on private funds and gifts for their continued services and development, and entirely on private sources for their acquisitions.

Indeed, there is no more fitting example of public and private cooperation than our own great National Gallery. This is maintained by the Federal Government, but even this great institution would exist as an empty shell were it not for the private gifts of works of art adorning its walls, which were given by a relatively small number of public-spirited citizens. Though only thirty-five years of age, the National Gallery has already taken its place as an institution in which every citizen can take justifiable pride, largely because of private giving of tangible property, works of art, high in quality and large in number.

III. THE PROPOSED BILL AND THE DAMAGE THREATENED

It is now proposed in the current bill, HR 13270, to cancel the existing tax incentives to giving works of art. At the same time, tax incenatives to gifts of intangible property—stocks, bonds, securities—would be preserved and reaffirmed. Thus, while quite properly preserving the life blood of universities and colleges, the life blood of equally deserving educational institutions, museums, is summarily cut off. In the world of art and culture, the damage will be prolonged and catastrophic, out of all proportion to the relatively small fiscal return to the Federal Government.

The official figures, cited by Mr. Edwin Cohen, Assistant Secretary of the Treasury,[1] tell the story. In 1966, nine billion dollars, including tangible and intangible property, was given to all tax-exempt institutions. Of this amount, appreciated tangible property accounted for about seven hundred and sixty million dollars, or approximately eight percent. Of this eight percent, the I.R.S. estimates that not more than fifty million dollars involved the giving of works of art, or about seven percent of the eight percent of the whole; in other words, about one half of one percent of charitable giving.

While one cannot accurately estimate the actual tax realized by the Government, it would surely be small in Federal terms. The importance of the cultural value to the American people represented by this giving, on the other hand, is immense. Indeed, in most cases this giving represents nothing less than the continued life and growth of the museums' permanent collections open to the general public. In 1968, for example, over 60 percent of the aquisitions of The Metropolitan Museum of Art were by private gifts given during the lifetime of the donor; at the Museum of Fine Arts in Boston, the figure was 42 percent. One of the most dramatic instances of this preponderance of private giving is that of the two museums in Phoenix, Arizona, the Art Museum and the Heard Museum of Anthropology and Indian Art: over 98 percent of the value of their collections is accounted for by private gifts.

It requires no extraordinary imagination to envisage what will happen, if this tradition is destroyed, to the collections of existing museums. They will stagnate and, once dormant, will become less and less capable of betterment. If this should occur, future generations will pass harsh judgment upon us. The situation will be even worse for the younger museums, many of them being built by public funds, such as the new art museums of the State University of New York at Purchase, the Museum of the University of Nebraska, or those just finished in Oakland, California, and the University of Wisconsin in Madison. Some will not even have the opportunity to stagnate, since their collections will not be given the chance to begin to grow.

Even graver consequences may follow. Works that might have entered the public domain by gift will inevitably appear on the world market, some to be sold abroad without hindrance since, unlike most European countries, the United States does not regulate the exportation of cultural property. Increased state subsidies for museums in England and France, for example, pose an immediate

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[1] Remarks delivered before the American Bar Association, Section on Taxation, August 9, 1969.

and concrete threat to America's position among those nations participating in the art world.

We, as museum directors, feel it our responsibility to point out that nations have later only looked back with regret on those periods in their histories when short-sighted policies have alienated their cultural life; on the contrary, nations cite with pride those moments when commerce and a vital cultural life have flourished together. The Florence of the Medicis and France of the 18th Century are two well-known examples.

IV. WHY CHANGE THE LAWS?

The pragmatic orientation of the American character has often been noted, and often with approval. From De Tocqueville on, foreign and domestic commentators have noted our practicality and our genius in engineering, technology and manufacture. Nevertheless, we find it very difficult to account for the peculiar discrimination built into the present bill. Stocks and bonds *may* be given and their full value deducted; but tangible personal property, including works of art, may *not* be given at full market value. IBM risen to 340 is acceptable; but the fortunate man who inherits or buys Rembrandt or Homer or Wyeth becomes an unfortunate giver since he can deduct fully only his cost! Where is the logic and consistency of principle in this unfair and particular discrimination?

It is objected that stock values are readily verifiable and that the values of paintings or antiques are not. In the words of the House Committee's Report, works of art are "very difficult to value." We beg to differ. Works of art are just as susceptible to valuation, by those who have spent a professional lifetime in their study, as are stocks. We point with pride to the endorsement by the Treasury Department and the Internal Revenue Service of the Advisory Panel on the Evaluation of Works of Art to the I.R.S. We helped develop the panel and have continued to assist in manning it with professionally distinguished personnel. The panel has been in operation for two years, so successfully that its life has been extended for another two years by the Secretary of the Treasury. In its still brief history, the panel has aided the I.R.S. in identifying and controlling the minority of abuses that have given the donation of works of art an occasional bad press, an ill-deserved reputation which deeply concerns the profession and one which has already received corrective attention.

Indeed it should be noted that all of the abuses cited in support of the present discriminatory tax measures occurred before the operation of the panel. The I.R.S. has informed us that the abuses have decreased notably in the last two years, and further, the opinions and findings of the panel have yet to be questioned by the complainant taxpayer. This is a fine example of the government working in close cooperation with the private sector in a self-policing operation. Thus, continued existence of this panel is proper and sufficient means of minimizing the kind of abuses that led to the framing of this section of the bill—without incurring the incalculable loss to the American people should the present vital flow of works of art into American museums and historic places be cut off.

V. RECOMMENDTATIONS

In brief, we submit that there should be no difference between tangible and intangible property so far as the tax law is concerned. The abuses giving rise to illusory differences are the appropriate subject of regulation, *not* legislation.

If the words "(B) tangible personal property" are removed from proposed Section 170(e)(2), the result will be to continue the vital encouragement essential to the growth of the museums of the United States. It should be particularly noted that if this is done, gifts of tangible personal property with full deduction of the current market value will be possible only to "operating foundations' or "publicly-supported institutions", and *not* to private non-operating foundations. Thus the encouragement implicit in the change accompanies the elimination of the device of giving such property to a private non-operating foundation to hold for the future outside the public domain.

It should also be noted that nothing in this recommendation affects other provisions of the bill involving tangible property which would normally be treated as ordinary income under proposed Section 170(e)(2)(A).

It is gratifying to know that the statement of the Secretary of the Treasury supported our position in this matter.

VI. OTHER ASPECTS OF THE BILL

The tax reform bill also contains other proposals which can adversely affect the world of art, education and culture in this country. One particularly has to do with the tax treatment of private foundations. The foundations themselves are presenting their own arguments. These, insofar as they affect foundation-supported museums operated for the public benefit, have our support. The taxes that foundations will have to pay under the new legislation will, in many cases, reduce the amount of funds that otherwise would be available to cultural institutions. The Administration's recommendations in this matter offer a clear and reasonable solution to these vexing problems.

We are also concerned with some technical problems in that the proposed definition of private foundations for purposes of the new tax provision may inadvertently cover many organizations which should not be treated as private foundations. Many deserving organizations may fail to meet the second exception provided for determining what organizations are not private foundations because of the requirements: (1) that gifts from substantial contributors (*i.e.* those who contribute more than $5,000 in any year) cannot count toward the required ⅓ public support test: (2) that related income receipts from any person in excess of 1% of total support likewise do not count towards ⅓ public support; and (3) that ⅓ of total support cannot come from gross investment income. This last test should be dropped, since investment income already is included in the denominator but not in the numerator of the fraction used to measure whether more than ⅓ of total support is derived from gifts, contributions, membership fees, or related income. Moreover, the third exception has a number of technical defects. It certainly could not have been intended to penalize a trust which now must be operated entirely for charitable purposes simply because as originally constituted part of the income was required to be distributed to private annuitants for a term of years or for their lives. It also should be made clear that organizations with defective characters may amend them to satisfy the "organized" test. Finally, there is no reason why a separate organization which is operated "in connection with" two or more qualified institutions, rather than one such institution, should not be protected under the third exception to the definition of a private foundation.

It is clear that those sections of the bill having to do with the "limit on tax preferences" and the "allocation of deductions" will inevitably result in reduced, not increased, private financial support of cultural and educational institutions. For this reason, we support the Administration's recommendation to delete the appreciation element from the limit on tax preferences and the allocations of deductions sections.

VII. CONCLUSION

Three hundred million people visited American museums and historic sites last year—these are the men and women who will be directly affected by the provisions of this bill. We are confident that the Senators now considering this tax reform bill will study our arguments with a care and sympathy equal to the magnitude of the effect this part of the bill would have on the public, national and regional cultural heritage.

The CHAIRMAN. Now we will hear from Mr. Dunn. I have a lovely brochure here, Mr. Dunn, inviting me to visit the Longwood Gardens and it has some very beautiful pictures. I regret to say the Congress can't afford the money to publish color prints of our committee hearings. If they did, I would put this in the record. I think it is a lovely thing and I hope to visit it some day because you obviously have some gorgeous flowers and trees and you put on some beautiful displays with geyser fountains from time to time.

Would it cost me anything to go through there or could I go through free of charge?

STATEMENT OF H. STEWART DUNN, JR., LONGWOOD FOUNDATION, INC.

Mr. DUNN. It is entirely free of charge and it is about this subject that I would like to ——

Senator BENNETT. But don't pick the flowers.

Mr. DUNN. No. Don't pick the flowers, please.

I am appearing on behalf of the Longwood Foundation, Inc. My name is H. Stewart Dunn, Jr., and I am with the Washington law firm of Ivins, Phillips & Barker and I am appearing as counsel for the foundation and, Senator Long, I would like to take a heavy share of your advice and put aside our written statement and just discuss with you, Mr. Chairman and Senator Bennett, the specific points that concern us.

We have an interest in all of the matters that have been discussed earlier but we do have some specific points that we think were not intended to work against Longwood in the way it appears that they would. So I would address myself immediately to those specific points.

There are two of them, Mr. Chairman. The first has to do with the operation of proposed section 4942, which imposes a tax on undistributed income.

Let me start off by saying that Longwood Foundation has had a pattern over its entire history of distributing all of its income. It has every anticipation that it will continue that. However, the name belies the technical workings of that provision because you have to distribute 5 percent or your income, whichever is greater.

Now, there is an exception provided in the case of an operating foundation and one of my principal reasons in attaching this lovely booklet, Mr. Chairman, was to demonstrate that Longwood is an operating foundation in any normal sense of the word. Nevertheless, we find that we are not an operating foundation within the definition of the House bill. So I would like to tell you briefly something about Longwood Foundation.

Possibly either of you gentlemen or other members of the committee have been through Longwood Gardens, but if not, it is a public facility that is located outside of Philadelphia, between Philadelphia and Wilmington, that is in the heart of the northeast metropolitan area. It is and has always been open to the public year round without charge. At the present time, approximately a million people will go through the gardens and spend a day or some portion of the day there this year and at the rate of increase we expect that approximately 3 million people will be going through the gardens in the next 10 years. Now——

The CHAIRMAN. May I ask you just a question?

Were those gardens just as beautiful when they were under private enterprise as they are today, at least in the private ownership as they are today?

Mr. DUNN. I can only speak indirectly on that, Senator. However, I can say that the answer is that they were not. Of course, it was the home of the late Pierre S. du Pont and his home, being a man of considerable wealth, was a very handsome place. But a tremendous amount of money has been spent on the gardens making them most useful by the public generally and expanding them. Even the acreage has been expanded. It is now 1,000 acres and it was substantially less than that at the time of Mr. du Pont's death.

Each year funds in excess of $3 million are spent to maintain and expand the operation of the gardens. And a substantial portion of that goes into new improvements in the way of greenhouses, walks, providing—this is not just a passive garden, Mr. Chairman.

It also provides a concert series, lecture series, musical programs. It is available for a wide range of purposes and always open to the public without charge at all times.

Now, we believe that this is an operating foundation and would so be considered by any American citizen. However, because of one provision in the House bill, which we think may have been unintended, a self-sustaining operating foundation cannot meet the test of an operating foundation under the bill. When I say a self-sustaining foundation, Mr. Chairman, I mean a foundation which uses its own resources to provide the income with which to pay its expenses and make its improvements. If it were not self-sustaining, it would have only three courses to pursue.

One, to charge admission. Two, to go out and compete with other charities for charitable contributions. Or, three, to discontinue its operations.

All of these alternatives are undesirable and the Foundation wishes to continue to operate the gardens in their present format so that it is open to the public without drawing upon funds needed for other pressing public and charitable purposes.

Now, what would be required to correct this situation, Mr. Chairman, is simply to include within the assets of an operating foundation the securities and the endowments that it uses to generate the income that pays the costs of maintaining the foundation. As I say, there is no indication in the House report or in the background of this that there was any intention to treat self-sustaining operating foundations differently from other operating foundations. And therefore it is our request, Mr. Chairman, and Senator Bennett, that this committee consider a revision in that provision so that an operating foundation is defined to include not only the assets which are in the form of the nuts and bolts, so to speak, whatever the facility may be, but also the securities that are needed to maintain the operation of those operating assets.

I think that this is possible without any change of the spirit or the purpose of the House bill.

Now, the second point, Mr. Chairman, that I would like to call to your attention is section 4943, the Excess Holdings provision.

Longwood Foundation holds only securities in publicly-held companies, with one exception that I will mention. Its securities are widely diversified portfolio and they seek as large a return on their investment as is possible, consistent with the growth potential. Their portfolio is based on advice from well-recognized investment counsel and changes as circumstances change to assure a maximum income.

However, the Foundation does own approximately 30 percent of its assets in the form of stock in Christiana Securities Co., which in turn is a holding company that holds substantially only assets of publicly-held companies, principally the Du Pont Co.

Now, section 4943 is intended to get at a situation in which the Foundation has a substantial interest in the business and this may well be a desirable purpose. But if the stock is held in a holding company which is not engaged in any business, then the provision should be applied by a technical amendment so that you look through the holding company to the stocks of the company held by the holding company. There-

fore, if a holding company owned 100 percent of the stock in another company, the bill would operate just as it does in its present format.

But, Senator Long, if a foundation, an operating foundation, owns stock in a holding company which in turn owns less than 1 percent of stock in various other companies, there is no reason why they should have to dispose of the stock of the holding company because the holding company is not engaged in business. The foundation cannot be engaged in a business and none of the apparent defects that exist under present law could exist in that situation.

Therefore, Senator Long, the other specific recommendation that we would like to urge on this committee is that section 4943 be amended so that it not be applied to a holding company but in order to avoid any evasion, that the stock of the holding company be attributed to the foundation and its qualified purposes and this would protect against all the apparent goals of the House bill without requiring Longwood and certain other foundations, I am sure, to dispose of stock.

Now, we would suffer a hardship if we had to dispose of this stock because this stock could not be disposed of in the public market. This is not a listed security. It is over the counter and under the SEC rules it is what is known as a controlled stock and cannot be sold without difficulty of registration. It is not clear it could be registered but if it were registered, it would only be done so at substantial cost. Thus we would be in a position where we would suffer a loss of value in stock in order to meet the bill as it now is, but there is no need to require us to dispose of this stock in order to meet any of the purposes of the bill in its present format. And these are the two specific recommendations that I would like to urge on the committee, Mr. Chairman.

The CHAIRMAN. The problem you have here is shared by a number of others and when we have the testimony of the other people and an explanation of their problem, we will try to work out some common denomimator that might be able to solve the problem of the same group. I understand the Williamsburg Foundation and certain others have the same problem and we will try to work out something.

Mr. DUNN. Mr. Chairman, I appreciate that, and we will be very pleased to work with Mr. Vail and others.

It is interesting that in the House report they state that the purpose of the operating foundation exception was to permit Colonial Williamsburg, Calloway Gardens, and Jackson Hole to be excluded and treated as operating foundations, and these foundations are doing exactly the same type of operations as Longwood and we only ask equal treatment with regard to that matter.

The CHAIRMAN. Well, I understand that the House has suggested that an operation of this sort might collect fees for people to go through and one thing and another, and thereby change its status so it wouldn't have this problem. Is that correct?

Mr. DUNN. If we charged a fee and charged a sufficiently large fee that we could defray a large portion of our expenses, we would then be within the House bill. But I submit, Mr. Chairman, that it would not be a desirable social function to charge a fee at this type of a public facility any more than it would be at the museum on Pennsylvania Avenue to which you referred, or any other museum or facility which is now open to the public. Any event can meet the

requirement by charging a substantial fee, but I don't think this is the desired solution nor is it necessary to accomplish the purposes the House had in mind.

The CHAIRMAN. Well, I myself kind of like the idea of being able to drive somewhere and suddenly you are in old Colonial Williamsburg, for example, rather than having some great big gate up there and somebody selling tickets and peanuts and popcorn while I stand in line to get my tickets, which makes you feel that you are entering Disneyland, let us say, or a commercial operation. In fact what someone has tried to do is reestablish something that the feeling, the atmosphere of something that once was and something that was lovely, and that we would like to preserve forever, and that is the kind of things you are trying to do, I take it.

Mr. DUNN. That is exactly what we are trying to do, Mr. Chairman. That is what the organization has been doing for many years. We are only asking to be able to continue that type of operation, because if a charge is imposed, for one thing, the desire—this is, as I say, in the heart of the northeastern metropolitan area.

The CHAIRMAN. Northeastern——

Mr. DUNN. Of the United States; yes.

And many of the people who come bring their families and if one has to pay an admission of $5 or $10 and you are there with a carload of children, you think of going past it. You think a long time before you go.

The purpose here is to give an area where there are facilities that are usuable by the public, where you get a park and garden area, get away from the maddening rush of the metropolitan areas, a chance to go on a picnic, enjoy sights that we can't even see in our public parks, and we only ask that we be able to continue this. We are not talking about any further contributions and we are really not addressing ourselves to any present loopholes that may exist in charitable contributions because we seek no charitable contributions.

The CHAIRMAN. You have made a very fine presentation. I kind of like the thought that the best things in life are free. I am not sure it is true, but I like the idea.

Thank you very much.

Mr. DUNN. Thank you.

(Mr. H. Stewart Dunn, Jr.'s prepared statement follows:)

STATEMENT OF H. STEWART DUNN, JR., ON BEHALF OF LONGWOOD FOUNDATION, INC.

Summary

(1) Longwood Foundation, Inc. (Longwood) is deeply concerned about several provisions of Section 101 of H.R. 13270, believing that the tax, penalties and restrictions placed on foundations are well in excess of what is needed to correct any abuses that presently exist. Since many foundations and other organizations will be testifying on the adverse effect that Section 101 of H.R. 13270 will have on foundations generally, Longwood will limit its testimony to the peculiar application which two specific provisions of Section 101 have on Longwood.

(2) Longwood owns and operates Longwood Gardens which is a 1,000-acre park and horticultural garden open to the public throughout the year without charge. Longwood Gardens will be visited by approximately one million persons during its current fiscal year. It has more than two hundred full-time employees. Longwood's expenditures for Longwood Gardens exceeded three million dollars during its last fiscal year. Nevertheless, Longwood would apparently not be an

operating foundation under the House-passed Bill. Operating private foundations are not subject to the penalty tax on the failure to distribute income or five percent of principal, whichever is higher; whereas other private foundations are subject to this tax.

The main shortcoming in this portion of the House Bill is that it apparently does not include as an operating asset the investments held by the foundation to produce the income needed to maintain a foundation's public operations. As a consequence, it is practically impossible for any self-sustaining private operating foundation to meet the definition of a private operating foundation in the House Bill. Therefore, this definition should be clarified to include in operating assets the portion of the endowment fund of a foundation which is required to provide the income expended in the active operations of the foundation.

Also, your Committee Report should make it clear that an existing foundation may be divided into two separate foundations so that the operating portion may meet the dual test for an operating foundation.

(3) The provision in the House Bill contains an ambiguity regarding the tax on excess business holdings when the stock held by the foundation is in a passive holding company. The House Bill imposes a tax on private foundations which continue to hold more than certain stated percentages of the stock in a business enterprise. It seems clear from the Report of the Ways and Means Committee and the Treasury's Tax Reform Proposals of April 22, 1969, that this proposal was addressed to the problems that may arise where a foundation, its managers and its major contributors hold a significant interest in an operating business. There is no reason why these restrictions should be applied to a holding company provided the stock held by the holding company is proportionately attributed to the foundation, its managers and its major contributors in determining whether the foundation has an excessive holding in any underlying business. The House Bill uses the term "business enterprise" which should not include a corporation which conducts no business, but only holds a minority stock interest in operating companies. Nevertheless, this portion of the Bill is unclear. Again, the ambiguity could probably be corrected by a statement in your Report that a "business enterprise" does not include a holding company.

Statement

My name is H. Stewart Dunn, Jr. and I am a member of the Washington law firm of Ivins, Phillips & Barker. I am appearing on behalf of Longwood Foundation, Inc.

DESCRIPTION OF LONGWOOD GARDENS

Longwood owns and operates Longwood Gardens in Kennett Square, Pennsylvania. Longwood Gardens is a 1,000 acre-park and horticultural garden which is open to the public throughout the year without charge. It was established in 1937 by the late Pierre S. du Pont. With insignificant exceptions, Longwood has received all of its contributions from Mr. du Pont during his life or under his will. Mr. du Pont died in 1954.

Longwood Gardens is located at the center of the northeastern megalopolis. It is thirty miles from Philadelphia and only twelve miles from Wilmington. It is within approximately a 100-mile range of New York, Washington and Baltimore. The Gardens are not only of interest to those who are particularly interested in horticulture, but are of great interest to the general public. In the current year, it is estimated that approximately one million persons will visit Longwood Gardens. At the rate at which attendance has been increasing, this number should increase to three million within ten years. In addition to its indoor and outdoor floral displays, its gardens and its fountains, Longwood Gardens presents a regular series of concerts, lectures and other performances which are also open to the public. Attached as Exhibit A to my statement is a brochure, describing Longwood Gardens in words and pictures. This is one of the regular brochures which is available to visitors at Longwood Gardens.

Longwood employs over two hundred full-time salaried employees at Longwood Gardens who are solely engaged in maintaining and operating this facility for the public. For the most recently completed fiscal year of Longwood, its expenditures in operations and improvements at Longwood Gardens were in excess of three million dollars. In addition, Longwood finances various horticultural studies and assists educational institutions and other public charities in this and related fields.

Based on a recent study, it appears that Longwood is the eleventh largest foundation in the United States. Very few of the twenty-five largest foundations in the United States are engaged in any direct or active charitable, educational, religious or other direct charitable activity. To the best of my knowledge, Longwood is one of the only two of the twenty-five largest foundations which are primarily engaged in operating facilities open to the public.

DEFINITION OF AN OPERATING FOUNDATION—SECTION 4942(J)(3) (SECTION 101(B))

The House Bill proposes a tax on private foundations which do not make qualifying distributions that are equal to the greater of the foundation's adjusted net income or five percent[1] of the aggregate fair market value of the nonoperating assets of the foundation. This tax on the failure to distribute income is not imposed upon an operating foundation. Under proposed Section 4942(j)(3), an operating foundation is defined as one which spends substanially all of its income on the active conduct of the activities constituting the purpose or function for which it is organized and operating, and substantially more than half of the assets of which are devoted directly to such activities or to such functionally related activities. While the Bill does not define what will constitute substantially all of the income or substantially more than half of the assets, for purposes of the definition of an operating foundation, the Committee Report states that the income tests will be satisfied if at least eight-five percent of the income is spent for the active conduct of the organization's exempt purpose.

The assets test is met if at least sixty-five percent of the organization's assets are devoted to such activities. H.Rep. No. 91-413 (Pt. 1), 91st Cong., 1st Sess. 42 (1969). The Committee Report further states that the assets test is intended to apply to organizations which provide facilities to the public. The assets test is intended to apply particularly to organizations "such as museums, Callaway Gardens (a horticultural and recreational area for the use of the public at Pine Mountain, Georgia), Colonial Williamsburg . . . and Jackson Hole (which operates functionally related businesses in connection with public parks and its exempt purposes)". H.Rep. No. 91-413 (Pt. 1), 91st Cong., 1st Sess. 42 (1969). It would seem clear, therefore, that the House intended to include under the definition of "operating foundation" an organization such as Longwood Gardens. Since the principal function of Longwood is to operate and maintain Longwood Gardens for the benefit of the general public and in view of the size and scope of this operation, Longwood would certainly be considered to be an operating foundation under any normal standards. However, under the House Bill, Longwood could not qualify as an operating foundation. The principal difficulty is that the House Bill would apparently not include securities maintained to provide income for operations as part of the assets which are devoted to operations.

As stated above, Longwood received practically all of its endowment from Pierre S. du Pont during his life or under the will of Mr. du Pont and has received no significant contributions since 1954. It is, therefore, entirely dependent upon its own endowment to sustain the operations of the Gardens. Over its history, Longwood has expended all of its income from its endowment in maintaining and improving Longwood Gardens and in the other charitable operations of the Foundation. However, if Longwood does not come within the definition of an operating foundation, it will become necessary for Longwood to distribute annually part of its principal in order to meet the requirements of section 4942. For example, if the Bill had been fully applicable for the last fiscal year of Longwood, the Foundation would have been required to distribute more than three million dollars of its endowment even though the Foundation's expenditures and contributions were in excess of one hundred percent of the income of the Foundation in that year. Thus, the Bill as applied to Longwood would annually erode its endowment and would ultimately make it impossible for the Foundation to continue to operate Longwood Gardens.

It is clear that this was not the intention of the House or of the Ways and Means Committee. As noted above, the Ways and Means Committee expressly stated that the assets test in the definition of an operating foundation was to protect organizations such as museums, Callaway Gardens, Colonial Williams-

[1] For taxable years beginning after 1970, the percentage may be adjusted upward or downward by the Secretary's Delegate to reflect changes in interest rates and investment yields.

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burg and Jackson Hole. Certainly, Longwood Gardens is engaged in the same type of activity as the organizations referred to in that report. In order to correct this unfair and apparently unintended consequence, the assets test in 4942(j)(3)(B)(1) should be modified to include securities and other assets maintained by the foundation to the extent that the income from such investments is expended in the active operations of the foundation. There should also be a comparable modification of the language of section 4942(e)(1)(A) making the same change in the definition of assets used in carrying out the foundation's exempt purpose.

Furthermore, your Committee Report should make it clear that an existing foundation may, if it so desires, be divided into two separate foundations in order that the operating assets, together with the endowment to support such operations, may be transferred to one foundation, with the balance of the assets being transferred to a second foundation; with the result that the first foundation would be an operating foundation provided it meets the requirements of section 4942(j)(3), as modified, and the second foundation would not be an operating foundation.

EXCESS HOLDINGS REQUIREMENT

Longwood's endowment is invested in a widely diversified portfolio of stock and bonds. Its holdings include common stock in more than fifty publicly-held companies. In none of these companies are its holdings in excess of the two percent de minimus rule provided by section 4943(c)(2)(C). However, it does own between four percent and five percent of the outstanding common stock of Christiana Securities Company. Because of the very broad sweep of the attribution rules under section 4946(a), it appears that Longwood and persons who would be disqualified persons own in the aggregate more than twenty percent of the stock of Christiana Securities. Christiana Securities is not engaged in any active business and is simply a holding company. Its principal asset is stock in the du Pont Company. However, if the du Pont Company stock held by Christiana Securities Corporation were attributed pro rata to Longwood and disqualified persons, their total aggregate holdings of du Pont from all direct and indirect sources and attribution would certainly not exceed twenty percent of the outstanding stock of the du Pont Company. The test of excess holdings of stock under the House Bill applies only to holdings in a business enterprise. Certain items are excluded from the definition of a business enterprise under section 4943(d)(4). However, the definition of stock in a holding company is left ambiguous.

The Treasury's Tax Reform Proposals state that the purpose of this provision is to require a foundation "to sell or contribute to a publicly-supported charity a controlling interest in a corporation conducting *an unrelated trade or business*". Technical explanation of Treasury Tax Reform Proposals of April 22, 1969, Tax Reform Proposals Contained in the Message of the President of April 21, 1969, page 120. The Ways and Means Committee Report states that the purpose of its proposal is to prevent a foundation from controlling a business. H. Rep. No. 91-413 (Pt. 1), 91st Cong., 1st Sess. 27 (1969). Thus, it appears that neither the Treasury nor the House intended the Bill to apply to a holding company which was not engaged in any business activities. Of course, in order to avoid any improper use of holding companies as a device to avoid the impact of section 4943, any stock of operating companies held by the holding company should be proportionately attributed to the shareholders of the holding company. If by such attribution plus other ownership, the foundation then has excess holdings for purposes of section 4943, it would be required to dispose of such excess holdings in the holding company. Christiana Securities Company and Longwood are prepared to comply with such a modified definition of excess holdings. As a consequence, none of the purposes of the Bill would necessarily require Longwood to dispose of its holdings in Christiana Securities.

In the absence of any substantive purpose for applying section 4943 in a situation such as this, the provision imposes unnecessary hardship. The Christiana stock held by Longwood may be regarded by the Securities and Exchange Commission as controlled stock for purposes of the Securities Act of 1933. This would place substantial limitations on the market for Longwood's Christiana stock unless Christiana were willing to undergo registration and Longwood were willing to bear the expense in having the stock registered. Furthermore, the tax imposed by section 506 would be applicable on this sale to the extent that the

sales price exceeded the Foundation's basis in the stock on December 31, 1969. The net result of these various proposals is that the assets of Longwood would be dissipated by this sale; whereas, the sale is not required in order to carry out any of the legislative policies which lie behind section 4943. Therefore, it is requested that the definition of "business enterprise" in section 4943 be clarified to exclude a holding company unless the foundation and disqualified persons own the required percentage of stock in the underlying operating company after application of all the attribution rules in the Bill, plus the attribution of a proportionate amount of the stock of the operating company held by the holding company.

CONCLUSION

As noted in my summary, my presentation is limited to the two technical provisions in the Bill which have a particularly adverse effect on Longwood. It appears that neither of these results were intended. It would be indeed unfortunate if the work of a major operating foundation which is directly engaged in providing facilities to the public should be curtailed as a consequence of technical provisions which have an impact not intended by their sponsors.

I wish to thank the Committee for its kind consideration of these points.

The CHAIRMAN. John J. Schwartz, vice president, American Association of Fund-Raising Counsel, Inc.

STATEMENT OF JOHN J. SCHWARTZ, VICE PRESIDENT, AMERICAN ASSOCIATION OF FUND-RAISING COUNSEL, INC.

Mr. SCHWARTZ. Mr. Chairman, you already know who I am and whom I represent. I want to thank you and Senator Bennett for giving us the privilege of testifying today.

I am going to try to cut down on the redundancy because our position on many of the things that have been said today is similar to the views already expressed.

Since we work in broad fields of philanthropy in our organization, we have more interest than some other groups in Government partnership with the private sector in common public endeavors which is sometimes underestimated by Americans generally.

I would like to add to the testimony of the other witnesses today a few figures to set a larger stage against which the provisions of the bill before you may be considered.

Government not only has stimulated private giving with tax status including the deduction of charitable contributions, but also by quite a few progressive laws providing for matching funds. The Hill-Burton Act is a classic case of this. It came out in 1947 and in 21 years, interestingly enough, 10 billion of construction of new medical facilities has been built as a result.

The important thing from today's standpoint is that $3.5 billion of the money came from private philanthropy much of which, without the Government inducement would not have been given and consequently the hospitals involved would not have been improved or erected.

Similarly, the Educational Facilities Act, since it began in 1964, has already given $2 billion to 1,500 colleges and universities but this has generated $7 billion worth of new construction for higher education and most of it has come from philanthropy.

Americans have responded to this kind of stimulus to a high degree every year for 30 years which is as long as we have been able to keep track of what they have been giving. The giving has increased. In

1968 it was $15.8 billion and 77 percent of this is from individuals. In 1969 it will surely exceed $17 billion and we project at least $25 billion for 1975.

So we are talking about a major financing by the private sector of the institutions that we have been hearing about today. This financing obviously takes encouragement in the form of Federal tax law, not discouragement, for the ultimate benefit of the country.

Therefore, we would go on record as being opposed to several provisions of the House bill that have been discussed at length today. I am not going to take time to do any more than mention them: the allocation of deductions, the amount of appreciation of gifts of property being included in tax preference income.

Our Association did a survey of institutions, large and small, to see how important gifts of appreciated property have been in recent years. In our written testimony there are figures from quite a number of schools and hospitals and other organizations.

Just to summarize the major findings, with 50 colleges and universities which received $468 million in their programs, 48 percent of their money was received in gifts of appreciated property. Three hundred twenty hospitals received $148 million and 45 percent of their money came from gifts of appreciated property.

The bill as it affects foundations directly refers to philanthropy in a couple of instances which I would like to just take a moment to mention. I don't think anybody, any good citizen of this country, wants to see foundations accumulate funds or engage in self-dealing. But at the same time, taxing their investment income by 7½ percent is going to have a very measurable effect on philanthropy.

One and a half billion dollars was given by foundations last year to nonprofit institutions and agencies. Seven and a half percent of this is more than $100 million but actually it could be twice this, because foundation giving very often is in the form of challenge grants where the recipient institution matches that gift on a 2-to-1 or 3-to-1 basis.

Some major programs for small institutions as well as large would not get off the ground without this kind of stimulation.

One quick example. Sixteen colleges and universities had capital programs a few years ago and raised $35 million. The same schools all received Ford Foundation challenge grants and the programs with those challenge grants, raised $118 million, or more than three times as much.

Another thing that we feel will hurt philanthropy in the long run is the provision that gifts of appreciated property when given to a grant-giving foundation have to be distributed within 1 year or the donor cannot claim the appreciated value. We feel this will discourage the flow of new capital into foundations, and in fact if it had been in existence many years ago, some of the foundations which have done commendable things for our country might not even be in existence today.

The future needs for social improvement are staggering, as we all know. The Carnegie Commission of Higher Education says that in 1968, $17.2 billion were expended for higher educational facilities. This figure is going to go up to $41 billion in 1976, according to this Commission. If we maintain the pattern of philanthropy, 10 percent of this will come from private donors.

The former Secretary of HEW has said that it would take $10 billion to modernize the nation's health facilities. If, in this realm, we maintain the pattern of private to public giving, $4 billion would have to come from private gifts.

So, in conclusion, the provisions we would like to see either deleted or revised all bear on this same problem, to keep stimulating more gifts to American philanthropy because our society will never get as much as it really needs from this resource.

Thank you, sir.

The CHAIRMAN. Thank you very much.

Senator BENNETT. Just one brief question. I came in in time to hear you express your concern about the time limit on gifts to grant institutions that have grants. Is it the 1 year that bothers you or are you bothered by any time limit?

Mr. SCHWARTZ. I am more bothered Senator, about the fact that if someone donates appreciated property to a foundation, either to begin it or to expand its giving capacity, he would not be able to take the appreciated value of that gift as a tax deduction unless the Foundation distributes it within 1 year, which is not always practical.

However, I will say that we all feel that the measures that would have foundations distribute their income within a reasonable period we applaud because this would certainly keep some of them from sitting on their funds, which has been the case, as we all know.

Senator BENNETT. Thank you.

The CHAIRMAN. Thank you.

(Mr. John J. Schwartz' prepared statement follows:)

SUMMARY STATEMENT OF JOHN J. SCHWARTZ, EXECUTIVE VICE PRESIDENT, AMERICAN ASSOCIATION OF FUND-RAISING COUNSEL, INC.

Introduction

Mr. Schwartz represents the American Association of Fund-Raising Counsel, Inc., an organization of 23 fund-raising counseling firms. Members serve 1,000 organizations annually, on programs which raise $1 billion in contributions.

The Association believes several provisions of the bill are detrimental to philanthropy.

The voluntary sector

Philanthropy and its institutions have grown with the nation. They constitute a free enterprise social system. Tax incentives have encouraged a dual system of social programs.

The partnership

Partnership with government is mutually advantageous to public and private sector. This is readily apparent in health and education. Private giving is a major factor in hospital and educational construction. Tax incentives have encouraged private support, which has maintained an upward trend for 30 years, now stands at $15.8 billion annually. Incentives are necessary to continued advance.

A reversal of philosophy

Proposed bill is a complete reversal of legislative philosophy on philanthropy. Several sections will have drastic effect on contributions:

1. Allocations of deductions.
2. Limitation on tax preferences.
3. 7.5 percent tax on foundations.
4. Treatment of capital gains in gifts of property to private foundations.

Importance of gifts of property

Gifts of appreciated property comprise 48% of total giving to educational construction, 27% of annual gifts to colleges, 38% of gifts to hospital construction

and 35% of annual gifts to hospitals. These gifts are equally important in other fund-raising programs. When identified as leadership gifts, they have strong psychological impact.

Allocation and tax preference provisions will discourage gifts of this type.

Incentives not loopholes

Incentives deliberately provided by previous congresses to strengthen social system. Removal will force abandonment of programs or dependence on added tax funds.

Foundation proposals

Proposed foundation tax would come from funds available for grants, which often have effect of "challenge" to stimulate individual and corporate giving.

Proposal to tax appreciation in gifts to private foundations would impair their worthwhile activities.

The future needs

Social needs are increasing. Funds necessary for higher education will more than double by 1976. Ten billion dollars is needed for hospital modernization. Costs and demands are rising in all areas. Private giving must be encouraged if the private sector is to fulfill its role.

Changes requested

At least:

1. Exclude charitable deductions from allocation.
2. Exclude appreciation in charitable gifts from tax preference income computation.
3. Delete foundation tax.
4. Continue present treatment of appreciated property gifts to all foundations.

STATEMENT

Mr. Chairman, and distinguished members of the committee, it is a privilege to appear before you today, and one which is greatly appreciated.

I am (John J. Schwartz) Executive Vice President of the American Association of Fund-Raising Counsel, Inc., a professional organization, established 34 years ago, of fund-raising counseling firms. Our 23 member firms, located across the nation, engage in management of fund-raising programs for the nation's nonprofit philanthropic agencies. I estimate that our firms are currently serving more than 1000 philanthropic institutions or agencies, assisting them in raising more than a billion dollars annually in voluntary contributions from the general public, corporations and foundations.

The objectives of the Association are to encourage continued high standards of ethics and procedures in philanthropic fund raising, to serve as a channel of information to the public about philanthropy and its benefits to society, and to provide a center for information and assistance for all philanthropic organizations.

Our member firms serve philanthropic organizations on a fixed fee basis, in a management capacity, so that the passage of this bill does *not* affect us economically. In fact, passage in its current form may actually increase the need for our services. We are appearing because our acquaintance with the fund-raising problems of thousands of organizations, and with the giving motivation of philanthropic-minded persons, places us in a unique position to observe the philanthropic scene.

From that vantage point, we must conclude that the tax reform bill, as passed by the House of Representatives, would have a very detrimental effect on the development—and possibly the continued existence—of many of our social institutions which rely on voluntary private contributions for a share of their support.

The voluntary sector

Practically all of these institutions were initiated by small groups of citizens acting voluntarily to meet a social need. As their worth was demonstrated, other citizens joined in support, and these institutions grew along with the nation and its economy, giving us a free enterprise social system unmatched anywhere in the world. Many of them eventually came under government control as tax-supported institutions. Others remain as viable private institutions often

working in partnership with government. This partnership has long been encouraged by government, which has granted tax exemptions to the institutions and provided for deductions from taxable income by their supporters.

The partnership

This partnership has worked to the advantage of both public and private sectors. This is most readily apparent in health and education. Federal grants in these areas have helped to stimulate private giving, and private giving has helped to build classrooms and health facilities without excessive debt financing or heightened demands for tax funds.

Giving to hospitals is a major factor in hospital construction. In the twenty-one years since the inception of the Hill-Burton program for medical facilities construction, total construction under the program cost more than $10 billion, of which $3.1 billion came from Federal grants, while an estimated $3.5 billion came from private contributions, most of which would not have been contributed without the stimulus from the Federal government. The other $3.4 billion came from borrowing or local government sources.

During the past six years, private expenditures for hospital construction totaled $7.6 billion, of which about 50 percent came from private contributions.

Since the Higher Education Facilities Act became operational in 1964, 1500 institutions have received Federal grants for construction totaling a little more than $2 billion, which generated a total of nearly $7 billion worth of construction, a substantial part of which was financed by private philanthropy. In the same period, private gifts to higher education totaled more than $7 billion, a majority of which went into construction and other development projects.

Since deductions for contributions were written into the income tax law in 1917, succeeding generations of legislators have liberalized these provisions in recognition of the efficacy and worth of a dualistic social system—part free enterprise and part government supported.

Encouraged by government support of this system, the American public has demonstrated a willingness to share its growing affluence in support of its private institutions by direct contributions. Such support has continued an upward trend for 30 years. In 1968, it reached a new high of $15.8 billion and should go beyond $17 billion this year. Seventy-seven percent of the 1968 total, or $12.1 billion, came from individuals.

In 1968, these funds were distributed to the major philanthropic areas approximately as follows:

Religion: 46.8% ($7.4 billion).
Health and Hospitals: 17.3% ($2.7 billion).
Education: 16.7% ($2.6 billion).
Human Resources: 7.0% ($1.1 billion).
Civic and Cultural: 4.5% ($710 million).
Other: 7.7% ($1.2 billion).

As the needs in these areas increase, the giving response from the public keeps pace. Approbation of government through tax incentives has been a major factor in maintaining this pace. In the foreseeable future, the needs will continue to increase at an even greater pace. We are confident that, if tax incentives are continued, the private sector will continue to shoulder its share of the burden.

Although we have not conducted recent surveys in other areas, our experience has proven that these gifts are equally important to fund-raising programs, for youth and welfare agencies, churches, and civic and cultural projects—particularly those for capital expansion. For instance, the Council of Jewish Federations and Welfare Agencies estimates that, of total contributions of $235 million to its agencies last year, 25 percent was in the form of appreciated property.

It is obvious that these gifts, in a monetary sense, are important to the success of programs to maintain, expand or improve the nation's social resources. Less obvious is the tremendous psychological value they have. When identified as leadership gifts, they serve to motivate donors of smaller sums, and elicit a greater response to the fund-raising appeal.

The drafters of the House Bill avoided placing a direct tax on the capital gains contained in gifts of property, but these two provisions—for allocation of deductions and limitation of tax preferences—will tax them indirectly, and reduce the tax benefits to the donor. Although studies have shown that these benefits are not the primary motive for giving, they are an important factor in motivating large gifts.

These provisions are aimed at the high income group, who are generally also the big givers. Publicity attendant to tax reform has created the erroneous im-

pression that deduction of charitable gifts by these donors is a loophole—an abuse of the law. This is not so. Tax benefits merely enable a donor to give more. The *benefit* accrues to the *charitable institution*, not to the donor. Much has been made of the statements in the tax reform proposals presented to the House Ways and Means Committee on April 22nd by the Treasury Department (U.S. Govt. Printing Office—Publication No. 28-2000, page 28) concerning the 154 individuals with incomes of $200,000 or more in 1966 who paid no income tax. The statement reveals that these person had a combined adjusted gross income of $112 million. Their deductions for contributions totaled $78.6 million, or 70 percent, of which $55 million was in non-cash gifts. Since the normal limit on charitable contributions is 30 percent, it is probable that a substantial number of these qualified for the unlimited charitable deduction permitted by law. The bill would repeal the unlimited deduction and eventually establish a limit of 50 percent of income. This will reduce these gifts by 50 percent. Since two-thirds of these gifts are made in property, they could be further reduced by the limited tax preference and allocation proposals.

The tax money saved by these people does not go back into their own pockets. It goes to support a variety of programs which are essential to well-being of our society.

Incentives not loopholes

So-called "loopholes" arise from oversights in drafting of legislation. The tax incentives for charitable contributions are not "loopholes." They were deliberately written into the law by previous Congresses to strengthen our free enterprise social system—and they have achieved the desired effect. If this system is to meet the ever-increasing demands of todays' society, their continuation is essential.

A reversal of philosophy

With regard to philanthropic organizations, the proposed tax bill is not a reform, it is a complete reversal of that legislative philosophy of encouragement of private contributions.

There are several provisions in the House bill which will have a drastic effect on voluntary giving.

The most serious of these is allocation of deductions between taxable income and preference income, with the gain in value of appreciated property which is donated included in preference income. By making such a gift, a donor would not only receive a limited charitable deduction, but would reduce his other deductions by the ratio of preferenced income to taxable income.

Almost equally serious is the provision for limitation of tax preference income, with the gain in value of appreciated property given to a philanthropic institution included as an item of preference income. In cases where an individual's tax preference income exceeded his taxable income, he would be taxed indirectly on appreciation in gifts to charitable institutions.

These two provisions combined would serve to greatly reduce tax incentives for gifts of appreciated property. Such gifts are extremely important to the success of fund-raising programs of the nation's colleges, hospitals and other philanthropic institutions, both for annual operating expenses and capital expansion.

Importance of gifts of property

To document their importance we recently conducted a survey among a sample of institutions, both large and small, in the areas of higher education and health. Fifty institutions of higher education of all types reported that in recent capital fund-raising campaigns, which raised an aggregate total of nearly $467.8 million, more than $224.8 million, or 48 percent, of the total was given in gifts of appreciated property. The percentages for individual schools ranged from 10 percent to 82 percent, with half of them getting more than 46 percent of the value of gifts in this form.

In annual fund-raising programs, twenty-four of the colleges and universities raised a total of nearly $64 million, with 37 percent, more than $23 million, coming in gifts of securities which had appreciated in value.

Analysis of a survey of hospital fund-raising programs revealed similar results. In 349 capital fund-raising campaigns for hospitals, which raised nearly $217 million, mostly for building purposes, nearly $83 million, or 38 percent, was contributed in gifts of property. Percentages for individual hospitals ranged from 76 percent to zero percent, with half of them getting more than 44 percent

of the total value of gifts in this form. Thirty-five of these hospitals reported raising nearly $8 million in annual giving programs, with $2.7 million, or 35 percent, coming in property gifts.

Specific examples of the importance of these girts to individual institutions are attached to my written testimony.

If the provisions of the House bill stand, many of the programs funded by philanthropy will either have to be abandoned or the funds for them will have to be provided through appropriations from general tax revenue.

Foundation proposals

Some of the proposals in the House bill affecting private foundations would also weaken support of our philanthropic institutions. Foundations last year distributed about $1.5 billion in grants. About 41 percent of it went to education; another 34 percent to health, welfare and science, and about 10 percent to the humanities. Imposition of the 7½ percent tax the bill proposes would reduce funds available for distribution by just about the same percentage.

Foundation grants assume far more importance than their monetary value when they are used as challenge grants—a device which helps to raise the sights of prospective donors. This importance was pointed up by a recent survey, conducted by one of our firms, of the effect of Ford Foundation challenge grants on sixteen college and university capital fund-raising campaigns. Each of the schools had conducted prior campaigns, in the recent past, which raised an aggregate total of $35 million. With the stimulus of the Ford grants, the same schools raised a total of $118 million—more than three times as much—in their challenge campaigns.

Another harmful provision is that gifts of appreciated property to a private foundation must be distributed by the foundation within one year if the donor is to deduct the appreciated portion of the gift. Such a provision would discourage channeling of new capital into foundations, which constitute a growing source of funds for social betterment and play an important role in seeking solutions to society's problems—both existing problems and those which emerge with changing social conditions. If this provision had been in effect in the past, many of the large foundations which now exist might never have been formed.

We favor the foundation provisions in the bill which would eliminate self-dealing and other abuses, but feel strongly that those cited would seriously impair the worthwhile activities of those foundations which have not been guilty of abuse. We believe that congressional actions should strengthen the ability of foundations to carry out their objectives—not weaken them, as the proposed provisions would do.

There are other provisions which will affect charitable giving to a lesser degree. Other witnesses will present expert testimony on these points, but I would like to touch on those provisions which would eliminate or sharply curtail tax incentives for deferred gifts, such as charitable remainder trusts, life income contracts and gift annuities. Such forms of giving are becoming increasingly important, particularly to colleges, universities, hospitals, and religious projects. This importance is pointed up by an example: Of 18 Southwestern colleges responding to our survey, eleven of them had income totaling $2.1 million last year from such gifts, and ten of them had on their books a total of $20 million in deferred gifts which will accrue to them when trusts or contracts mature.

The future needs

The need for funds in social programs increases at an alarming rate. Rising costs and increased demand have escalated expenditures in all areas, and the outlook for the future is that they will rise even more rapidly.

The Carnegie Commission on Higher Education estimates that college and university expenditures will rise from $17.2 billion in 1968 to $41 billion in 1976. About ten percent of this must come from private gifts.

The former Secretary of Health, Education and Welfare estimated that $10 billion was needed to modernize the nations health facilities. If the past patterns are followed, about $4 billion of this must come private gifts.

In all other areas—religion, welfare, the arts, youth agencies, and civic programs—increased costs and demands are creating crises in financing.

In the past, a fair share of this burden has been carried by philanthropy. Now, more than ever, increased giving must be encouraged, so that the private sector may continue to carry its share. The tax incentives to giving should be left unchanged, or liberalized, if the philanthropic institutions are to continue to fulfill their vital role.

Changes requested

We respectfully request that you consider at least the following changes to sections of the House Bill:

1. Section 302—exclude charitable deductions from those which must be allocated between taxable income and tax preference income;
2. Section 301—exclude appreciation in the value of property contributed to charitable institutions in computing tax preference income;
3. Section 101—delete provisions for imposition of a 7½ percent tax on net investment income of private foundations;
4. Section 201—delete that portion of the section, page 124, lines 4 through 21, which provides that a donor who contributes appreciated property to a private foundation must elect between:
   (a) Deducting only the cost of other basis of the property; or,
   (b) Deducting the fair market value of the property and including the appreciation in his tax base, unless the foundation makes a distribution out corpus, in an amount equal to 100 percent of all such contributions, within one year after the close of the taxable year in which the contribution was received.

EDUCATIONAL INSTITUTIONS

CAPITAL CAMPAIGNS

Institution	Total contribution	Total in appreciated property	Percent property
Mercersburg Academy	$1,784,804	$519,727	29
Washington & Jefferson College	1,079,337	417,148	38
Dartmouth College	30,000,000	24,600,000	82
University of Rochester	26,400,000	19,500,000	75
Emory University	23,000,000	[1] 6,700,000	29
University of Pennsylvania	[2] 31,320,700	16,600,000	53
18 Pennsylvania colleges	[2] 105,900,000	43,415,000	41
Harvard University	[3] 84,500,000	45,500,000	54
Rose Polytechnic Institute (Indiana)	1,792,000	443,000	24
Grinnel College (Iowa)	3,304,000	1,225,200	37
Earlham College (Indiana)	4,594,000	3,600,000	78
Ripon College (Wisconsin)	2,569,000	1,226,610	48
Worchester Polytechnic Institute (Massachusetts)	15,400,000	9,446,360	61
Converse College (South Carolina)	4,350,000	2,011,680	46
Trinity College	[4] 8,191,000	2,866,850	35
15 Southwest colleges and universities	37,276,982	6,037,187	16
Carnegie-Mellon University	57,000,000	28,800,000	40
Saginaw Valley College (Michigan)	4,300,000	433,000	10
Lehigh University (Pennsylvania)	25,000,000	11,500,000	46
University of Cincinnati	30,000,000	14,000,000	47
Beloit College	1,706,000	955,000	56
The Masters School	623,500	152,500	24

[1] 130 donors.
[2] 3 years.
[3] All contracts last 7 years.
[4] 1966–69.

ANNUAL FUND

Institution	Total contributed	Amount in securities	Percent in securities
Mercersburg Academy	$176,418	$43,208	25
Dartmouth College	2,000,000	620,000	31
University of Pennsylvania	2,000,000	[1] 1,000,000	50
16 southwestern colleges and universities	26,860,539	10,233,292	38
Carnegie-Mellon University	[2] 30,499,490	10,939,106	36
Saginaw Valley College (Michigan)	414,000	175,000	42
Creighton University (Nebraska)	[3] 800,000	160,000	20
Hastings College (Nebraska)	200,000	20,000	10
Lehigh University	1,015,230	294,408	29
Collegiate School (New York)	2,000,000	600,000	30
Beloit College	[4] 13,600,000	2,500,000	18
The Masters School	195,000	35,000	18

[1] Annually.
[2] 3 years.
[3] 2 years.
[4] 10 years.

MEDICAL INSTITUTIONS

CAPITAL CAMPAIGNS

Institution	Total contributions	Amount in property	Percent in property
320 hospitals (25 years)	$148,000,000	$66,600,000	45
Newton-Wellesley Hospital (Mass.)	3,500,000	724,000	21
Shadyside Hospital (Pittsburgh, Pa.)	3,300,000	1,110,000	34
3 affiliated hospitals (Boston, Mass.)	7,500,000	2,652,446	35
Children's Hospital (Boston, Mass.)	15,800,000	6,952,000	44
2 hospitals (Erie, Pa.)	6,870,000	755,700	11
Montefiore Hospital (Pittsburgh, Pa.)	3,000,000	290,000	10
Beverly Hospital (Mass.)	3,300,000	2,500,000	76
19 Southwestern and Midwestern hospitals (Kansas, Colorado, Texas, Arkansas, Missouri, and Arizona)	25,395,535	1,300,693	5

ANNUAL CAMPAIGNS

Institution	Total contributions	Amount in property	Percent in property
Community Hospital (Glen Cove, N.Y)	225,000	85,500	38
Newton-Wellesley Hospital (Mass.)	232,000	108,817	47
Shadyside Hospital (Pittsburgh, Pa.)	80,000	20,000	25
3 affiliated hospitals (Boston, Mass.)	708,061	434,261	61
Children's Hospital (Boston, Mass.)	1,703,000	749,000	44
York Hospital (Pennsylvania)	[1] 282,680	267,125	95
Montefiore Hospital (Pittsburgh, Pa.)	200,000		48
Riverview Hospital (New Jersey)	239,500	35,000	12
Beverly Hospital (Mass.)	[1] 404,553	78,727	19
Southwestern and Midwestern hospitals (Texas, Missouri, Colorado, Arizona, Kansas, Oklahoma, and Arkansas)	3,672,554	938,977	26

[1] 2 years.

The CHAIRMAN. Mr. Lloyd Tupling, Washington representative, Sierra Club.

STATEMENT OF W. LLOYD TUPLING, WASHINGTON REPRESENTATIVE, SIERRA CLUB

Mr. TUPLING. Mr. Chairman, Senator Bennett, you have my prepared statement and summary and I think I can summarize the thrust of our arguments in two or three sentences here.

The Sierra Club believes that the Internal Revenue Code should be changed to allow donors to deduct all contributions to nonprofit membership organizations which are used to support their charitable and educational purposes, including disseminating propaganda, and legislative activity in support of their charter purposes.

As you know, the Sierra Club last year lost its status as a 501(c)(3) organization on the basis of a finding by the IRS that we had engaged substantially in influencing legislation, citing the case that was an outgrowth of the proposal of the Department of Interior to build some dams in Grand Canyon. We ran some ads and the day after the ads ran, the IRS said, you are influencing legislation, so we are going to put you on the list where you can't gain any tax deductible funds.

It is interesting to note that after this happened the central Arizona project was enacted into law last year by the Congress and in the wisdom of the Congress they wrote into the statute that there should be no dams built in Grand Canyon.

When the President signed this bill into law, he made special mention of the fact that this bill which went through Congress, and which he was signing it into law, prohibited the building of dams in the Grand Canyon National Park.

It seems to me that it is an anomaly of the statute that an organization that has spent some money, no doubt about it—it may have influenced legislation, it may not have influenced legislation——

Senator BENNETT. Was its purpose to influence legislation?

Mr. TUPLING. Yes.

Senator BENNETT. Then it didn't matter whether it influenced it or not. Its purpose was to influence.

Mr. TUPLING. Yes. Its purpose was to influence.

Senator BENNETT. OK.

Mr. TUPLING. But the problem with the statute is that it has to be substantial and the Internal Revenue Service to this day has never described what is "substantial." Now, if it is effective, that may be substantial. I don't know, but it should be a specific part, or there should be some level above zero that you can judge substantiality by. And the statute doesn't have this in it at all.

Senator BENNETT. The interpretation of the word "substantial" has generated more lawyers' fees than any other word in the English language and it will continue to do so.

Mr. TUPLING. Well, Senator Bennett, that is why we proposed in our statement to the committee that in this bill there be a provision written in that organizations, broadly based, public-supported organizations, are permitted to have this leeway, this ability to devote some part of their funds, to state it plainly, to propaganda and influencing legislation.

I really think it is a valuable, socially desirable activity for organizations that are broadly supported by the public to bring their views to Congress and to influence legislation just as business is permitted to do with the provisions that were made in the 1962 act where business was permitted to deduct lobbying activities as business expenses.

The CHAIRMAN. I think that the best point of your argument is that the Internal Revenue Service down there just picks and chooses who gets tax exemption and who doesn't when they make some effort to influence legislation.

It just depends on whether they think you are right. If you are right and you are doing something they want you to do, then what you are doing is not substantial, and that would appear to be decided practically out of the White House.

If the executive agrees what you do helped to pass legislation with which the executive seems to agree, then they rule what you do is not substantial and if the executive doesn't seem to be agreeable with you at that particular point, whatever you do is substantial.

As I understand it, your organization tried to preserve the Redwoods, did they not?

Mr. TUPLING. That is right.

The CHAIRMAN. What did they rule about that? Was that substantial or not?

Mr. TUPLING. Our expenditures in the Redwood Park campaign came after we had been given notice by the Internal Revenue Service that they could not guarantee that contributions to the Sierra Club would be deductible after that date. And it took almost a year and a half for the question to get settled on this issue

The CHAIRMAN. Well, they did not make you taxable, though.

Mr. TUPLING. No, no.

The CHAIRMAN. Based on your Redwoods campaign. So they apparently concluded, inasmuch as what you were doing was something which you agreed in trying to preserve the Redwoods they concluded what you did was not substance, even though—if I understand it, at that point you had already lost your exemption anyway.

Mr. TUPLING. We hadn't lost it entirely because we were in kind of a limbo situation. We felt that notice from the District Director of the Internal Revenue Service in San Francisco saying that after that date they could not guarantee a contribution to the Sierra Club would be deductible for income tax purposes, had the effect of stopping contributions. It took 18 months before it was finally decided here in Washington. The Director and the Secretary of the Treasury confirmed the District Director's decision.

So here we were 18 months, you know, in limbo and people didn't know whether they could deduct it or not.

The CHAIRMAN. Well, it would seem to me that anything foundations or tax-exempt organizations that want to influence legislation should not be tax-exempt, whether they are right or wrong.

Now, if you arrive at that conclusion, then you haven't got to argue about whether it is substantial or not substantial. The question is, are you trying to influence legislation? And if it is, then your activities in that regard should not be tax exempt. Then we will treat them all alike. We won't try to decide whether we agree or disagree. The question is, are you trying to influence legislation. If you do, then no tax exemption, because if it needs any influencing at all, then it is controversial.

Mr. TUPLING. Corporations and associations, industry associations, are able to deduct costs of lobbying under the statute and——

Senator BENNETT. But their entire income is not tax exempt. Corporations—maybe they use part of their income for lobbying but ninety-nine and ninety-nine one-hundredths percent of their income is taxable.

Mr. TUPLING. This is hard to analyze—unless you are going to account for every industry, every business——

Senator BENNETT. There is a basic difference between a taxable corporation and a tax-exempt foundation.

Mr. TUPLING. Yes, I know there is. And I agree with you entirely on that point. But every dollar that, say, somebody like Georgia Pacific Corp. that we had the argument with on the Redwoods, every dollar they spent for their newspaper ads was a deductible expense under the statutes.

The CHAIRMAN. Yes, but Georgia Pacific Corp.——

Mr. TUPLING. On the other hand, we are penalized, we lose our tax-exempt status because we are trying to influence legislation. It doesn't seem like simple justice.

Senator BENNETT. Wait a minute. If you had then moved into the status of a corporation and become subject to tax, you could have deducted the cost of the ads as a legitimate expense of your operation just as the corporation does.

Mr. TUPLING. Well, perhaps that is the way this bill ought to be rewritten, so that charitable organizations that spend all their money,

or don't spend all their money, are taxed at the same rate as corporations.

The CHAIRMAN. You posed the problem and we will try to work out some answer. Right now I don't know.

Thank you very much, sir.

(Mr. W. Lloyd Tupling's prepared statement follows:)

STATEMENT OF W. LLOYD TUPLING, WASHINGTON REPRESENTATIVE, SIERRA CLUB

SUMMARY

The Sierra Club's loss of its status as a 501(C)(3) under the Internal Revenue Code illustrates the short-comings of existing law as it affects broadly supported public charitable and educational groups. The Internal Revenue Service denied the Club 501(C)(3) status on grounds that it had engaged in propaganda and influenced legislation. The Club denied this and held that only an insubstantial part of its total activity was directed toward legislative matters. Vagueness of language in the present law acts as a deterrent to traditional, publicly based organizations interested in legislation.

The Sierra Club urges that the present unworkable and grossly discriminatory limitations on activities of broadly based, public charitable organizations be removed. Two limitations should remain:

1. Permissable legislative activities must be related to legislation affecting the continued existence of the organization or to legislation involving the objectives that this organization was formed to pursue;
2. There must be no intervention in elections.

These changes would overcome the adverse effects of the Code as it is now being interpreted. At present, the Code gives an advantage to the profit-seeking sector of public opinion; puts non-profit corporations at a competitive disadvantage when they are opposing business corporations on an issue before Congress; puts many publicly supported membership organizations in the same category with privately endowed foundations; and puts public-service membership organizations under a mandate to comply with language, designed to limit their activities, which is so vague as to be undefinable.

STATEMENT

Mr. Chairman, my name is Lloyd W. Tupling. I am the Washington Representative for the Sierra Club and for Trustees for Conservation. I am appearing and filing a copy of this statement on behalf of the Sierra Club, an organization having more than 72,000 members who are devoted to the preservation of outstanding scenic and natural areas and the integrity of our physical environment.

Since its inception, the club has communicated its convictions about the value of keeping enough areas natural to both the public at large, and when appropriate, to Congress. At times it has done this inconspicuously, but at other times the imminence of threats to superlative natural areas, which are irreplaceable, has forced the club to be more conspicuous in publishing its message. This has been necessary if the Club was to be effective, in a competitive sense, in thwarting the designs of those who were actively promoting projects which would materially damage those areas.

As you know, it was as a result of such action that the Sierra Club lost its status as a group to whom donors might make deductible contributions under section 501(C)(3) of the Internal Revenue Code, a status the club had enjoyed since the 1930's. As a result of the club's successful opposition to dams in Grand Canyon, the Internal Revenue Service ruled finally in August of 1968 that the Sierra Club had engaged in propaganda and inuenced legislation in a manner which IRS charged violated the limitations of that section of the Revenue Code. The club denies this, asserting that only an insubstantial part of its total activity was involved with opposition to these dams or to other legislative matters. We believe that the Internal Revenue Service misunderstood the facts and that its decision cannot be squared with the Internal Revenue Code, with First Amendment freedoms or with sound public policy.

The core problem is that the amount of legislative activity which the statute allows to 501(C)(3) organizations is so vague as to deter any such activity by many such organizations. The IRS action in the case of the Sierra Club reveals the grave risk to most publicly supported charities and educational organizations if—like the business enterprises with which they may disagree—they attempt to convey their position to the Congress. The Sierra Club's case demonstrates the need for modification of the limitations under which broadly supported charitable and educational groups must operate if the historic policy of Congress to sponsor and encourage such institutions is not to be seriously eroded.

H.R. 13270 would create a new category of section 501(C)(3) organization denoted as "private foundations". (Section 101(b)) These "private foundations", unlike 501(C)(3) organizations that are broadly based, would be brought under stricter surveillance by the Internal Revenue Service in order to assure that their activities further the public charitable, religious, scientific, and literary objectives for which they are formed. Traditional, broadly based public-type charitable and related organizations, however, are unaffected.

Section 101(b) of HR 13270 prohibits "private foundations" from engaging in *any* activities affecting legislation. The restriction upon such activities is absolute.

The distinction proposed between "private foundations" and traditional, publicly based charitable organizations now makes feasible reconsideration of present limitations imposed by present section 501(C)(3) on broadly based charities falling outside the "private foundation" category. As Mortimer M. Caplin, former Commissioner of the IRS, phrased it in an article adopted from a 1968 address at American University:

"No sound policy reason exists for denying charitable and educational organizations latitude in the political field equal to that allowed to business organizations. Without jeopardizing their tax exemptions, these entities should be permitted to engage in legislative activities similar to those described by Code section 162(e) as permissible tax deductions for businesses. . . .

"Charitable and educational organizations are playing a larger role in achieving the social and economic goals of our nation. In the fields of their special experience and expertise, their voices should be heard and they should be free to give legislative bodies the benefit of their views. . . ."

We urge that the present unworkable, unnecessary and grossly discriminatory limitation on activities of broadly based, public charitable organizations which affect legislation be removed. Two limitations should remain, however: (1) *Permissible legislative activities must be related to legislation affecting the continued existence of the organization or to legislation involving the objectives that this organization was formed to pursue; (2) there must be no intervention in elections.* Surely, if organizations like the Sierra Club are to fulfill their public trust, they should not be precluded from resisting destruction of irreplaceable redwood forests or from arousing public interest in the preservation of the Grand Canyon, notwithstanding that such activities involve the passage or defeat of legislation.

We specifically propose to this end an amendment to section 501(C)(3) which is closely related to that proposed by the American Bar Association Committee on Exempt Organizations and reported in *Tax Lawyer*, Vol. XXI, No. 4, pp. 967–68, as follows:

"Sec. 1. Section 501 is amended by redesignating subsection (e) as subsection (f) and inserting after subsection (d) the following new subsection:

"(e) Appearances, etc., with respect to legislation.—(1) None of the following activities by an organization described in subsection (c)(3) shall be deemed 'carrying on propaganda, or otherwise attempting, to influence legislation':

"(A) Appearances before, submission of statements to, or sending communications to, the committees, or individual members, of Congress or of any legislative body of a State, a possession of the United States, or a political subdivision of any of the foregoing with respect to legislation or proposed legislation of direct interest to the organization.

"(B) Communication of information between the organization and its members or contributors with respect to legislation or proposed legislation of direct interest to the organization.

"(C) Communicating information to the general public for the purpose of influencing legislation or proposed legislation of direct interest to the organization.

"(D) For purposes of this paragraph, matters of direct interest to the organization include—

"(i) those directly affecting its exemption under this section;

"(ii) those directly affecting the deduction of contributions to such organization under sections 170, 642, 2055, 2106 or 2522;

"(iii) those directly affecting any exempt purpose or function for which the organization was organized and is operating, in the case of an organization 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 purpose or function constituting the basis for its exemption under this section) from the United States or any State or possession or political subdivision thereof or from direct or indirect contributions from the general public.

"(2) Activities described in paragraph (1) shall not include any attempt to influence elections or referendums.

"SEC. 2. Section 170(c) is amended by adding the following new sentence at the end thereof: 'For purposes of this subsection, the phrase "carrying on propaganda, or otherwise attempting, to influence legislation" in paragraph 2(D) shall be subject to the qualifications set forth in section 501(e).'

"SEC. 3. Section 2055(a) is amended by adding the following new sentence at the end thereof: 'For purposes of this subsection, the phrase "carrying on propaganda, or otherwise attempting, to influence legislation" in paragraphs (2) and (3) shall be subject to the qualifications set forth in section 501(e).'

"SEC. 4. Section 2106(a)(2)(A) is amended by adding the following new sentence at the end thereof: 'For purposes of this subparagraph, the phrase "carrying on propaganda, or otherwise attempting, to influence legislation" in clauses (ii) and (iii) shall be subject to the qualifications set forth in section 501(e).'

"SEC. 5. Section 2522 is amended by redesignating subsections (c) and (d) as subsections (d) and (e) and by inserting after subsection (b) the following new subsection:

"'(c) CARRYING ON PROPAGANDA, OR OTHERWISE ATTEMPTING TO INFLUENCE LEGISLATION.—For purposes of this section the phrase "carrying on propaganda, or otherwise attempting, to influence legislation" in paragraph (2) of subsection (a) and in paragraphs (2) and (3) of subsection (b) shall be subject to the qualifications set forth in section 501(e).'

"SEC. 6. These amendments shall be applicable to taxable years beginning after the date of enactment thereof and to estates of decedents dying after the date of enactment thereof."

As it now is being interpreted, the Code:

(1) gives an advantage to the profit-seeking sector of public opinion in that a 1962 amendment to the Code facilitates their lobbying by allowing businesses to deduct direct lobbying expenses;

(2) it puts non-profit corporations that lack clear rights of deductibility for lobbying at a competitive disadvantage when they are opposing business corporations on an issue before Congress, as we were in trying to overcome lumber company opposition to the Redwood National Park that Congress recently established;

(3) it puts many publicly supported membership organizations in the same category (501)(C)(3) with privately endowed foundations, when their nature, purposes, and problems are far different;

(4) it puts such public-service membership organizations under a mandate to comply with language, designed to limit their activities, which is so vague as to be undefinable. As a practical matter, this limitation has grown into a virtual prohibition in that compliance can only be safely assured by totally eschewing legislative activity.

As Mr. Caplin also pointed out in his article: "Today, the policy justification of the present limitations on exempt organizations' legislative activities is questionable. Since 1962, profit-making businesses have been permitted to claim income tax deductions—as 'ordinary and necessary' business expenses—for financing legislative appearances and related activities which are closely connected with their business operations. The 1962 amendment to the Internal Revenue Code overruled the well-established case of *Cammarano* v. *United States* (358 U.S. 498), which had previously denied income tax deductions for this type of lobbying. As the Senate Finance Committee pointed out, it was felt to be desirable 'that

taxpayers who have information bearing on the impact of present laws, or proposed legislation, . . . not be discouraged in making this information available to the Members of Congress or legislators at other levels of Government."

"Congress thus recognized in 1962 that it was legitimate for business entities and the trade organizations they support to participate in lobbying for legislation of direct interest to them. Yet, if this is true for business entities, why isn't it equally valid for educational and charitable organizations? This 1962 income tax relief for businesses suggests that Congress should reexamine the entire area of legislative activities of exempt organizations with a view to granting them a broader measure of freedom in the legislative sphere."

While deductibility is not a *sine qua non* of survival for membership organizations, it is a practical requirement in most cases for effective operation, inasmuch as adequate funding can only be secured in this way. The present state of the law, therefore, inhibits effectiveness. To become effective, an organization needs deductible money: when it gets it, however, it cannot effectively use it to promote its cause with the public and Congress. Those that do use their money in this way lose their deductibility. A premium, thus, is placed by the law on ineffectualness.

Our proposal differs in one respect from the American Bar Association proposal in that our proposal recognizes that appeals to the general public respecting legislation is part of the same process as is a direct representation to the legislature.

It is important, in liberalizing the tax treatment afforded non-profit membership organizations, that allowance be made for both *indirect*, and direct, lobbying by such charitable organizations. While there is a distinction between communication directly with Congress and communicating to the public at large for the purpose of urging them to contact Congress, these two approaches are not easily separated in practice. Almost all organizations interested in legislation engage in both operations simultaneously. The two are interacting parts of the same process. Any limitation on indirect lobbying will have the effect of hobbling the effectiveness of direct lobbying, in that information will be conveyed directly to legislators in the absence of any indication of the intensity of public interest. The importance of allowing both is acute for non-profit membership organizations.

But in any event simple equity—indeed constitutional mandates in the view of the Club's attorneys—requires that publicly based charities be placed in a comparable position to that in which the 1962 amendments to the Revenue Code placed private business enterprises and their associations. These 1962 amendments in effect allow as a business deduction all expenditures involved in making direct representations to Congress and other legislative bodies. The 1962 amendments deny deductibility with respect to expenditures for advertising campaigns designed to stir public interest in pending legislation. The *same result* may be obtained with respect to charities by denying deductibility of gifts to a charity if the charity engages in such activity *and* cannot demonstrate that the funds used by it for such public campaigns had never qualified as a charitable deduction. There is no reason why charities, unlike private business and their associations, should be precluded from receiving any tax deductible gifts merely because a small part of the charity's funds were used for influencing legislation. We urge the Congress to adopt the language proposed herein, but, failing that, at least to give broadly based charitable organizations equal treatment under the law as compared with private business enterprises.

The CHAIRMAN. Mr. Bronson P. Clark.

STATEMENT OF BRONSON P. CLARK, EXECUTIVE SECRETARY, AMERICAN FRIENDS SERVICE COMMITTEE, PHILADELPHIA

Mr. CLARK. The Quakers are noted for helping people in distress. I think, Senator Long and Senator Bennett, you qualify. And probably what my religious instincts tell me to do is make this as brief as possible.

Senator BENNETT. The Quakers are also noted for silence. [Laughter.]

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Mr. CLARK. We will try to make the product mix a little better today.

For 52 years the Quakers have been at the business of concerning themselves with issues which also concern our national leaders in the areas of poverty, jobs, housing, rural and urban poor, problems of the underdeveloped world, and so forth. We are not a large organization. We have ten regional offices.

We probably have something like 5,000 volunteers working with us. And maybe 100,000 Americans contribute to us from all the religious faiths.

We have no endowment. We live on current contributions. We are classified under section 501(c)(3) as an association of churches. Alan Hunt, who is sitting down, is our corporation counsel and he specializes in some of our deferred giving and life-income contracts. So we are entirely dependent upon contributions for what we are about.

I would say there are five things that concern us and I will boil down four of them and concentrate on what I think is the important one.

These four you have been hearing about, inclusion of the appreciated gift, and in the allocation of deduction formula, we share the objections and concerns which have been stated here over and over. We do the same on limitations of deferred giving.

We would like to emphasize that this is particularly helpful to our small giver, the person who can give a modest amount but needs the income, and we have life-income contracts sometimes as low as $1,000.

Lifting of the standard deduction, we feel that it is quite a different thing to deduct a medical expense from making a voluntary act of a contribution. A tax on foundation income, that is a provision that we interpret as virtually an action on our income. We receive for our budget 25 percent of our income from foundations and in effect that would just be a dollar cut on what we are about.

At the least of it, we would favor the administration's position of the 2 percent, if any.

This brings me to what I think is really the heart of the matter and maybe your last witness will sound like the first, but without the same size bank account. You will recall John Rockefeller testified on the pluralist society, the fact that there is a partnership involved here in government and public effort, and I would like to give you three examples from the American Friends Service Committee.

The first is housing. We went into the coal fields of Pennsylvania, in the pit of a depression. We were able to start immediately that idle miners with idle hands and poor shacks, that there might be a catylist used to use that idle time, and there we introduced the first conception in America of sweat equity in which by joint effort and forming themselves into crews, these miners built their own homes.

This sweat equity now resides in title 213 and some of the FHA statutes and cooperative housing is spread very widely now, even though some features of it don't include sweat equity, of course. But this concept which we worked on in the 1930's continue to this very day and if you go to a little valley in Southern California, El Porvenir, you will find migrants building their homes by a sweat equity effort which in effect means by their muscle instead of a financial down payment they are putting together an entire little village.

The CHAIRMAN. You say sweat equity. You mean by dint of hard work, the sweat of their brow and sweat of their muscle, they proceeded to get out there and build some homes for themselves.

Mr. CLARK. Right. If you have a $10,000 home and FHA says you have to have $1,000 down in order to get this mortgage insured, they will accept sweat equity under the provisions.

The CHAIRMAN. I see.

Mr. CLARK. The American Friends Service Committee developed this concept and pioneered it. This is one of our successes. We won't express our failures. Our failures save the Government money, too, but I think in this case it was a trial dry run of what people can do, and I am making a point more specifically.

The CHAIRMAN. We could stand a lot more of that sweat equity here in this country.

Mr. CLARK. I think the American Indian is another example of a partnership. American Indians are still scattered all over this country. They are beginning to understand some of the provisions of the laws that Congress has passed but they understand them poorly. There is already lots of legislation on the books to the benefit of American Indians but they are either unaware of them or it is a question of citizenship awareness, you might say.

Now, I think——

Senator BENNETT. Some of the Indians are smart enough to know that it is better for them not to admit that they are aware of them. We run into that problem. I come from the Indian country.

Mr. CLARK. I know. We are canny enough to include this Indian bit because of Senator Bennett's presence here. We think that some of the things actually happening, for example, there is a real partnership between the American Friends Service Committee and the Bureau of Indian Affairs trying to help a group of Indians on reservations who are fighting to get an elementary school education that meets their cultural requirements.

This is the relationship we have with the Bureau of Indian Affairs.

I am trying to make the point that the Bureau of Indian Affairs can do a certain kind of job as a Government agency but private resources can also do some things in the partnership. We are running 69 programs and I am just picking three of the kind of partnership things I think put money in the banks as far as the partnership with the Government is concerned.

The third one is what we call our conferences and seminars program. Since 1954 we have been taking diplomats from all of the nations. We take them to places like Katmandu or Lake Geneva. We lock them up in a hotel for 10 days. There may be anywhere from 20 to 30 countries represented.

The U.S. State Department pays the way of American diplomats to go to these conferences. There is nothing on the record. There is no resolution passed. Nobody had to depend on statements to be issued because there is no statement.

The purpose of these conferences is an effort in communication to let diplomats, off the record and in an informal setting, really sit down and discuss the Berlin wall, the Cambodians, and Thais. We just had a conference at Siem Reap where Cambodians and Thais sat down

together in the same room, which is an achievement. They don't even have diplomatic relations.

We were the first private organization to get Indians and Pakistanis to join in this kind of a conference involving problems of Indians and Pakistanis. Undoubtedly there will be an official conference on problems that divide the world, government conferences; but when issues are very hot and it is difficulty for government representatives to deal with them, sometimes the private organization—they can attend a conference because it is off the record.

Well, 10 percent of the entire diplomatic world community have gone through these conferences and this is for us an exercise in human communication.

Well, these are three examples. In our domestic programs, we estimate that if this bill, the House bill, were adopted as is, that 75 percent of our programs involving the rural and urban poor, quality education, and housing, because these appeal to some to our foundation supporters, that 75 percent of our program would be very adversely affected.

So I join in the feeling of the first witness that the pluralistic approach has proven a financially sound investment for the Government and that the bill changes the climate for the contributor.

I am not an expert tax witness but I can tell you what would happen to our program that I have described if this bill stood as it. It would adversely affect us.

I think I have a couple of minutes and I am open for questioning.

The CHAIRMAN. My only question of you is, whether you have fully documented and stated these various programs that you didn't have the time to discuss in your full statement. Now, I do not believe that you have tried to do that; have you? You have mentioned that you have a lot of other programs——

Mr. CLARK. Yes.

The Chairman (continuing) that have not been discussed here and I think you ought to make that available for the record because I think it undoubtedly will support your case, and those of us who find great appeal in what you said here would like to know more about it.

We don't have the time to go into it now but sometime in the quiet of an evening we can turn off the TV program and sit down and read through it because I am familiar with some of it and I think it is a very fine thing.

If you are able to get some of these people to talk their problems out to the extent that you avoid a war that perhaps could have been avoided which you say—you would save for the Government a fantastic amount, even what you save for a third party, like the United States sitting on the side, because it costs us a fortune picking up the pieces from a war that should have been avoided.

I know it is fine work and I know we shouldn't do anything to keep it from being effective.

Mr. CLARK. Thank you very much.

The CHAIRMAN. That concludes today's witnesses. It is now 2:15. We will meet again at 4 o'clock, at which time we hope to consider in executive session some nominations that should be on our calendar and we would like then to consider the interest equalization tax.

The hearing resumes tomorrow at 10:00 a.m.
(Mr. Bronson P. Clark's prepared statement follows:)

STATEMENT BY THE AMERICAN FRIENDS SERVICE COMMITTEE

SUMMARY

The American Friends Service Committee (AFSC) has for more than 50 years engaged in programs of relief, service and education as an expression of Quaker faith and practice.

The work of the AFSC is supported almost entirely by contributions, bequests, and foundation grants. Of the total amount given or granted to us each year, about 20% is in the form of property on which there is capital appreciation, and about 10% comes in as "deferred gifts"—life income contracts, charitable remainder trusts, and annuities. Foundation grants provide about one-quarter of our budget.

We have no interest in preserving AFSC for its own sake. We have a deep interest in preserving the ability of AFSC to be of service to great numbers of people in this country and abroad. H.R. 13270, by cutting deeply into every major element in our financial base, will deprive these people of much of the help we have been able to provide.

H.R. 13270 represents an abrupt and ill-considered reversal of consistent Congressional policy to encourage the private support of philanthropy by tax incentives to charitable giving. This is not the time, when the burdens of government have clearly outstripped its resources, to abandon that policy in the name of "tax reform". The provisions of H.R. 13270 with which we are particularly concerned do not serve the objectives of greater fairness or greater simplicity in our tax laws, nor would they yield significant revenue.

Specifically, we object most strenuously to five of the major features of H.R. 13270. These are:

(1) The inclusion of appreciation on gift property as a "tax preference" and gifts to charity in the "allocation of deductions" formula. Gifts to charity can and should be excluded from the operation of these provisions.

(2) Limitations on "deferred giving arrangements". Designed presumably with wealthy donor in mind, these limitations would have their greatest impact on small donors, with whom we have a great many life income contracts.

(3) Lifting of the standard deduction. This simply increases the unfairness of present law, which already discriminates against the donor to charity.

(4) Tax on foundation income. This is really a tax on us. And it may well reduce our resources by more than the amount of the foundation tax because foundation grants often stimulate other support.

(5) Limitations on foundation activities related to legislation. These would also reduce grants to us, and would cripple the effectiveness of foundations and their grantees in areas where both have made important contributions to widespread understanding of public policy issues.

STATEMENT

The American Friends Service Committee (hereinafter AFSC) has, since 1917, engaged in religious, charitable, social, philanthropic, and relief work in the United States and in foreign countries on behalf of the several branches and divisions of the Religious Society of Friends in America. While the AFSC is a corporate expression of Quaker faith and practice, it does not undertake to speak for all members of the Society of Friends; the Society is not organized so that any group or individual can do this. The AFSC has been ruled by the Internal Revenue Service to be an "association of churches" within the meaning of I.R.C. section 170(b)(1)(A)(i), and exempt from tax under section 501(c)(3).

In carrying out its purpose, the AFSC undertakes programs of relief, service, and education, ministering both to the physical and to the spiritual needs of men, on a non-sectarian, non-political basis. It is our conviction that each human life is sacred, each man a child of God, and that love expressed through creative action can overcome hatred, prejudice, and fear.

The work of AFSC is made possible by the efforts of some 4,500 workers—mostly volunteers—attached to ten regional offices across the country and by the financial support of about 100,000 concerned persons of all faiths. Since as a

matter of policy we have never sought endowment funds, we are almost wholly dependent upon current contributions and bequests.

During its most recent fiscal year the AFSC spent approximately 7.4 Million Dollars. This sum supported activities in more than 20 countries, but around one-half was expended for work in the United States.

The AFSC has deep commitments in many of those areas—equality of opportunity in education, jobs, housing and the problems of urban and rural poor—with which the federal government is also deeply concerned, and shares with many of our political leaders the view that the solution of the problems of race and poverty is critical to our survival as a nation, and that government alone cannot solve these problems.

The continued ability of private agencies to attract large sums of money is vital to the solution of these problems, we believe, not only because the private agency can experiment and innovate, on a modest scale, but also because the *private agency is the prime medium through which millions of Americans can and do make direct, voluntary, personal commitments of time and money.* In this way, and probably only in this way, can a great many Americans become an active part of the solution rather than a part of the problem.

These are of course precisely the considerations which have consistently moved the Congress over the years to encourage the private support of philanthorpy by tax incentives to charitable giving. And yet, *at a time when the arguments for such incentives have acquired ever-increasing force as domestic problems mount in scope and urgency, the House of Representatives, moved by proper zeal to end some abuses, proposes abruptly to charge the tax climate for charities and has aimed at 501(c)(3) organizations such as AFSC a series of blows which would cripple our efforts to be part of the solution.*

The AFSC does not, of course, object to the proposed lifting of the ceiling on deductible gifts to organizations such as AFSC from 30% to 50%, nor to a number of the other provisions of H.R. 13270 which would affect the operations of charities, but *we must and do object most strenuously to five of the major features of H.R. 13270. The adoption into law of any of these would seriously hurt us financially, and the adoption of all of them would require the drastic curtailment of our present programs and in practical effect rule out any expansion of our activities for years to come.* All of this sacrifice, we note, would be unredeemed by any notable increase either in tax revenues or in the fairness of our tax laws.

The most objectionable changes wrought by H.R. 13270 are in our view the following:

(1) The inclusion of appreciation on gift property as a "tax preference" and gifts to charity in "allocation of deductions" formula

Many of our donors, including a number to whim we look for regular and substantial gifts of securities, will be inhibited or deterred completely from making such gifts if the appreciation thereon must be included as a "tax preference" and if gifts to charity of any kind are made part of the "allocation of deductions" formula.

Moreover, while H.R. 13270 would undoubtedly permit some of our donors to give appreciated property without the loss of the tax benefits now available to them, *the complications of these provisions are such that we would lose many gifts in the process of persuading potential donors that the tax benefits are still there. We cannot afford the loss of these gifts.* Donations of appreciated property currently make up about 20% of our income.

We believe the intent of the "minimum tax" and "allocation of deductions" provisions is praiseworthy, but we believe as well that the objective of tax equity can be achieved without making charitable gifts a part of the formula either on the income or on the deductions side. The charitable gift, as a voluntary act, is a very different thing from the payment of such legal obligations as interest on a mortgage or a medical bill. Despite all existing tax incentives to charitable giving, we know and are constantly encouraged by the fact that the primary motive of our donors is to forward our work. Yet we freely concede that tax benefits motivate many of our large givers to contribute more than they would otherwise. *We urge this Committee to adopt the approach of the Administration's Bill and to exclude gifts of appreciated property from the limitation on tax preferences and allocation of deductions provisions, because:*

(a) An act in which the human impulse to help others plays so important a part is worthy of encouragement for its own sake;

(b) Charitable gifts are highly susceptible to legislative encouragement; and

(c) Government thus has at hand the means, in addition to an ample rationale, for enabling private agencies to do more of what government would otherwise be obliged to do.

(2) *Limitations on "deferred giving" arrangements*

The severe limitations placed by H.R. 13270 upon "deferred gifts"—the life income contract, the charitable remainder trust, and the gift annuity—would all but destroy the usefulness of these arrangements to our donors and to us. Here we want to emphasize two things. *First, this type of giving has great attractions for the small donor.* We write a great many life income and annuity contracts for under $10,000.—in some cases for as little as $1,000. These donors are people to whom the reservation of an income for life on a few thousand dollars is important. If the option of retaining life income is made either impossible or unduly complicated to achieve, these gifts will not be made. *Second, these gifts are of great importance to AFSC.* During the last three years they have amounted to about ten per cent of our income. And this figure does not begin to show the importance we attach to deferred giving. *We have developed a deferred giving program carefully and cautiously over the years, at a large investment in staff time, training, and legal assistance.* Now as gifts made earlier mature, and as we have put our program—through fulltime fundraisers working out of our Philadelphia headquarters and out of all ten of our regional offices—on a solid footing, we look to deferred giving to prodrce a sharply-increased percentage of our contributor dollar, year after year.

Moreover, as a matter of tax equity we do not believe a life income donor should lose his deduction because he wishes in effect to make a "bequest" during his lifetime. In many cases his chief motivation is to see his assets put into the hands of an organization where they will be used as he wants them used at his death, with costs and complications at his death kept to a minimum. He should and does rightly expect to be taxed on whatever life income he receives. When he foregoes a claim to capital appreciation we see no equitable reason for taxing him on it. To tax such appreciation is to tax the charity itself, not the income beneficiary.

(3) *Lifting of the standard deduction*

This change would simply increase an inequity which exists in the present tax law whereby a taxpayer using the standard deduction and giving to charity is treated the same way as the standard-deduction taxpayer who gives nothing. *We believe charitable contributions should be deductible without regard to the standard deduction*, and unless that is done we are strongly opposed to any increase in the standard deduction.

(4) *Tax on foundation income*

This is in reality a tax on us. Approximately twenty-five per cent of our support comes from foundation grants. There is no reason to suppose that a reduction, through taxation, in the income available to foundations will not over the course of time work out simply to a corresponding reduction in the foundation funds available for our programs. In fact, *because foundation grants often stimulate other support, the reduction to us is likely to be even greater.*

Foundations support some of our most challenging and constructive domestic programs. For example, we pioneered the technique of self-help housing (a means by which low-income families have acquired adequate shelter) and have, with foundation support, assessed and consolidated that experience so that it may be used widely. Some of our work with American Indians on their complex of social and economic problems is also foundation-supported. More generally, much of our current foundation-supported domestic work creates the citizen-awareness and involvement which is essential if legislation in the areas of education, housing and economic opportunity is to be made real for those it is intended to benefit. What we do here can fairly be considered as simply a logical and necessary extension of government action—and as a contribution to making that action work.

To increase the burdens of government in exchange for the relatively modest revenue to be realized from the proposed foundation tax is, we submit, false economy as well as unsound social policy in levying what amounts to a tax on operating charities.

(5) Limitations on foundation activities related to legislation

The limitations contained in sections 4945 (c) (1) and (2) would bring about a reduction in foundation grants to organizations such as AFSC just as surely as would the proposed foundation tax. In fact, the likely effect on us of these limitations would be threefold:

(a) Some grants would not be made at all;

(b) Some grants would be diverted from problem areas in which our work might suggest solutions;

(c) Our relationship with granting foundations would change from one of accountability based upon mutual respect and confidence to one of accountability based upon constant fear and uncertainty as to whether Internal Revenue requirements were being met. From our point of view, the granting foundation would cease to be a partner and become a watchdog—watched in turn by a sharply augmented governmental bureaucracy of supervision.

Apart from the serious impact these limitations would have on much of our own domestic program, we oppose the limitations for the following further reasons:

(1) The language of the Bill, even as amplified in the Committee Report, leaves unanswered a number of critical questions as to the reach of these provisions;

(2) The extreme severity of the penalties strongly suggests prohibition rather regulation—to the point where constitutional issues will surely have sufficient merit to be strongly pressed;

(3) The limitations would cripple foundations, and their grantees, in precisely those areas where important contributions have been made by both to widespread understanding of public issues. Such contributions will become sterile indeed if the whole area of public policy is to be foreclosed to all but the most coldly academic reporting. We are not contending for a foundation's right to lobby, in a narrow sense, nor do we seek greater latitude in this regard for ourselves. But, we emphasize again our belief that government will find itself increasingly alone in facing problems which are beyond both its resources and its wisdom if it undermines the financial base of charitable organizations by limiting, as contemplated by H.R. 13270, both the ability and the freedom of foundations to make grants to these organizations.

(Whereupon, at 2:15 p.m., the committee adjourned, to reconvene at 10 a.m., Thursday, September 18, 1969.)

TAX REFORM ACT OF 1969

THURSDAY, SEPTEMBER 18, 1969

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

The committee met, pursuant to recess, at 10:05 a.m., in room 2221, New Senate Office Building, Senator Herman E. Talmadge presiding.

Present: Senators Long (chairman), Anderson, Gore, Talmadge, McCarthy, Ribicoff, Byrd of Virginia, Williams of Delaware, Bennett, Curtis, Miller, Jordan of Idaho, Fannin, and Hansen.

Senator TALMADGE. The committee will come to order.

This morning the Committee on Finance continues hearings in th charitable contribution provisions of the House-passed tax refor bill. In the light of the comprehensive nature of the testimony received on this subject at yesterday's hearing, there is little chance that new thoughts will be developed today. The committee urges witnesses today to state their positions on the bill as expeditiously as possible and to avoid repetitious testimony in their oral statements.

Our first witness this morning is Mr. Logan Wilson, president of the Tax Committee, American Council on Education. Mr. Wilson, you may come forward and proceed, sir.

STATEMENT OF LOGAN WILSON, PRESIDENT, AMERICAN COUNCIL ON EDUCATION; ACCOMPANIED BY PROF. JULIAN LEVI, UNIVERSITY OF CHICAGO; WILLIAM FRIDAY, PRESIDENT, UNIVERSITY OF NORTH CAROLINA; LANDRUM BOLLING, PRESIDENT, EARLHAM COLLEGE; AND JACK MYERS, COUNSEL TO AMERICAN COUNCIL ON EDUCATION

Mr. WILSON. Mr. Chairman, and members of the committee, I am Logan Wilson, president of the American Council on Education——

Senator TALMADGE. You may be seated if you wish, sir.

Mr. WILSON. Thank you—which numbers 1,538 colleges and universities and associations of higher education.

I am accompanied today by Prof. Julian Levi of the University of Chicago on my right, chairman of the Council's Committee on Taxation. President William Friday of the University of North Carolina, and President Landrum Bolling of Earlham College in Richmond, Ind.

The composition of this panel will suggest to you the importance of private philanthropic support to all institutions, public and private alike.

In compliance with the committee's request that testimony be consolidated, a number of other associations are joining us in this statement. They are listed on the cover sheet.

In proceeding, I want to note that in our detailed statement we have sought to argue from fact rather than conjecture. Rather than trying to summarize here the financial burdens under which higher education is laboring, and the crucial importance of voluntary support, I would refer the committee to the opening pages of my testimony, and the data we have provided.

Mr. Chairman, and gentlemen, I had several pages of introductory comments, but in the interest of saving your time, I will refrain from giving those orally.

Senator TALMADGE. Without objection the statement will be inserted in full and you may extemporize as you see fit.

Mr. WILSON. This panel is here, gentlemen, to attempt to answer any questions that you may want to direct to us. We are at your disposal.

Senator TALMADGE. Senator Williams.

Senator WILLIAMS. No questions.

Senator BENNETT. I didn't hear the testimony but I have no questions.

Senator TALMADGE. Senator Jordan.

Senator JORDAN. I yield.

Senator WILLIAMS. The statement will be examined carefully by the committee and we appreciate the precise manner in which you presented it.

Senator BENNETT. I am sure you know we had testimony yesterday on the same subject, rather effective testimony from Dr. Wilkinson of Brigham Young University.

Mr. WILSON. Mr. Chairman, might we have at least one comment from Mr. Julian Levy here?

Mr. LEVY. I would hope that the committee, in examining this testimony, would examine two documents which are specifically filed along with the testimony. The first is the report of the Committee on Financial Aid of the American Alumni Council which summarizes the support which higher education received in 1967 and 1968.

The second is a study which was sponsored by the American Council on Education, Patterns of Giving to Higher Education, which is an analysis of approximately 2 million donor transactions to higher education in 1962–63 year, totaling something over $1,200 million in aggregate support.

Now, in this I would like to make just a few factual observations. I don't want to argue the case at all. In 1967–68 higher education received in aggregate $1,500 million. The thing which is remarkable, and which is shown in this report, is that 1 percent of all donor transactions account for 75 percent of all support. Higher education is enormously dependent upon the large gift.

Second, individuals, alumni, and nonalumni, account for approximately 47 percent of all of the support.

And finally, this study shows that the large individual gifts are invariably gifts of appreciated securities and property. The result is that the discussion which higher education has had with regard

to the effect of the limited tax preference, and the allocation of deductions is not in any sense a theoretical issue. The pyramid of support puts a tremendous reliance on the large gift, and when the tax incentive is blunted as a result of the allocation of deductions and the limited tax preference, higher education is going to be in enormous difficulty in securing the large fiigts upon which it is dependent.

Senator TALMADGE. Thank you, sir.

Mr. BOLLING. I would like to give an illustration, if I might, of what this means to the privately supported colleges. There are about 850 of us across the country and our giving patterns do sustain this very clearly.

For example, my own small college in Indiana had a fundraising drive which we completed about 3 years ago. We set out to raise $3,600,000, part of a campaign that we had been planning for quite a while, and very important to us. About seventy-five percent of those gifts came to us in the form of appreciated property. Last year we made a very intensive effort also to increase our giving and last year over 90 percent of gifts above $10,000 came in the form of appreciated property.

The big giver is terribly important also in triggering the small giver: the two go hand in hand. It is hard to get the great mass of the alumni givers fired up to give unless you have this incentive of the big giver, and the big giver, I think, again and again is someone we have had to educate on the basis of showing him how he can do this in ways that he can manage, either through appreciated gifts or in some cases gifts on a deferred life income basis.

These types of giving are terribly important in triggering the big giver who in turn is really the backbone of our fund-raising drives. For the private colleges, if we are forced to cut back on our receipts here, we are going to be in serious trouble indeed, which means that we will have to throw ourselves more and more on to the taxing agencies for support of various kinds. I think it is a crucial question for the very large number of private institutions across the country.

Senator BENNETT. May I ask for one comment, do you think if this bill were passed in its present form it would generate enough additional tax revenue to make up for the loss of the gifts?

Mr. BOLLING. I would doubt it very much for this reason: I think that giving is largely as I have heard many people who have had long years of experience in this say, a matter of education, and the Congress over the years through its tax incentive provisions has helped to educate donors to the possibility of giving in terms far beyond anything they would have thought possible. I think that if you simply cut tax rates and expect that we are automatically going to pick up more gifts this is an illustory hope. I think it is very doubtful that it will come about in this way, particularly if you tell a person that his gift of appreciated property is now going to cost him more than he is at the moment having to pay.

Mr. LEVI. I am in position to supplement this as a result of our study. Securities are tremendously important in the large individual gift, which is the basis of the fund raising. On the other hand, if you look at the total in our test year security gifts accounted for approximately 17 percent of the total or some 220-odd million dollars.

Now, if you assume that the base for tax purposes of this $220 million was zero, which is, of course, an assumption that no one can make, the recovery to the Government conceivably would be something over $50 million as against the fact that the loss to higher education in the campaigns and the rest of it would be simply horrendous.

Senator CURTIS. What is the gain to the Treasury if they don't make any gifts?

Mr. LEVI. That is, of course, the other part of it because the key, is this, Senator, as your question very well indicates. The donor is not really confronted with the question of does he sell and pay a capital gain or does he give. The question is much more, does he give or does he keep? What happens in these cases is that the donor determines that he will keep, and where the capital gain is large he will never pay it, because it will be kept and will pass in his estate, so that it becomes a matter of estate tax.

Senator CURTIS. Mr. Chairman, may I be recognized?

I notice your comment about the giving of stock of appreciated value and while that is very true, out in a rural State here is what we find. particularly older people. Many times they are very much interested in the cause of education, they are very devout people, they are interested in their church and their church colleges, and they will give a farm, maybe it is their last remaining asset, and they will take in exchange a life annuity, and the life annuity has to be figured to a basis that the college gave it. Perhaps that farm and that home have been owned for 40 years. The base is just so small that a capital gains tax is terrific. Not allowing the gift to be deducted on the basis of its current value, will just put an end to those arrangements, and in the State of Nebraska the church colleges carry 30 percent of the cost of education. In addition to these proposals changing our system very much are going to increase our tax burden, it is going to increase it sizably, from the local and State level, the community colleges, the State colleges. If someone doesn't give something away there is no revenue particularly when it can go on to one generation at its appreciated value.

Now, my attention, I haven't had time to read it, but my attention has been called to an example in your appendix A of the material you had prepared in advance, that the limited—you submitted an example which implies that the limited tax preference a person making a charitable contribution to a college cannot calculate the impact that the contribution will have on his income tax. In the third paragraph on page 2 and the second paragraph on page 4 you indicate that such a determinate is in effect a circuitous calculation in which the taxpayer needs to know his limit on the tax preferences before he can determine his limit, what his limit is.

Will you illustrate what you mean?

Mr. BOLLING. Well, I think that when you talk to a donor about making a major gift he has to figure out what this is going to cost him in his total financial picture. If in the allocation procedure he will not know until the end of the year how these things are going to be allocated, he will find it extremely difficult to give you a yes or no answer as to whether he can give you that gift. He may have to get legal counsel and it will complicate our fund-raising, particularly in

deferred giving as in the illustration you stated a moment ago that is precisely——

Senator CURTIS. What is your college?

Mr. BOLLING. Earlham College in Richmond, Ind., a Quaker college, and it has precisely the experience you talked about. We have a dormitory on our campus given to us by a farm widow. She could not have given us cash, but she was willing to give us a farm on a life income contract basis and this has worked out very well for us, and she could do this, but if we had to go through the circuitous routes now proposed we could not get this gift because today our whole deferred giving program has ground to a halt.

Senator CURTIS. Very briefly then your point is that the very complexity in the application of what is proposed in the House bill in addition to the loss of the tax incentive will decrease gifts.

Mr. BOLLING. This is our judgment, Mr. Levi is more of a financial and legal expert on this.

Mr. LEVI. I would answer that question unconditionally yes, Senator. The fact is that you have got to calculate three formulas simultaneously to determine what the allocation amount is, what the tax preference amount is, and the result is that you lose all incentive. When a man makes a gift he ought to know at that given point what the tax consequence of his behavior is, and it is utterly impossible for him to know.

Senator CURTIS. Mr. Chairman, I would like to pursue this for sometime because I am so interested in it, but with the many witnesses I will defer.

Senator RIBICOFF. Mr. Wilson, I understand the importance of private donations, but I want to know when the changes you are recommending would enable a taxpayer to avoid income tax at all, altogether.

Mr. WILSON. We are not making any such recommendations, Senator. Would one of the panel care to comment at some length on that?

Mr. LEVI. I would say this—higher education's attitude, as I understand it, and certainly the attitude of our committee on taxation is that no donor who makes a gift should make money. We expect that any donor who makes a gift decreases his worth. We are not interested, of course, in making available a deduction in order to permit someone to avoid the payment of a tax and at the same time increase his net worth.

The apprehension that we have on bill before us, is that it is so complicated that the incentive is lost entirely.

Now, there is one other thing that I think is very important, Senator, and that is that we must recognize that this issue is by no means limited to the private institutions. Twenty percent of all of the funds which were given to higher education in 1967 and 1968, were given to the public institutions and perhaps President Friday, of North Carolina University, would like to comment.

Mr. FRIDAY. Senator, I should like to endorse completely the testimony given by President Wilson here and speaking for myself, say that this position that has been developed by the American Council speaks to the quality, the continuing quality, of all of higher education, and we support this program because it is exceedingly important that both the public and the private institutions remain very strong and, as Mr. Levi says, this has great importance to those of us in the State systems.

Let me illustrate. I live in a State that is No. 41 in per capita income. Seventy cents out of every general fund tax dollar goes into education from the first grade to the graduate school. But we could not claim the distinction we hold as the University of North Carolina if it were not for the fact that many people, many citizens, share their wealth with us in the form of gifts and benefactions. Without developing that further, I simply wish to identify myself completely with the positions which have been offered, speaking for one State-supported institution in this country.

Senator RIBICOFF. May I ask this, to any one of you gentlemen, you talked about leadership gifts, which means the extra large donation which acts as a catalyst when there is a drive going on.

What would you think of permitting a waiver of the 50 percent deduction limit for a single year for an individual? In other words, any individual once in his lifetime could make a major gift without being subject to the 50 percent limitation? Doesn't this frequently happen when a college has a drive; a man of substantial means wants to give a million dollars or $500,000 for a building, a professor's chair, or for other purposes?

Mr. LEVI. I would say, Senator, the idea is attractive but we would want to examine it in considerable detail, and then file a memorandum concerning it. Let me explain that from our viewpoint the privilege which higher education has, and has had since the inception of the tax law is a very, very precious one, and it is one that we want to be sure at all time is not abused, and it is only with that in mind that we would want to examine this very carefully.

Senator RIBICOFF. Do you have any figures at all in your files indicating how frequently this major gift takes place; where a donor might give once in his lifetime and never repeat? I imagine many schools, hospitals, and museums must have such figures.

Mr. LEVI. Of course, this is true and as my figures show, 1 percent of all of the donor transactions account for 75 percent of the total support. Higher education is enormously dependent on the large gift, and this is particularly true in the case of individuals. What we did, for instance, in this Patterns of Giving to Higher Education, was to analyze the eight categories of donors, and this is based on an analysis of some 2 million transactions, and then broke them down by size of gift. You will find that this pyramid effect operates almost every place except in the case of gifts by corporations.

Senator RIBICOFF. What would the revenue loss be if your recommendations became law instead of the House proposal?

Mr. LEVI. Well, I am not sure if the House bill were adopted that it will result in any additional revenue. I think what it is apt to result in is people simply not making gifts. Assuming that they were to continue to make the gifts, assuming that all of the appreciated property would have been subject to tax on some basis, and assuming that the basis figure was zero, we are talking about a figure less than $50 million.

Senator RIBICOFF. I have been told by many friends of mine who are on both sides of the table, those who seek gifts for institutions such as yours, and many of my friends who are donors, that since the passage

of the House bill that there has become great confusion in the entire field of charitable giving and that charitable giving has almost ground to a halt because prospective donors haven't the slightest idea where they stand or what is going to happen, and that basically institutions such as yours are facing a major crisis. I would like a comment on that.

Mr. BOLLING. I would like to give you a specific illustration about this. At the time the House bill passed one of our donors, one of our alumni who happens to be a constituent of Senator Miller's, was about to make to my college a very major gift. It may have been one of these once in a lifetime gifts; several hundred thousand dollars. We were at the last stages of negotiating this deferred gift contract. When the House bill passed his lawyer looked at the thing and said to him, "You simply can't make that gift now." Our lawyers looked at it and we agreed. Deferred giving has ground to an absolute and complete halt as a source of income.

Now, this sometimes relates to major givers. Many times it relates only to the modest or medium giver. Here is the farmer who wants to give a farm. Many deferred gifts are not from the very rich and they are certainly not designed to give special unfair breaks to a rich man, but they mean a great deal in building the endowment of our colleges and particularly providing capital for buildings and things of this sort, chairs as you say. This kind of giving has been really just about stopped since the House bill, we have told a number of people that we simply can't talk about this until this legislation is clairified.

As far as the appreciated gift is concerned, here again we are feeling the effects because people are saying, "Well, we don't know what the effect of this will be." So it has introduced a whole element of uncertainty in the minds of the giver and their legal advisers, and this is a very serious problem for us in trying to meet our financial obligations.

Senator BENNETT. I was going to ask the Senator if he would yield for an observation?

Senator RIBICOFF. I would be delighted.

Senator BENNETT. I have checked this with the staff. Here is a farm which has a base of $10,000 but a current value of $100,000. Under the law this has to pass to the recipient for $10,000. Now you can't make a deferred annuity contract on a $10,000 base as you could a $100,000 base. The person giving the gift and becoming dependent for the rest of his life on the deferred annuity can't afford to give it if all he can get is an annuity based on $10,000. This is part of it.

Senator CURTIS. You said the law, you meant the House bill.

Senator BENNETT. Yes, the House bill.

Senator RIBICOFF. Do you have figures available as to the amount private colleges, or universities have received by way of gifts and donations and how much public universities have received by way of gifts and donations. Take any recent years that you may have.

Mr. LEVI. The most recent figure that we have is the report of the Council on Financial aid voluntary support of Education 1967–68, which we are filing in the record. Page 60 shows that the total of support of major private universities is $605 million. Private men's colleges $58 million. Private women's colleges $69 million. Private coeduca-

tional colleges $277 million, professional and specialized schools $99 million. Public institutions, these are the State universities, $231 million, municipal colleges and universities $9 million, junior colleges $19 million, for a grand total of $1,371 million.

Senator RIBICOFF. That is for what year, sir?

Mr. LEVI. This is the academic year 1967–68.

Senator RIBICOFF. What is the present breakdown of student enrollment between private colleges, and universities and public colleges and universities? Do you have your figures in a present breakdown?

Mr. LEVI. Well, it varies a lot state to state as you know.

Senator RIBICOFF. Nationwide.

Mr. LEVI. Nationwide.

Mr. WILSON. Two-thirds—one-third.

Mr. BOLLING. Two-thirds public in my State it is; a little over 40 percent private and about 60 percent public.

Senator RIBICOFF. Now, you have today in all our colleges and universities about 7½ million students—is that the figure, about 7½?

Mr. WILSON. 7.1 million.

Senator RIBICOFF. 7.1 million and the student enrollment will continue to increase each year as our population increases and there is more demand for higher education.

If you cut off the source of private contributions the public will have to pay the bill, to have these universities and colleges exist, isn't that correct?

Mr. BOLLING. In our State of Indiana the public institutions made a calculation of what it saves the taxpayers of Indiana to have the private colleges carrying a student there. They calculate for each student we keep in a private college it saves the taxpayers of our State about $1,000 a year in educational costs. If we are not able to educate those—I think it is 26,000 students we have in the private colleges there now—this is going to throw a very substantial burden back on the taxpayer. So you are not saving any tax money if you undercut the private colleges as an important sector of the whole system, and throw this burden on to the taxpayers.

Senator RIBICOFF. Are the public colleges today in position to take on the student body of the private colleges and universities.

Mr. WILSON. No, sir.

Senator RIBICOFF. Thank you, Mr. Chairman.

Senator GORE. Mr. Chairman, could I ask a question?

The CHAIRMAN. Sure; go ahead.

Senator GORE. I want to advert to the example Senator Bennett gave of the gift, a deferred annunity contract of the farm on which there was a $10,000 basis and a $100,000 value. As I understand the bill it doesn't prevent a contract at all. It only provides for the recognition of the gain of $90,000.

Senator BENNETT. The Senator is right. I had been misinformed.

Senator GORE. Thank you.

Now, if you use figures of a different size then you realize the tax loophole involved here. Instead of a $10,000 farm let's take a million dollar piece of real estate that has a current value of $10 million. Such a contract would represent in reality a capital gain of $9 million on which under present law the tax situation is presently recognized but which this bill proposes to change,

Now, yesterday I placed in the record an example of how a taxpayer can wrap the cloak of the good Samaritan about him, grab the flag of public citizen No. 1, and rush before the photographer as a great philanthropist, a great charitable giver. Yesterday I used an example of a capital gain.

I would like today to place in the record an example of a taxpayer in the 77-percent bracket who makes a gift of an ordinary income property. Take a simple example: The value of the charitable contribution for a $100 gift for his income tax liability plus surtax liability, that would be a tax reduction, his tax reduction, of $77. Now, if this was also normal gain for normal income he would have a tax saving of another $77, which would mean for this taxpayer that by giving this very noble and charitable gift of $100 he would receive from the gift $154.

Now, I noticed that one gentleman said earlier in his statement that he, too, as other witnesses yesterday asserted, wished to take the profit out of charity. You did not wish to see the donor actually receive a monetary reward from the U.S. Treasury for the so-called charitable gift. Now, in this case what part of the $154 are you referring to?

Mr. LEVI. I would hope that, Senator, you would look at the full statement that we have filed.

Senator GORE. I know, but would you answer this particular question?

Mr. LEVI. We do not approve of the idea of using ordinary income on a capital gain basis at all, sir, for the purpose of making gifts. I mean that example——

Mr. BOLLING. Let's take the Senator's example.

Mr. LEVI. We would not support——

Senator GORE. I would like you to answer the question.

Mr. BOLLING. I think we can answer your question very directly, Senator, I think your illustration is based upon an assumption, that the man is going to sell this property and derive the return from this sale. That is not necessarily the option he is going to take. He may just sit on this property and keep it for years and years and pass it on to his children. There is no guarantee he is going to sell that property and get the gain.

Senator GORE. Not if he can give it to you and get a $1.54 return on it for each dollar.

Mr. BOLLING. No, but the choice here is not between selling it and taking a gain. It is between holding the property and giving it away, and you are diminishing his net worth by this total amount.

Senator GORE. I know, but you are discussing my assumption, not my question. My question is what part of this $1.54 for each dollar donation do you think should be denied the taxpayer.

Mr. MYERS. I am the council's counsel. In the first place, as Mr. Levi said, the council endorses the proposal of the Ways and Means Committee which is that no donor be entitled to deduct the fair market value of property which if sold would give rise to ordinary income or short-term capital gain, which is your example. So in this case we do not endorse that. We feel that that provision of the bill should be retained.

Senator GORE. Now, all you are saying here then is that he should not get the additional $54?

Mr. MYERS. No.

We are saying he gets a deduction in that case for nothing if his basis is zero or he reports the entire income as taxable.

Senator GORE. What I am trying to find out is whether or not you said you do not wish him to get $154 from the U.S. Treasury for giving you $100.

Mr. MYERS. Right.

I would question that.

Senator GORE. Would you want him to get $100 from the U.S. Treasury for giving you $100?

Mr. MYERS. Well, I am not quite sure I understand how he gets $100. I think in your example, sir, he had a basis of zero. If he had a basis of zero and it was property which if sold would give rise to ordinary income, then under the proposed tax bill he has to take either his basis or report the entire amount of income.

Senator GORE. Whatever his basis is, he would have $100 in gain.

Mr. MYERS. Yes, but he would report that under the House bill and we endorse that proposal. It is ordinary income property.

Senator GORE. Neither of you are qualified to say what portion of the gain you wish him to receive. The point I am trying to make is that we have a situation in which many people make a handsome profit from so-called giving, and I am trying to find out from somebody representing the beneficiaries whether they wish the Treasury to subsidize it at 100 percent. You said that you didn't wish it to go beyond 100 percent.

Mr. MYERS. That is quite correct.

Senator GORE. Do you wish to subsidize it at 100 percent?

Mr. MYERS. I don't think I can answer that, but I don't believe that there will be a subsidy of 100 percent under the proposals endorsed by us. I suppose it is a possibility but it is a very remote possibility, and under our proposals no donor would benefit. As you suggested the donor does benefit albeit slightly differently than I.

Senator GORE. Thank you, Mr. Chairman.

Senator CURTIS. Would the distinguished Senator explain his illustration? This is a gift of property in kind.

Senator GORE. This is——

Senator CURTIS. If he sold it would be ordinary income.

Senator GORE. This example which I asked an aide to prepare is of a taxpayer in the 70-percent bracket and, of course, with the surtax, this is now 77 percent. He makes a gift of property on which he has an ordinary income of $100.

Senator CURTIS. It is a gift in kind, not in cash.

Senator GORE. Yes.

The value of the charitable contribution of $100 to him taxwise is $77. Then secondly he has a saving taxwise from not selling of $77 which, thirdly, brings a total benefit, according to the staff, of $154.

Senator CURTIS. Well now, just let me question you. Suppose a farmer gives away $100 worth of wheat, that is ordinary income that he could have sold. Do you mean to tell me that under existing law he does not report that as income and he also takes a deduction for it?

Senator GORE. I wish to assert that the U.S. Government has lost two suits in court on precisely that item. The answer is yes: he does

not report the wheat for income but he deducts his gift from taxes, and this is wrong.

Senator CURTIS. I am not sure that is universely followed.

Mr. LEVI. Senator, may I read you from our statement please? [Reads:]

It is recognized that in certain limited instances a high bracket donor of appreciate property, which if sold would give rise to ordinary income or short-term capital gain, may be in a better position financially as a result of having made a contribution than he would have had he sold the property in question. For this reason the provisions of the proposed bill which would require a donor of such property to limit his deduction to his tax basis in the property or include the unrealized appreciation as income if he elects to deduct the fair market value of the property have merit.

We are not contending that in any transportation where there is a short-term gain that an arrangement of this kind ought to be possible at all, Senator.

Senator CURTIS. But the distinguished Senator did not limit it to a capital gain.

Mr. LEVI. No; he was speaking of ordinary income.

Senator CURTIS. Ordinary income?

Mr. LEVI. You see, our response there is it is not applicable.

Senator CURTIS. And I raised the question, if a farmer responds to a charitable drive and says "I will give you $100 worth of wheat," I seriously question whether or not he can take a charitable deduction without first reporting his income and I would like to have the staff, not at this point, but to clear that up. If that is the law the Internal Revenue agents out in the country are not following it.

Mr. LEVI. And we, Senator, are not contending that there should be an avoidance of tax in that situation. That is the purport of what I just read.

Senator RIBICOFF. Mr. Chairman.

Senator CURTIS. It is the same proposition as if an office holder was tendered an honorarium——

Mr. LEVI. Precisely.

Senator CURTIS (continuing). For a speech. He cannot say "Do not give the honorarium to me, give it to my favorite charity"——

Mr. LEVI. And then claim the deduction.

Senator CURTIS. And claim a deduction. If he claims a deduction he has to report it as income.

Mr. LEVI. That is our position precisely.

Senator CURTIS. Well, that is the law. That is the law now, and I do not know what usual situations the distinguished Senator from Tennessee has drawn his illustration from, but in general that is the law now. You can't say "I don't want it" and at the same time appropriate it for yourself and say, "This is income and I gave it away."

The CHAIRMAN. Let me just pose to you the background of this thing as it comes to this Senator. I first became concerned about this matter back in the days when we had an income tax above 70 percent—it would go up to 85 or more. I can think of some stocks people have held for a long time where the stock is worth 1,000 times what it was when they paid for it 30 or 40 years before. If a person chose to give some of that away, where his investment base was practically zero, but it

was worth great value now, then after he paid 25 percent out in taxes on $100,000 of sale he would have $75,000 left. By the time he paid our State 6 percent he would not have had that much left.

But, on the other hand, if he gave it away, and he was in an 80-percent bracket and had a large amount of income, let's say a million dollars of income, from other sources, that is ordinary income, then against an 85-percent tax rate, that would be worth $85,000 to him as a deduction, and he would not have to include the appreciation in his income. So he would by doing that make a profit against Uncle Sam by giving something away rather than selling it.

Now, would any of you advocate that it should be that way, that a fellow could actually make a profit on Uncle Sam by giving something away? It always seemed to me if you gave something away, it ought to be some part of yours you gave, you shouldn't just make a profit out of it.

When you drop your rate down to a 75-percent bracket, it no longer becomes possible for it to be a better deal to give it away than it does to sell it. But that is assuming that you would get the same appraisal when you give it that you do when you sell it.

If you are selling it the seller is trying to get it at the lowest possible price that he can get it and when you are giving it to someone the person who is receiving it, the donee, has no real interest in placing a low value on it because it costs him nothing anyway. So we have a situation where there is a piece of property that someone leaves in his will or someone gives, and everybody in town wants to see the university get the piece of property. So the whole community from the U.S. Senator right on down to a street sweeper is all in favor of this donation being made, and it is to everybody's advantage there to make it as favorable as possible for that person to make that donation.

I think you can easily understand why on a piece of undeveloped property all the realtors in town, all the civic leaders, everybody connected with the State university, for example, in that community would all want to put the highest appraisal on it that they can put on it. If you are selling, the purchaser is going to insist on buying at the lowest price. In the other case you are giving it to someone who would like to encourage the realtor or anybody assessing it to give it the highest possible evaluation.

What is your reaction to that problem?

Mr. MYERS. If I may comment, Senator, I have a great deal more confidence in the Internal Revenue Service and their audit procedures. If that asset is of any value, I assure you, you are going to have a controversy with the Internal Revenue Service, and the Internal Revenue Service will have ability to contest any valuation of the sort which you state and hypothesize is 50 percent really above its real value. It is a possibility.

I would also note that under the present law the basic rate will reduce to 65 percent, and so the gap is even larger than we were talking about. I do think there is always a possibility of what amounts to very close to fraud, but the Internal Revenue Service is designed and has procedures to take care of that. I would say it is possible that someone might be able to do that. I would say that is very remote if the property has any substantial value.

The CHAIRMAN. Well, if you get the top rate down to about 50 percent, and I find some appeal in that, the use of that device and the temptation to use it would disappear completely, wouldn't it?

Mr. MYERS. That is right, sir; yes, sir.

The CHAIRMAN. Well, I have no further questions.

Does anyone else?

Senator MILLER. Do I understand that the only part of the House-passed tax bill that you thing should remain in relates to this treatment of the ordinary income gift?

Mr. MYERS. In so far as the gift of appreciated property is concerned, yes. The ordinary income or short-term sale gift.

Senator MILLER. Well, I am talking about the other provisions. The treatment of deferred giving as contained in the House-passed bill, you are opposed to that? The allocation of deductions approach you are opposed to that. The limit on tax preferences approach you are opposed to that?

Mr. MYERS. Yes.

Senator MILLER. The only one that is left over that you support is this one having to do with the gift of ordinary income property.

Mr. MYERS. It is not quite correct to say that. We have questions about for instance, the deferred gift, and we raise them in detail in our statement. We are not entirely satisfied that these changes are necessary, but we suggest that if the changes are made, consideration be given to other factors, and in detail that is discussed in the statement.

Senator MILLER. You are opposed to the provisions of the House-passed bill relating to the deferred gift, are you not?

Mr. MYERS. We are not specifically opposed to them. We ask that the committee carefully consider them. We are not sure that the charitable unitrust and the charitable annuity trust is a necessary change in the law, but we suggest that if you do think that this is a necessary change then that you give consideration to other factors, such as that the donor of such an interest should be in no different position than the donor who can afford to part with his property outright.

Mr. BOLLING. We particularly oppose the retroactive provisions in this bill because this is really going to put us in a serious bind with some of the contracts already signed.

Senator MILLER. I can't quite understand why you have this opposition to the limit on tax preference approach, however. Understand that we have the problem, on the one hand, of continuing to encourage charitable giving, which is a longstanding policy of our Government. We certainly have such a policy, I think, generally supported, to encourage giving to our private educational institutions. On the other hand, you have the problem, and it is a very real problem, of encouraging the voluntariness of our tax assessments system, and public opinion is becoming quite aggravated especially when the public reads in newspapers and magazines that a few taxpayers, or a few individuals, I should say, receive a large amount of income but pay very little or no income tax. That was the genesis for the House action.

Now, I personally think the House went considerably too far, but let's not fool ourselves. The House is responding, granted that I think

they went too far, to a strong feeling among the general public, and I think that the general public wants to continue the charitable giving incentive, on the one hand. On the other hand, they want to avoid this abuse which they feel very strongly about.

Now, to avoid the abuse, about the only provision you support, is this one having to do with ordinary income property, and I suggest to you most respectfully that I do not believe that that alone will satisfy public opinion on this point. The minimum tax approach or the limit on tax preferences approach could go a long way to satisfy that. I don't know whether it will or not, but it is quite persuasive, and when you can point out to aggravated ordinary income taxpayers that there is a limit on what can be done in this area, generally there is a pretty responsive reaction.

Mr. MYERS. I might say just to make it clear, we have no position with respect to the limit on tax preference or the allocation. We do have a position with respect to the inclusion "tax preference as a income" of the unrealized appreciation in property contributed to colleges and similar entities.

Now, we believe, one, that that unrealized appreciation is by the nature of the statement unrealized. It is not something that passes to the donor like the tax exempt income which he gets and can use.

Secondly, we believe that that is really within the law a fourth limitation on the charitable deduction because you already have a 50 percent limitation, you have a 30 percent limitation if it is appreciated property under the House bill. You have an allocation of the charitable deduction to other items of preference income. This is a fourth limitation which has to be computed before a donor can determine what his gift is, you have the allocation of all itemized deductions to the unrealized appreciation and this is the reason for our position.

Senator MILLER. I can certainly see a lot of merit to taking unrealized appreciation out of the allocation of deductions program, because the rationale behind that provision as expressed by the Treasury has been, that, for example, in the case of tax exempt municipal bond interest it gives a source of income out of which to make charitable contributions to pay real estate taxes, to pay medical expenses and so on, and you do not have that rationale satisfied by the appreciated value. I can understand that.

But when it comes to the limit on tax preferences where by making a gift you can end up with a profit or a neutral position, this aggravates a lot of people, and I must say that I can't understand why, how this would impinge very much on you. For example, if you have a problem in the gift of a farm because this might possibly get you into appreciated value which comes with the unrealized portion of long-term capital gain and municipal bond interest might put you in a taxable position on a little bit of the tax preference amount, I am not sure that that would deter the charitable giving, and if it might then we can always have this straddled by making a gift of half of it one year and half in the other year, and I just haven't run on to many situations where I am satisfied that the limit on tax preferences with respect to appreciated property is going to impinge very much on it and certainly as distinguished from some of these other areas such

as the deferred giving which I think is one that would indeed impinge very greatly.

Mr. MYERS. Julian, would you like to answer?

Mr. LEVI. I would say this, Senator: The committee for instance has not opposed elimination of the unlimited deduction. The problem which arises regarding the allocation in this limited tax preference is simply——

Senator MILLER. Please, I don't want to get into the allocation of deductions because I have already pointed out to you how the rationale, in my judgment, is satisfied. I want to concentrate on the limit on tax preference treament.

Mr. LEVI. The problem we have is the sheer complexity of the situation when we sit down and begin to get into these calculations. It is impossible to say to the donor what the tax consequences of his behavior will be, and it is that situation which makes it, as far as we are concerned, devastating.

There might be other ways of doing it but we haven't seen that this is workable. We think that it will discourage giving.

Senator MILLER. If you have somebody who is receiving so much income from the limited tax preferences as to get over 50 percent of the total amount of the income counting the tax preferences I can see the difficulty in computing that although I don't think it would necessarily be insuperable. But how many of these donors are in that situations? I would think very, very few of them.

Mr. LEVI. The problem, Senator, is that 1 percent of all donor transactions accounts for 75 percent of our support. Higher education is enormously dependent on these large gifts. That is our problem.

Senator MILLER. I appreciate that. But how many of those large donors are in that situation? I can't see that very many of them are. I haven't found more than one or two examples, of concrete examples, that anybody has shown me that that was the problem.

Mr. MYERS. May I just give an example which comes from my interpretation of the bill, which not everybody agrees with, but I think it is a logical interpretation and one that a court might take. This is the example of a donor who has, say, $100,000 of income and is very generous and wants to make a gift of a million dollars property which has appreciated substantially $900,000 or the like.

If you read the law as I do, in the year of gift the donor has to include the entire unrealized appreciation as "tax preference income." This increases taxable income instead of decreasing it in the year of gift. In fact it increases it about threefold and it results in his tax being increased fivefold.

Now, I will agree that I don't believe that maybe this was intended, but certainly the law can be read that way, and this is a result which obviously would completely prohibit a donor from making such a gift.

It is time that such a donor, has a recovery in the later years but this recovery is dependent upon a number of factors, and the computation, and the way in which it is computed, and he has got to live to take advantage of it, he must not have other tax preference income or he loses out. Believe me, the computation is very difficult, and very complicated. Where you have a pledge or carry over gift or major gift of this sort, the computation of how this is going to affect you in a future

year with respect to tax preference is so difficult that a donor will just not make the gift; that is the way we feel about it.

The CHAIRMAN. Yes, now if I might say we have 12 witnesses to hear today. Perhaps I have been derelict in my duty but I spend a lot of time in this room. My friend, Wallace Bennett, has probably spent more time than I and the same thing might be true of Clinton Anderson. If we interrogate each one of these witnesses in depth to the satisfaction of every Senator, we are just not going to get through here. I would hope that each Senator would try to limit himself to about 5 minutes of questions so we can get their statement in the record. I think the witnesses have made their position clear and I want to urge that if the Senator wants to get more information, I will try to make a reporter available to record all the additional information he wants and put that in the record as part of the testimony. Senator, go ahead for 5 more minutes, but I am going to ask we try to move on.

We have been here an hour and only have heard one witness. There are just not enough hours in the day. I am committed, whether the Republican Party is or not, to try to get this bill out on the floor by October 31 and I would hate to just report this thing out of here without any amendment at all because I know that is what the witnesses don't want. They would like to see some of these things taken out of this bill. But if we proceed this way we will never complete the bill. Go on for 5 minutes, but let's get on with the next witness.

Senator MILLER. With the idea of helping my able chairman getting this out by October 31, I will just ask one more question.

You talk about the uncertainty. I think you are very strongly in favor of prompt action by the Congress on this bill so that the uncertainty will be removed.

Mr. MYERS. Yes, indeed.

Senator MILLER. Thank you, so am I.

Senator FANNIN. Mr. Chairman, just one question. I was wondering whether there could be an estimate made of the impact of the House bill on educational funds in a specific State. For example, North Carolina was used and I think you stated that 75 percent of the tax funds in North Carolina go to education.

Mr. FRIDAY. Yes, sir.

Senator FANNIN. I don't know how much of a load is carried by the contribution but I was trying to get an estimate as to how much this would add. Would this mean you would have 75 percent more than necessary to be assumed by the public in this case or what? Do you have any idea how much more would be involved?

Mr. FRIDAY. Senator, I don't have a precise figure, but in the biennium we are now in, the budget of the university is $223 million. Fifty-one percent of that money comes from State appropriations and the balance has to be met by fees, gifts, grants, and other kinds—I will get you——

Senator FANNIN. Do you have any idea how much comes from grants or contributions?

Mr. LEVI. The figures for the public institutions in North Carolina alone, I am only talking about the public ones, 1967–68, Ashville-Biltmore College, $28,000; Elizabeth City State College, $113,000; North Carolina College at Durham, $100,000; North Carolina State

University, Raleigh, $3,066,000; North Carolina University, Chapel Hill, $3,054,000.

Senator FANNIN. Do you have an approximate figure?

Mr. FRIDAY. He is coming close to about $7½ million.

Mr. LEVI. I am coming close to $7½ million in private support in North Carolina in the public institutions alone in 1967–68. This does not include, for instance, the private institutions in the State. That would be additional.

Senator FANNIN. I see.

Do you have any idea what that would be? I am trying to get an estimate of what the impact would be and, of course, contributions would still continue but how much it would be a factor we won't know.

Mr. FRIDAY. Senator, we will send you a letter answering that directly.

Mr. WILSON. Mr. Chairman, may I leave a copy of my statement with you?

The CHAIRMAN. Yes, and it will be printed in the record.

Senator Byrd, do you care to ask any questions?

Senator BYRD. No questions.

Senator MILLER. I don't want to detain you very long, but I think we got onto a point here I believe is very important, and I am referring to the example you gave me with a person who has $100,000 of salary and might make a gift.

Mr. MYERS. There is included in our statement a specific example which includes the effect of the allocation of deductions.

Senator MILLER. My present thinking is that the rationale behind the inclusion of the various preferences in the allocation of deductions question does not fit with the unrealized depreciation. I have a lot of reservations about this. The limit on tax preferences is the question I want to talk on.

Mr. MYERS. Assume a donor earning $100,000 in salary, who makes a $1 million gift. Under the House-passed tax bill, how would this be handled? Let's assume that the gift includes unrealized appreciation in value of $900,000. The total income for purposes of the LTP would be $1 million. Divide that by two and the result is a taxable income of $500,000. Actually, it is not as simple as that; it is less than that. There are people who disagree with me as to how you compute the LTP under these circumstances. There may be a problem with simultaneous equations. This demonstrates some of the complications. Regardless of these, however, the donor has actually increased his taxable income and his tax substantially by reason of the gift.

The CHAIRMAN. I don't think a reform bill has to increase someone's tax. I personally want to help education. How can we draft this thing so that it will benefit humanity?

Dr. WOODWORTH. The advantage in the bill goes to the schools over the foundations.

The CHAIRMAN. That is as it should be. Louisiana State University has a large campus. Someone discovered oil beneath the land, and I see no point that they couldn't use that oil. We have Loyola with a radio station; they have had it for many years. What they can make from it is used to help educate students at Loyola. WDSU–TV, is a competing station, owned by the Stern family. Much of the Stern

money is being dedicated to education and educational opportunities. Perhaps they are benefiting from a foundation deduction. But I couldn't think those people over at WWL will do wrong. They are enjoying tax advantages which help others. If the TV station is taken away, we will have to subsidize every one of the schools with tax money. I think we ought to have a grandfather clause. Putting in money without taking advantage of the tax situation to injure competition. Let them go ahead and dedicate that to the university. Your people pretty well subscribe to that.

Mr. MYERS. There was a grandfather clause, Senator Long, under the 1950 law with respect to the Western University Press. We would like to have a pretty firm rule. It could reduce the revenue at Loyola a bit, but they can keep the station. However a grandfather wouldn't disturb us.

Senator MILLER. Someone gives us a going business and gets all kinds of fancy deals. You pay for the business by the fact that it does not pay tax.

The CHAIRMAN. The new provision was intended to get at people who were buying up going businesses at a tax advantage. This is not the kind of situation. Maybe it should be protected. By the time we are through, you will not have less donations, but more, and we should move this date forward to January 1.

Mr. MYERS. We would like to call your attention to the problems brought about by the effective date with respect to life income gifts. Because of the way this proposal has been made and because of the effective dates, life income gifts cannot now be made. All are jeopardized. We would like to know in some way, by announcement or otherwise, that the changes which are to be made in this area will not affect gifts made before December 31 of this year. Then gifts can be made which do not involve abuse in any sense.

The CHAIRMAN. I think we might do well to make the date effective when we pass the bill.

Mr. LEVI. We made one suggestion in connection with the bill in the House that might be very helpful to colleges and universities. A person does not know what his financial position will be at the time of his death. If he makes a specific bequest, the market may have dropped. If he sets the bequest up as a percentage, it invites adverse parties to value the assets as high as possible. We would hope that some kind of a provision would be put into the law that while the estate is in administration, the heirs can agree on a gift to a qualified charity, and what gift would be deductible as a bequest for purposes of the estate tax. The problem is that the well-to-do man does not make an outright gift in his will because he does not know what his family position will be and he may find that the bequest will do what he doesn't want it to do. The heirs should be able to get together and decide what they want to make as a deductible charitable bequest.

Senator MILLER. The revenue loss is likely to be minimum. More of a tax advantage and probably would not affect the revenue. I realize that we may be mixing apples and oranges. You have the loss of revenue from the eventual sale and loss from charitable deduction.

Mr. BOLLING. You should not assume that a donor is going to sell, if he cannot give. Under the change proposed by the House, a donor can't

take advantage or ordinary income or short term gain property. The comparison should be if he sold, what would he have left as compared to what would he have if he donated the property. If the House proposal on gifts or ordinary income and short term property is adopted, the donor will always be worse off by giving than he would be by selling.

Senator MILLER. That is not quite what Treasury says. They look upon the fact that property will be sold by the educational institution. They look upon it as a double-barrel loss of revenue in any way. I would like you to consider whether the appreciated value could be included in LTP. Senator Ribicoff made a suggestion for one-time large gifts.

Mr. LEVI. Very intriguing idea.

Senator MILLER. We are getting into such a small area here. I find we have to balance business opinion against policies of trying to encourage charitable giving. I can't believe that we should ignore them. None of the givers would be in trouble because they are getting over this 50 percent income. They will be very small in number. Those people are certainly going to have competent tax counsel. I am not too afraid about that.

The CHAIRMAN. You are going to have some people who may be in a situation that should give half this year, and half 6 months later (January 1). I am troubled by public policy on this and I don't want to have someone say "See, the tax reform bill is passed now and see what you have done." That would be an argument on one side, but there are arguments on the other side.

Senator MILLER. You have people who are aggravated with those who pay in income tax. Only slightly diminished when you read that he pays only a little tax. Do I understand that you will go into Senator Ribicoff's idea?

Mr. LEVI. I would like to construct a pro forma balance sheet assuming a sale by a taxpayer and a pro forma balance sheet assuming a gift.

Senator MILLER. This is a beginning point. I haven't found anyone who disagrees with that tax minimization. Minimum deduction is impossible. Announce that because you are charitable, you don't contribute to any other causes.

Mr. MYERS. Under the bill there is a limitation on gifts of appreciated property.

Senator MILLER. Suppose we changed it to 50 percent. On the LTP, I would like to see what we can do about keeping it in without it being aggravating. I would like to see an analysis of how we would come out with the one-time gift idea, keeping the LTP in. Would the change from 30 to 50 percent affect that, and any other ways this might be handled—and also take into account the opportunity to make gifts from 1 year to the next. You might be able to find a computation of those to be done keeping LTP in. That would be helpful.

Thank you.

Mr. MYERS. Thank you, sir.

The CHAIRMAN. We appreciate your appearance and we wish we could have you here all morning because your people can provide us with so very much good information. We appreciate it.

(Subsequent letters received from the American Council on Education and Mr. Logan Wilson's prepared statement follow:)

AMERICAN COUNCIL ON EDUCATION,
Washington, D.C., September 24, 1969.

COMMISSION ON FEDERAL RELATIONS

Hon. RUSSELL B. LONG,
Chairman, Committee on Finance,
U.S. Senate,
Washington, D.C.

DEAR SENATOR LONG: During the course of the extended hearing that took place in the Committee's executive chamber on September 18, you expressed interest in a proposal advanced by Professor Julian Levi, a member of our panel.

Put briefly, we made a proposal having to do with bequests. As our study entitled *Patterns of Giving to Higher Education*, copies of which we have filed with the Committee, shows (page 11), bequests are the most important single source of gifts to higher education for capital purposes. That the Congress recognizes the high priority of these needs is amply illustrated in the Higher Education Facilities Act of 1963, which authorizes the appropriation of over $1 billion annually for academic facilities alone. This authorization of Federal funds entails at the moment matching of about 75 percent in non-Federal funds. For understandable reasons, prospective donors, as they draw up their wills, are inhibited in the size of their bequests by the fear that they may leave their heirs inadequately provided for. If they try to protect against this possibility by specifying a percentage of their estate, an inevitable conflict arises. We would propose that if, while an estate is in probate, the heirs agree to make a gift to charity on settlement, the gift be treated as deductible exactly as if that gift had been included in the will.

Senators Miller and Ribicoff asked us for additional comments on the subject of a one-time unlimited charitable contribution and on questions pertaining to tax preference income. We are working on these questions and shall hope to supply the requested information in the near future.

May I express to you and other members of the Committee our gratitude for the time and attention you have devoted to our concerns.

Sincerely yours,

JOHN F. MORSE,
Director.

AMERICAN COUNCIL ON EDUCATION,
Washington, D.C., October 22, 1969.

Hon. RUSSELL LONG,
Chairman, Committee on Finance,
U.S. Senate,
Washington, D.C.

DEAR SENATOR LONG: Reference is made to the questions raised by Senators Miller and Ribicoff at the hearings of the Finance Committee on September 18, when the American Council on Education testified on behalf of itself and other associations of colleges and universities, public and private.

1. Senator Miller desired to know what position the American Council on Education, as spokesman for colleges and universities, might take with respect to inclusion of the unrealized appreciation in gift property only for the purposes of LTP and not for allocation of deductions, on the assumption that a donor would be entitled to deduct a full 50 percent of unrealized appreciation in the case of contributions to colleges and universities, hospitals, churches and similar entities. We have carefully considered this matter and remain of the opinion that the inclusion of unrealized appreciation as tax preference income for either allocation of deductions or LTP would be most damaging. In the case of LTP, the complicated nature of the computations necessary would be a substantial deterrent to the making of major gifts. Moreover, in the case of major gifts of appreciated property in one year, we believe it entirely possible that a donor might be required to pay a tax on income substantially in excess of his ordinary taxable income solely by reason of having made the gift. This would be true even

if the amount of unrealized appreciation included for the purposes of LTP is limited to the amount by which the donor obtains a deduction in the year in question. The penalty would be such that the donors will hardly consider the making of such contributions. On the assumption that such gifts will not be made then, there is hardly any loss of revenue involved. Even if some gifts were made, the revenue involved would be minimal.

As indicated in our testimony, we believe that the inclusion of unrealized appreciation as preference income is unfair in that it is not income realized by the donor except to the extent that it affects his deduction. The inclusion of unrealized appreciation in LTP alone would really introduce a fourth limitation on the benefits of the deduction after the 50 percent overall limitation, the 30 percent limitation on appreciation, and the allocation of all charitable contributions to other preference income.

2. We appreciate Senator Ribicoff's suggestion that individuals be permitted an unlimited deduction during one taxable year. If neither the LTP nor allocation of deductions apply, then clearly this would be an encouragement to substantial giving. Whether the grant of an unlimited deduction under these restricted circumstances is feasible, is, of course, for the Committee to decide. We would note, however, that a donor, under the present law, has the right to carry over that portion of the gift which exceeds his limitation for five succeeding years.

We trust the above will be helpful to the Committee.

Sincerely yours,

JOHN F. MORSE,
Director.

TESTIMONY OF THE AMERICAN COUNCIL ON EDUCATION

SUMMARY

The American Council on Education:

1. Supports the increase of the limitation on charitable contributions from 30 to 50 percent.
2. Endorses the proposal that donors of appreciated long term real and intangible property be entitled to deduct the full fair market value of the property without including the unrealized appreciation in income. We see no reason why this incentive should not be extended to gifts of tangible personal property and future interests.
3. Opposes the treatment of unrealized appreciation of gift property in tax preference income and the inclusion of charitable contributions within the allocation of deductions.
4. Doubts whether the alleged abuses in gifts of remainder interests warrant the implementation of the charitable remainder trust concepts and suggests there is no reason for denial of a deduction for a traditional legal life estate.
5. Endorses the denial of deduction for gifts of property, such as fair rental value, but contends that the language may extend its coverage beyond Congressional intent.
6. Endorses "Clay-Brown" and suggests (1) limiting the statute pertaining to advertising revenue by exempt organizations and (2) certain modifications that the promise to pay an annuity is not a debt subjecting an institution to an unrelated business income tax.
7. Suggests that if the present unlimited deduction for contributions of estates or trusts is altered, the change should have no application to irrevocable life income and annuity gifts created prior to the enactment of the bill.
8. Recognizes that there may be a need for colleges and universities to file returns but opposes making the name of donors or the amounts paid to highly compensated employees public information.
9. Opposes the 7½ percent tax on foundation income and supports a supervisory fee. Entities associated with higher education should be excluded from the definition of and not made subject to provisions governing private foundations. We believe that restrictions on legislative activity of foundations will seriously endanger the making of grants to educational institutions.
10. Recognizes that colleges and universities have been dependent on tax exempt bonds and can support only those changes in the law that would not inhibit the ability of institutions to raise funds at low interest cost.

Joined by—
- The American Alumni Council
- The American Association of Colleges for Teacher Education
- The American Association for Higher Education
- The American Association of Junior Colleges
- The American Association of State Colleges and Universities
- The American College Public Relations Association
- The Association of American Colleges
- The Association of American Universities
- The Council of Protestant Colleges and Universities
- The National Association of Independent Schools
- The National Association of State Universities and Land-Grant Colleges
- The National Catholic Education Association

GENERAL STATEMENT OF LOGAN WILSON, PRESIDENT, REPRESENTING THE AMERICAN COUNCIL ON EDUCATION AND OTHER ASSOCIATIONS

Mr. Chairman and members of the Committee: I am Logan Wilson, president of the American Council on Education, which numbers in its membership 1538 colleges and universities and associations of higher education. I am accompanied today by Professor Julian Levi of the University of Chicago, chairman of the Council's Committee on Taxation; President William Friday of the University of North Carolina; and President Landrum Bolling of Earlham College in Richmond, Indiana. The composition of this panel will suggest to you the importance of private philanthropic support to all institutions—public and private alike.

In compliance with the Committee's request that testimony be consolidated, a number of other associations are joining us in this statement. They are listed on the cover sheet.

This fall—1969—the United States Office of Education has estimated the enrollment of degree credit students in American colleges and universities at 7.1 million. The fact that 42 percent of all of American youth in their middle and late teens will enroll in a degree credit program in a college or university is the envy of every nation.

The financial burdens thus thrust upon higher education are, indeed, awesome. The United States Office of Education estimates total current expenditures for higher education in the 1967–68 academic year on the order of $15.3 billion. American colleges and universities have never been in more serious financial difficulties as they struggle with rising costs and increasing numbers of students. With remarkble bipartisan support, the Congress has passed many measures designed to provide Federal assistance to all our colleges and universities as they strive to meet these most extraordinary demands made upon them.

From its inception, antedating the formation of the Republic itself, American higher education has been dependent upon the generosity of voluntary support. Federal programs which often require university matching funds heighten, rather than diminish, the importance of voluntary support. The Council for Financial Aid to Education has reported that in that same academic year 1967–68 such voluntary support amounted to $1.57 billion. In other words, higher education relied on private philanthropy to provide 10 percent of its operating budget, and that 10 percent is what has kept our institutions solvent. State-controlled gress to do all in its power, through tax incentives, to increase and broaden survival and quality of public, as well as private, higher education in this nation is dependent upon greatly increased voluntary support over the coming years.

We believe it is not only sound public policy but good economics for the Congress to do all in its power, through tax incentives, to increase and broaden voluntary support from the private sector. Nevertheless, we understand and agree that tax policies, which affect all citizens, should be scrutinized regularly in an effort to uncover abuses and to bring about greater equity.

While in our view general Federal tax policy, as true throughout history of the Internal Revenue Code, should provide an incentive for giving to higher education, we would exclude any result which would leave any donor with an overall profit. We would require that the result of his gift invariably be to decrease his net worth and that higher education must not engage in transactions solely for the tax benefit of any donor.

Moreover, higher education and its friends must argue from fact rather than conjecture. Accordingly, the attention of the committee is called to two studies

accompanying this statement—the first sponsored by the American Council on Education entitled *Patterns of Giving to Higher Education*, analyzing approximately two and one-half million donor transactions resulting in gifts of $1,034,000,000 to higher education in the year 1962–63; the second sponsored by the American Alumni Council, the Council for Financial Aid to Education, and the National Association of Independent Schools entitled *Voluntary Support of Education 1967–68*. The findings of these studies as they bear upon the issues here presented will be referred to specifically.

It is in this spirit that we offer the following comments on several issues before you.

The Council, in testimony before the House Ways and Means Committee, supported and continues to support certain clear reforms. However—

Legislation presently before this Committee limits the right of the taxpayer to deduct the fair market value of appreciated property through application of allocation and limited tax preference restrictions. The findings of the American Council on Education and the Council for Financial Aid to Education studies are crucial in explaining our grave concern as to these sections.

Higher education is extraordinarily dependent on large gifts. The American Council on Education study of 1962–63 giving disclosed that of an aggregate 2,453,186 donor transactions accounting in total for $1,034,836,277 of support, 21,753 donor transactions of over $5,000 accounted for $774,881,482. Less than one percent of all donor transactions account for approximately 75 percent of all support (page 15).

Of that $1,034,836,277 of all voluntary support, $794,350,838 or 76.7 percent was received in the form of cash; $183,308,097 or 17.7 percent was received in the form of securities; and $57,177,342 or 5.6 percent was received in the form of property (page 24).

Gifts of security and property are most often received from the individual donor and the average size of donor transactions is significantly greater in gifts of securities or property than cash (page 17).

The Council for Financial Aid to Education study for 1967–68 shows that individuals, alumni and non-alumni, account for more than 47 percent of all voluntary support (page 67). Moreover, the study concluded that "Alumni support now stands alone as the fastest growing and most stable source of voluntary contributions." (page 5).

Studies carried out by eighteen representative Pennsylvania colleges and universities disclose that in the three years commencing July 1, 1966, and ending June 30, 1969, an average of 40.6 percent of outright gifts received from individuals consisted of securities. The same pattern is repeated in state after state.

It is thus a fair statement that in the years ahead colleges and universities will be increasingly compelled to seek support from individual donors whose patterns of giving consist to a most significant degree in gifts of securities. These transactions are, of course, voluntary. They reflect the generosity and concern of the individual donor who ought to be immediately aware of the tax consequences of that generosity. Otherwise, the incentive cannot operate.

We are advised that allocation and limited tax preference restrictions as now proposed can actually lead in some circumstances to the imposition of additional taxes against the donor by reason of his having made a gift. While in future years credits for such tax payments may be carried forward, their utility depends on the continued life of the taxpayer and the contingencies of his financial position. Moreover, calculation of these reductions is inconceivably complex. We include in Appendix A an illustration. To those of the Committee and staff who read it we wish to give assurance that we are not engaging in ridicule or satire. We embarked on a serious enterprise in order to determine the effects of the proposed law. Our conclusion is that literally no institution and no donor can come close to determining in advance the tax effect of a major gift. Without such determination it seems improbable that the gift will be made.

At best the practical effect will be to limit the tax incentive to a short few weeks at the end of the taxpayer's accounting tax year. Tax consequences, since they are related to tax preference income or allocation in any one year, may be markedly different in any one year as compared to another. Donors will tend to concentrate gifts in one year rather than another. Intelligent institutional financial planning will be gravely handicapped.

Moreover, as shown by the Council for Financial Aid to Education Report, approximately one-half of all funds raised by higher education are for capital

purposes, often the result of campaigns fulfilled by pledges or subscriptions for future years. These pledges are viewed as moral, rather than legal, commitments. The complications of limited tax preference and allocation formulaes will seriously jeopardize their collection.

PRIVATE FOUNDATIONS

Section 4945 defines taxable expenditures made by private foundations and imposes a tax on the private foundation equal to 100 percent of such expenditure and upon the foundation manager equal to 50 percent of the expenditure. Taxable expenditures are defined as any amount paid or incurred by a private foundation to

> "carry our propaganda or otherwise attempt to influence legislation" further defined as including but not limited to:
>
> > "(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."

While Section 4945 attempts to exclude "non-partisan analysis or research" from the interdiction of the law, the broad language of the statute and the penalty imposed will, as a practical matter, eliminate foundation support of college and university activity so essential that the Congress and state legislatures have over and over again turned to higher education.

We are, of course, aware of many examples of such university service as will be called to your attention. One evident case, however, arises from work performed over many years by university law schools for the Commissioners of Uniform State laws and for the Trustees of the American Law Institute. These law schools are uniquely qualified to perform these assignments which, while non-partisan, by their very nature are directed to the drafting and passage of uniform legislation over the nation to the end and that national justice or economic growth be not impeded by state lines of jurisdiction. Almost invariably this work has been supported by private sources.

We are gravely concerned with several provisions in H.R. 13270 that pertain to life income gifts, and in the technical analysis that follows we make a number of recommendations concerning them.

We are also concerned with the definition of private foundations which would, we believe unintentionally, include a number of educational organizations within that category. Our recommendations for change are also included in the analysis that follows.

The Committee will be hearing directly from many public witnesses on the proposal to impose a partial tax through the LTP provision on income from tax-exempt bonds. We wish to point out that to the extent this proposal increases interest changes or decreases the marketability of such issues, colleges and universities, especially public institutions, will find it that much more expensive to borrow for the construction of facilities.

Thank you, Mr. Chairman, for giving us this opportunity to appear. Our panel will be happy to answer your questions.

TECHNICAL ANALYSIS AND PROPOSALS

A. LIMIT ON TAX PREFERENCE AND ALLOCATION OF DEDUCTIONS

1. Problem

The most damaging provisions of the House tax bill, insofar as gifts to colleges, churches, hospitals and other public entities, are those requiring inclusion of unrealized appreciation in gift property as a "tax preference" for the purpose of the limit on tax preference (LTP) (Section 301) and the allocation of deductions (Section 302). The proposals result in an indirect tax on the unrealized appreciation reducing the tax benefit of the contribution below the limitations otherwise imposed by the bill. For this reason alone, they could severely reduce the substantial gifts of major donors which play such an important role in the support of institutions of higher education, public and private. Moreover, the complicated computations required would affect a taxpayer's income not only in the year of gift but in later years and make the planning of such gifts difficult, if not impossible.

The limit on tax preference provides in effect for a minimum tax. Under this a taxpayer's preference income which escapes taxation cannot exceed his taxable income. Under the allocation of deductions, virtually all of an individual's itemized deductions must be allocated in part to preference income which may be received without imposition of either penalty.

Under other sections, the bill provides that an individual donor may deduct the fair market value of certain kinds of appreciated property (real and intangible (securities) capital assets) which have been held for more than 12 months without being required to include the unrealized appreciation in income provided the donation is to a church, college, hospital or public entity (as redefined). The inclusion of that unrealized appreciation in the computation of the minimum tax and the allocation of deductions is not consistent with these sections and inappropriate for the following reasons:

1. All of the other items of preference income represent actual income received by the taxpayer which escapes taxation either through exclusion (i.e., tax exempt municipal bond interest and the untaxed portion of long-term capital gains) or the granting of an offsetting unrealistic deduction (i.e., excess depletion, excess farm loss and excess depreciation).

2. By its nature, the appreciation in property so given is "unrealized" and not received by the donor but by the donee institution.

3. The donee institutions are limited to those clearly operating in the public interest as defined by Congress.

4. The inclusion of the unrealized appreciation as a tax preference for LTP and allocation of deductions actually represents a fourth limitation on the charitable contributions deduction. The first is the limitation itself (50 percent under the proposed bill). The second is the limitation on the gift of appreciated property (30 percent under the proposed bill). The third is the requirement that charitable contributions be allocated in part to tax preference income as proposed in the allocation of deductions section.

5. Said inclusion, in effect, represents a double limitation on deductions within the allocation of deductions proposal itself, the donor losing the benefit of his deduction (a) by being required to allocate any charitable contribution in part to all tax preference income and (b) by being required to allocate not only all of his charitable contributions but also all of his other itemized deductions in part to the unrealized appreciation in gift property.

6. The combination of LTP and AOD is such as to severely penalize the generous donor who may wish to make a gift of appreciated property with no intent of realizing on the full benefit of the deduction. For example, a donor who makes a gift of appreciated property which substantially exceeds his ordinary income (a not uncommon event) may in the year of the gift, as a result of the inclusion of unrealized appreciation in LTP and AOD, *increase* his taxable income two or three fold and his taxes in the initial year four, five or six fold. Although provision is made for recapture of a portion of this penalty tax in later years, the recapture will be entirely uncertain and dependent upon the unpredictable circumstances in those later years and indeed upon the taxpayer's very survival.

7. The inclusion of unrealized appreciation as a tax preference will discourage those major gifts by generous donors on which colleges, churches, hospitals and similar public entities are so dependent, not only because the benefit of the deduction will be seriously curtailed but also because of the complicated nature of the computation required. This results from the interdependence of factors, some of which are wholly unrelated to the charitable contribution itself. No donor will be able to make plans for an orderly procedure with respect to the making of major gifts insofar as taxes are concerned since the benefit of the deduction will not be known until the very end of each tax year, if then. With respect to carryover gifts and satisfaction of pledges, this will be especially damaging. While it is demonstrably difficult for a donor to determine the effect of a gift in the year of contribution, it may well be impossible for him to estimate the effect of a contribution pledged for or carried over to a future year. In such case, the unknowns include not only the donor's future economic situation but the possible realization of other "preference income" (such as long-term capital gains), his other charitable commitments and even the likelihood of his survival.

II. Proposal

That the unrealized appreciation in gift property be excluded from the definition of "tax preference" in both the limit on "tax preference" and the "allocation of deductions" through the deletion of Section 84(c)(1)(A) as added by Section 301(a) of the bill (page 166) and the renumbering of the subsequent subsections.

B. GIFT OF APPRECIATED PROPERTY

I. Problem

It is recognized that in certain limited instances a high-bracket donor of appreciated property which if sold, would give rise to ordinary income or short-term capital gain may be in a better position financially as a result of having made a contribution than he would had he sold the property in question. For this reason, the provisions of the proposed bill which would require a donor of such property to limit his deduction to his tax basis in the property or include the unrealized appreciation as income if he elects to deduct the fair market value of the property have merit. Where the property is a capital asset which, if sold, would give rise to long-term capital gain, then the donor clearly departs irrevocably with an asset and the deduction recompenses him only in part for his loss. The encouragement of such gifts to colleges, churches and public entities as redefined would, therefore, clearly seem to be in the public interest. Indeed, the curtailment of this tax incentive might well be disastrous to the fund-raising activities of such charities operating within the public sphere. While it is imperative to retain this tax incentive as proposed in the present bill with respect to gifts of long-term appreciated real and intangible property, there seems no logical justification for excluding from this general rule gifts of tangible personal property and gifts of future interest in property.

Tangible Personal Property.—The abuses with respect to the gifts of tangible personal property have been largely eliminated by other provisions of the bill or by administrative procedures within the Internal Revenue Service. Thus, under other provisions of the bill, collections of personal papers will produce ordinary income if sold as will paintings created by the donor himself. (Section 518 of the bill (pages 285 through 287).) The deduction for gifts by such a collector or creator will, therefore, be limited to the donor's tax basis or the donor will be required to include the unrealized appreciation in income.

In the past, justified concern has been expressed with respect to the valuation of art objects. This abuse has been curtailed or largely eliminated through an improved audit program and the creation of a special advisory group to assist the Commissioner of Internal Revenue. Indeed, the valuation problem will not be eliminated under the bill because the donor will be entitled to deduct the fair market value if he includes the increment in income.

The restrictive rule proposed by the bill could have a disastrous effect on generous gifts of works of art, manuscripts and the like to university museums, art galleries and libraries whose collections are dependent on such contributions.

Gifts of Future Interests.—Donations of future interests have been of substantial value to churches, colleges, universities and hospitals. This method of giving antedates the tax laws and has been of special importance to small educational and charitable institutions which do not have access to major donors. Insofar as a donor of modest means is concerned, this may be the only way in which he can make a substantial gift to the institution of his choice.

Traditionally, such gifts are made in the form of property—a home or farm which the donor retains for his life or securities—from which the donor realizes a sufficient income to protect himself or his family during lifetime, with an irrevocable commitment to public or charitable use thereafter. The limiting of the donor to his tax basis for the purpose of computing the gift or the requirement that he include the unrealized appreciation in his income would impose such a burden on these donors that they will be precluded from the making of such gifts. There seems no logical reason why the donor of such property should not be entitled to the same benefits as the donor who can afford to part irrevocably with an appreciated asset of substantial value.

II. Proposal

Section 170(e) as amended by Section 201(c) of the proposed bill would be amended by striking subsections (B) and (C) of subsection(2) and the last paragraph of subsection (2) with corresponding deletion of "(A)" at the beginning thereof. (Pages 123 and 124.)

C. LIMITATION ON GIFTS BY INDIVIDUALS

I. Problem

Increase in Individual Limitation from 30 Percent to 50 Percent—The bill provides for an increase in the limitation on charitable contributions deduction from 30 to 50 percent for gifts to churches, educational institutions and public entities. While this will be of limited influence in encouraging gifts, the proposed increase should be approved.

Appreciated Property.—The bill also proposes that there be a special limitation on the gift of appreciated property to 30 percent of the contribution base even though made to a college, church or hospital (with an appropriate carry forward). There seems to be little reason for this discrimination. In any event, the limitation should be not in terms of the value of the property but in terms of the unrealized appreciation which escapes taxation as a result of the gift to a qualified charity. It is to be noted that the 30 percent limitation on the unrealized appreciation will further limit donations by major donors.

II. Proposal

That subsection (J) of 170(b)(1) as added by Section 201(a) of the bill (page 116) be deleted or, if retained, the limitation therein should be expressed in terms of "the total deduction for *that portion of the charitable contribution which is attributable to appreciation in the value of property not included in gross income* shall not exceed 30 percent of the taxpayer's contribution base."

D. CHARITABLE REMAINDER TRUST

I. Problem

Under the bill, a deduction for the fair market value of a remainder interest for *income, estate* and *gift tax purposes* would be allowed only if the gift is made to a "charitable remainder annuity trust" or "charitable remainder unitrust." A "charitable remainder annuity trust" is one which requires payment of a sum certain annually for a term of years or the life of the person. A "charitable remainder unitrust" requires that a fixed percent of the net fair market value of the assets computed annually be paid not less than annually to the life tenant. (Section 170(h) added by Section 201(e) of the bill (pages 127, 128); Sections 2055(e)(2) and 2522(c)(2) added by Section 201(h) of the bill (pages 130–134).) In both cases the remainder must pass to the qualified donee institution or be held by the trust for its use. Under the bill, neither trust will be subject to tax on gains or undistributed income. (Section 664 as added by Section 201 of the bill (pages 135–137).)

This provision is traceable to a tentative decision of the Ways and Means Committee announced by Chairman Mills on May 27, 1969:

> "to adopt a provision under which the charitable contribution deduction would be recaptured in whole or in part where the investment policies of the trust—as between the income and the remainder beneficiaries—are not consistent with the assumptions on which the deduction was originally computed."

It is obvious that the Committee was not able to draft the provision contemplated and, in the alternative, adopted the unitrust concept originally put forth in the so-called Surrey Report setting forth the recommendations of the prior Administration. Clearly, the purpose is to obviate the possibility that, through their investment policies, the life tenant may be benefited at the expense of the remainder interest passing to the charity.

Although the Surrey Report gave examples of situations under which a donor might obtain a charitable deducation based upon a remainder which would not in fact ultimately pass to the charitable remaindermen, the abuses thus specified are subject to correction under the present law either through imposition of ordinary local trust law concepts on the responsibility of the trustee or because the arrangement in fact constitutes a fraud of the tax laws. Further, although the charitable remainder trust concept as written into the law may curb the alleged abuse of improper investment policies, it is not clear that it will not create an opportunity for further abuses based upon the trust concepts as they apply to the taxation of beneficiaries receiving income therefrom.

The proposal would eliminate a 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 tenant or tenants to the church or college. There can be no investment abuse in such an instance and, therefore, there should be no reason why the tax advantages of making such a gift should not be retained.

Whatever the merits of the "charitable remainder trust" concept, no change in the statute should affect the income, estate and gift tax consequences of irrevocable transfers made prior to December 31, 1969.

The bill proposals would require that the deductions be determined on the basis of the value of the property transferred and the annual amount of percentage payable regardless of investment policies of the fiduciary. This means that the deduction will be the same regardless of the institution which is benefited or the amount of income realized by the fund. The concept has the disadvantage of making it possible, indeed likely, that the principal of the trust will be invaded to make the required payments. While this is proper with respect to the annuity trust, it may be improper insofar as the ordinary remainder trust is concerned, reacting to the disadvantage and detriment of the remaindermen by reason of the invasion of principal. Also, it should be made clear that in the case of either "trust" the benefit may be payable to one or more life tenants.

It is suggested that the abuses are not such as to require a drastic change in the manner of making ordinary life income or annuity gifts. Regardless, the incentive to fund such gifts with appreciated property should be retained. (See "Gift of Appreciated Property" above.)

If the Committee believes that the abuses are such as to require the placing of charitable remainder gifts in the straitjacket of the "charitable remainder trust" concept, then great care should be exercised to make certain that the application of this new concept and other concepts included in the bill will not unfairly affect ordinary life income and annuity gifts heretofore created by executed will or irrevocable trust. The effective date with respect to deductibility for income tax purposes should be no earlier than taxable years beginning after December 31, 1970. Certainly, there is no reason to apply this rule retroactively to April 22, 1969, as proposed in the bill since even the announcement of May 27, 1969, contemplated an entirely different rule than that ultimately adopted by the Ways and Means Committee in its bill. By the same token, change in the estate ax deducion should only affect wills executed after December 31, 1969. With respect to irrevocable charitable remainder trusts created prior to December 31, 1969, the estate and gift tax deduction should be allowed under the rules in effect at the time of the creation of the trust.

Finally, as noted below, a trust will no longer be entitled to an unlimited deduction for an amount permanently set aside as under present law. This rule should not be applicable with respect to irrevocable life income or annuity gifts created prior to December 31, 1969, since the burden of such a tax as applied to capital gains realized by such trusts will be borne almost entirely by the charitable remaindermen.

II. Proposal

1. Amend subsection (2) of Section 664(d) as added by Section 201(i) (page 137) by striking "and" at the end of the subparagraph (A) and substituting in its place "or", by relettering subparagraph "(B)" as subparagraph "(C)" and by substituting after subparagraph (A) the following:

"(B) From which the transferor retains a legal life estate in real property."

2. Amend subsections (A) of subsections (1) and (2) of subsection (d) of Section 664 as included in Section 201(i) (pages 136, 137) by adding in each case after the words "a person" "or persons" and modify the remainder of the section accordingly.

3. Make it clear in the legislative history that the fixed percentage may be different for each year provided the differing percentages are established in the instrument at the outset.

4. Amend subsection (A) of Section 664(d)(2) as included in Section 201(i) by adding after the words "valued annually" "(or a fixed percentage of the net fair market value of its assets, valued annually or the net income, whichever is the lesser)." (The legislative history should make it clear that the deduction shall be computed on the assumption that the fixed percentage will be paid. It should be clear that this is an alternative which is available to the donor and donee institution.)

EFFECTIVE DATES

1. Subsection (5) of Section 201(j) (page 188) shall be amended to provide that "The amendment made by subsection (e) shall apply to a transfer in trust made after December 31, 1969."

2. Subsection (A) of paragraph 7 of Section 201(j) (pages 137, 138) shall be amended to provide that "The amendment made to subparagraph (2) of Section 2055(e) by subparagraph (1) of Section 201(h) shall apply with respect to irrevocable transfers in trust made after December 31, 1969, and wills of decedents executed after December 31, 1969."

3. Subparagraph (B) of subparagraph (7) of Section 201(j) (page 139) shall be amended to provide that "The amendment made to subparagraph (2)(A) of Section 2522(c) as amended by subsection (3) of Section 201(h) shall apply with respect to gifts made after December 31, 1969."

4. Subparagraph (8) of Section 201(j) (page 139) shall be amended to provide that "The amendment of subsection (i) shall apply to transfers in trust made after December 31, 1969."

5. Subparagraph (6) of Section 201(j) (page 138) shall be amended to provide "The amendment made by subsection (f) shall apply to amounts paid, permanently set aside or to be used for a charitable purpose after December 31, 1969, provided that this amendment shall not apply with respect to a trust created by an irrevocable transfer prior to December 31, 1970."

E. COMMON TRUST FUND—COMMINGLED INVESTMENT FUND MAINTAINED BY ONE OR MORE COLLEGES OR UNIVERSITIES

I. Problem

For a number of years the Internal Revenue Service has questioned whether common investment of life income and annuity gift funds received by colleges, universities and similar entities, either with the endowment fund of the exempt entity or in a separate pool, may constitute an association taxable as a corporation under IRC Section 7701(a)(3) and Regulations 301.7701-2. In certain instances it has suggested that the same rule should apply with respect to a common endowment investment fund maintained by more than one college or university. The position of the Service is apparently based in large measure on the enactment of a special provision with respect to the common trust funds of banks. (Section 584)

Many life income and annuity gifts are relatively small and the only reasonable procedure with respect to investment is to commingle them either with the endowment fund of the institution or in a separate pool maintained for such purpose. The institution has a vested interest as remainderman of the property or indeed may be the legal owner of the property itself, having incurred only a contractural obligation to pay income or a fixed amount to the life tenant. It is difficult to believe that the Government has any interest in preventing the commingling of such funds for investment purposes.

By the same token, there seems every reason to encourage colleges and universities, particularly small institutions, to commingle their funds for investment proposes in order to have the advantage of a balanced portfolio, which are now available only to institutions with substantial endowments.

Regardless of the merits of the Internal Revenue Service position, the implied threat to rule that such entities are taxable as corporations deters educational institutions from following reasonable and appropriate investment practices which the Congress should encourage. It is suggested that the Code be amended to make it clear that the common investment of life income and annuity gift funds and charitable remainder trust funds or the creation of a common investment pool by more than one college or university does not give rise to an "association" taxable as a corporation.

II. Proposal

That Section 501 be amended by adding thereto the following subsection (f) and that existing subsection (f) be renumbered as subsection (g):

"(f) Common Trust Funds—

"(A) Definition—For the purpose of this subtitle the term 'common trust fund' means a fund maintained by one or more organizations described in section 170(b)(1)(B) exclusively for the collective investment and reinvestment of moneys and property contributed to one or more of the participating institutions, whether or not all or a portion of said moneys and property is subject to the obligation on the part of one or more of the participating institutions to pay either an income for life or an annuity or to make payments under a charitable remainder annuity trust or charitable remainder unitrust as defined in section 664(d).

"(B) Taxation of Common Trust Fund—A common trust fund shall not be subject to taxation under this chapter and, for purposes of this chapter, shall not be considered a corporation."

F. CHARITABLE DEDUCTION FOR THE RIGHT TO USE PROPERTY

I. Problem

In the tentative decision announced May 27 and the legislative history, the Ways and Means Committee indicated a determination to disallow a charitable deduction for the contribution to a charity of the right to use property or, in other words, the fair rental value. The bill (Section 201(a)(3)) would add subsection (8) to IRC Section 170(b), denying a deduction for a charitable contribution for "less than (a taxpayer's) entire interest in property other than through a charitable remainder trust", stating "that a contribution by a taxpayer of the right to use property shall be treated as a charitable contribution of less than a taxpayer's entire interest in said property." The provision goes far beyond the stated intention of the drafters which the Committee explained was to deny to a donor the "double benefit (of) giving a charity the right to use property which he owns for a given period of time." (H.R. 91-413 (Part 7) (page 57.) It, apparently, would result in denial of deduction for a partial interest in property, such as a fractional interest, as well as for a legal estate in property, such as a remainder after life estate. There seems no reason why the provision should not be limited to the denial of a deduction for the use or fair rental value of property.

II. Proposal

Subsection (8) of Section 170(b) as added by Section 201(a)(3) (page 121) should be amended to read:

"No deduction shall be allowed under this section for a charitable contribution by a taxpayer of a right to use property."

G. CHARITABLE CONTRIBUTIONS OF ESTATES OR TRUSTS

I. Problem

Under Section 642(c), an estate or trust is granted an unlimited deduction for amounts "paid or permanently set aside" for charitable purposes. With the apparent purpose of requiring a current benefit to charity where a deduction is involved, the bill proposes that a deduction be available only for amounts "paid" during the taxable year or within the following taxable year if the fiduciary elects to credit the payment to the prior year. (Section 201(f), pages 128-129.) There seems no reason for the application of this rule to estates where, under the present Code and regulations, termination and, therefore, ultimate distribution is required at the earliest possible date. With respect to irrevocable trusts created prior to the effective date of the Act as proposed (or January 1, 1970, as suggested herein), the rule should not apply. As indicated above, this has special application to ordinary life income gifts where the donor has irrevocably committed his property in a trust for tax purposes, the income of which is to be paid to a life tenant or tenants and the remainder of which is to pass outright to the charity. By their nature, these trusts cannot be amended. If the proposed change is made applicable to "amounts paid, permanently set aside or to be used for charitable purposes under the date of enactment of this Act", then gains realized from the sale of any assets during the term of the trust subsequent to that date will become taxable. Almost the entire burden of this tax will be borne by the charitable remaindermen. For this reason, the rules in effect at the time of the creation of the trust should be retained and the gains should not be taxed. Relief provisions should be included for situations where except for circumstances beyond the control of either the fiduciary or grantor, the payment must be postponed, such as in the case of a tax dispute or legal dispute as to the terms of the trust.

II. Proposal

1. See subparagraph 5 under "Effective Date" proposals with respect to charitable remainder trusts.

2. IRC Section 642(c), as amended by Section 201(f) of the bill, should be amended by striking the words "estate or" from the first line and adding at the end thereof "In the case of an estate, there shall be allowed as a deduction in computing its taxable income (in lieu of deductions allowed under Section

170(a) relating to charitable contributions and gifts) any amount of gross income without limitation which, pursuant to the terms of the governing instrument, is during the taxable year paid or permanently set aside for a purpose specified in Section 170(c)."

3. The conforming amendments of subsection (2) should be adjusted accordingly and a special provision should be included with respect to the allowance of the deduction where the trust is prohibited from making the distribution under circumstances beyond the control of the grantor or fiduciary.

H. FOUNDATIONS

1. *Tax on Foundation Income*

I. Problem

The bill proposes a 7½-percent tax on foundation income. It would appear that *any* "tax" imposed on private foundations will actually be a burden borne by the beneficiary organizations to whom the required distributions must be made. Thus, the tax would appear to be punitive in nature and serving no public purpose.

It is recognized that the activities of some private foundations are such as to require that the Internal Revenue Service conduct continual and extensive audit and review of the recepits and expenditures of all. It is, therefore, appropriate to suggest that the private foundations be required to pay a registration or audit fee which will provide the Treasury with a sum sufficient to cover the expenses of said review. This should be a fee and not a tax. In the first place, the tax, although modest, is subject to increase. Second, if a tax is imposed by the Federal Government, then the states will seek to impose a similar levy. Indeed, in the case of some states, this will be automatic since their laws are dependent upon the Federal statutes.

II. Proposal

A "supervisory *fee*" should be imposed on "private foundations" which is sufficient to provide revenue to cover the costs of audit and supervision.

2. *Definition*

I. Problem

A serious problem is presented because of the approach taken by the Ways and Means Committee with respect to the definition of private foundations. Instead of attempting to define a "private foundation" as such, the Committee originally defined a "private foundation" as any 501(c)(3) organization except a church, college, hospital and publicly supported and operated entity. It was obvious that such a definition would bring within the purview of the "private foundation" provisions many entities, including those associated with colleges and universities, which should not be subject to the strictures of the bill. Accordingly, two additional exceptions were included in an attempt to exclude from the definition of "private foundation" entities which are in fact organized, operated and controlled in the public interest. One is based upon an established realtionship between a foundation and one or more churches, colleges, hospitals or public entities. The other is based in the main, on the receipt of funds from the public. In both cases, restrictions are imposed to make sure that such entities are not in fact controlled directly or indirectly be interested individuals ("disqualified persons").

It is apparent that these definitions are not sufficiently broad as to encompass all those entities which should not be treated as private foundations. More important, there remains considerable doubt as to the status under these proposals of many entities which are organized and operated to carry out the functions of colleges and universities, such as joint ventures (encouraged by Federal and state governments), entities which are separately organized under Section 501(c)(3) because of the problems of state law (particularly as they affect public institutions of higher education) and associations of colleges and universities. Since the nature of such exempt entities is infinitely varied, the expansion of these definitions must in fact be on a piecemeal basis. However, several comments should be made with respect to the expanded definition as included in the bill:

a. Subsection (3) of Section 509(a) as added by Section 101(a) of the bill (pages 15 through 17) excludes from the definition of "private foundation":

"(3) an organization which—

"(A) is organized, and at all times thereafter is operated, exclusively for the benefit of, to perform the functions of, or to carry out the purposes of one or more organizations described in paragraph (1) or (2),

"(B) is operated, supervised, or controlled by one or more organizations, or in connection with one organization, described in paragraph (1) or (2), and

"(C) is not controlled directly or indirectly by one or more disqualified persons (as defined in section 4946) other than foundation managers and other than one or more organizations described in paragraph (1) or (2); and"

It was originally proposed that (A) and (B) be in the conjunctive, the limitation of subsection (C), preventing direct or indirect control by disqualified persons. "(C)" appears to eliminate the problem which concerned the Committee the most, namely, the possibility that an organization directly related to one or more colleges or universities or similar exempt entities might still be under the "control" of an individual or his family or related parties. The legislative history makes it clear than an organization, to be entitled to exclusion under this section, must meet the tests of (A), (B) *and* (C). If this is so, then it becomes important to examine carefully the provisions of (A) and (B).

With respect to subparagraph (A), the word "exclusively" is traceable to the basic exemption provision. It is argued that under this provision the word does not actually mean exclusively but "primarily." It is suggested that the word "primarily" should be substituted for "exclusively" if this is what is intended. Such an amendment is clearly appropriate in view of the fact that many of the organizations which should be excluded from the definition of private foundation under this section do have certain minimal activities which might remove them from the purview of this section if the word "exclusively" is narrowly interpreted. For example, many associations of colleges and universities have followed the practice of admitting to associate or similar membership other 501(c)(3) organizations which serve in one way or another the purposes of higher education. Some of these 501(c)(3) associates are "private foundations" within the meaning of the bill. It might be argued that such an association of colleges and universities is not operated "exclusively" for the benefit of its controlling member institutions.

Secondly, there seems no reason whatsoever to limit "in connection with" to one orgnization. If an institution must meet the tests of both (A) and (B), then (B) should read "in connection with one or more organizations described in paragraph (1) or (2)." If an institution is organized primarily for the benefit of a church, college or public entity and is operated, supervised or controlled by or in connection with one or more such public entities, then it should not be treated as a "private foundation" if, in fact, it is neither controlled either directly or indirectly by a "disqualified person or persons."

b. The provisions of subsection (2) of the same section are unnecessarily restrictive as regards the source of public support. To a limited extent there is no reason why gifts of disqualified persons should not count in determining the one-third support which indicates broad public interest. There also seems no reason to penalize a foundation which otherwise meets the test of "broadly supported organizations" because it is well endowed and, therefore, has a substantial gross investment income, particularly if it is made clear as in the case of (3) that such an organization is not controlled directly or indirectly by a "disqualified person."

There are many organizations which, for one reason or another, may not be able to qualify for exclusion from the definition of private foundation without a modification of their governing instruments or adjustment of their method of operation. The statute should encourage such entities to operate in the public sphere by meeting the tests which qualify them for exclusion. Regardless of the merits of the organization and its real purposes and activities, if it was a "private foundation for its last taxable year ending before May 27, 1969," it will be treated as such unless its status is terminated under Section 508 with all the penalties and taxes imposed by Section 507. This is entirely inconsistent with the general purposes of the private foundation provisions. Indeed, it is inconsist-

ent with the provisions which grant "private foundations" at least until the beginning of 1972 to modify their charters in such a way as to meet the new rules established by the statute. Since in most cases the changes will be of form rather than of substance, a transition period should be afforded within which an organization can adjust itself to come within the definition of those institutions which are not private foundations within the meaning of Section 509.

II. Proposal

1. Subsection (A) of subparagraph (3) of Section 509(a) as added by Section 101(a) (page 16) of the bill should be amended by deleting the word "exclusively" and substituting in its place the word "primarily."

2. Subsection (B) of subsection (3) of Section 509(a) as added by Section 101(a) of the bill (page 16) should be amended to read as follows:

"is operated, supervised, or controlled by or in connection with one or more organizations described in paragraph (1) or (2)."

3. Subparagraph (2) of Section 509(a) as added by Section 101(a) of the bill (pages 15 and 16) should be amended in accordance with the recommendations made above and in the light of special circumstances to be brought to the attention of the Committee.

4. Subsection (b) of Section 509 as added by Section 101(a) of the bill (pages 16 and 17) should be amended to read:

"If an organization is a private foundation (within the meaning of subsection (a)) for its last taxable year ended before January 1, 1972, such organization shall for the purposes of this title be treated as a private foundation for each succeeding taxable year (1) until it is determined that the organization is no longer a private foundation (within the meaning of subsection (a)) in such manner as the Secretary or his delegate may by regulations prescribe or (2) unless its status is terminated under Section 508."

3. *Restrictions on Grants to Colleges, Churches, Hospitals and Similar Exempt Entities*

I. Problem

The bill as proposed imposes severe penalties not only on private foundations but on any foundation manager with respect to the making of a "taxable expenditure." Under the bill, a taxable expenditure means any expense "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)." (Section 4945(b) as added by Section 101(b) of the bill (page 44).) A further subsection provides that "for the purposes of subparagraph (1) (see above) taxable expenditure includes, but is not limited to, (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 legislation, other than through making available the results of nonpartisan analysis and research." (Section 4945(c) as added by Section 101(b) of the bill (page 45).)

Although the legislative history indicates a narrow purpose, the statute, as can be seen, is extremely broad. Any direct or indirect activity might result in the imposition of severe penalties to the foundation and/or its trustees or officers. Colleges, universities and their related exempt entities are the recipients of many grants which result in reports and recommendations which could be considered to come within the purview of these broad provisions. The support of private foundations is essential to these clearly educational activities of colleges, universities and similar entities. As a result of the restriction, private foundations will be prohibited from making perfectly legitimate grants to such entities operating in the public sphere because of the fear of the imposition of penalties through the activities and reports of the recipient grantee organizations.

Private foundations should be free to make grants to such public entities without the fear of the imposition of penalties on the foundations and their managers. This is consistent with other provisions of the same subsection which permit grants to such organizations without the imposition of "expenditure responsibility" (Sections 509(b)(4) and 4945(b)(4) as added by Section 101(b) of the bill (page 44)) and individual grants which "constitute a fellowship or scholarship at an educational institution described in Section 170(b)(1)(B)" without specific requirement that the grantor demonstrate that the purpose of the grant

is to "achieve a spec[illegible] object, produce a report or other similar product or improve or enhance a literary, artistic, musical, scientific or other similar capacity skill or talent." (Section 4945(e) as added by Section 101(b) (pages 46 and 47). Section 4945(b)(3) of the same provision (page 44).)

II. Proposal

Subparagraph (b) of Section 4945 added by Section 101(b) of the bill (page 44) should be amended by adding the following subsection (6):

"Paragraphs (1) and (2) of this subsection shall not apply with respect to a grant to an organization described in (1), (2) or (3) of Section 509(a)."

I. UNRELATED BUSINESS—CLAY BROWN BILL

I. Problem

The bill includes a section which would enact the so-called Clay Brown Bill, extending its application to virtually all nonprofit institutions, including churches. Under this, such entities would be taxed on their "unrelated debt financed income"—in other words, income from investment in real, personal or other property traceable, directly or indirectly to borrowed funds. It is obvious that the attempt to relate investments to borrowing will present the greatest difficulty from an administrative point of view. Nonetheless, the bill as modified through various drafts has been endorsed by the colleges and universities through representative organizations. It retains certain provisions which were added at their request, including a provision which would in effect suspend the tax with respect to real property acquired by an institution with borrowed funds for its exempt purposes if the real property is actually reduced to use by the college or university for its exempt functions within ten years.

One special problem is presented in connection with the definition of "obligation". At the request of certain organizations, the bill made it clear that the promise by an institution to pay an annuity would not in itself constitute a "debt" for the purposes of the imposition of the statute. Since life income and annuity gifts have traditionally been funded by property, the statute should also make it clear that the promise to pay an income for life will not constitute a debt. On the assumption that the "charitable remainder trust" concept will be retained in the bill and that Congress will recognize the appropriateness of funding such gifts with appreciated property, it is suggested that the section dealing with annuities be amended to make it clear that the acceptance of a "charitable remainder trust" gift will not be considered to give rise to a debt obligation subjecting the institution to an unrelated business tax by reason of the funding of the charitable remainder gift with property, whether appreciated or not.

II. Proposal

Subsection (5) of Section 514(c) as added by Section 121(d) of the bill (pages 103 and 104) should be amended by deleting the whole thereof and substituting in its place the following:

"(5) Charitable remainder Trust.—The term 'acquisition indebtness' does not include an obligation to make payments under charitable remainder trusts as provided in Section 664."

(The legislative history should make it clear that property received under life income and annuity gifts heretofore created will not be affected by the provision.)

J. UNRELATED BUSINESS—TAXATION OF ADVERTISING REVENUE

I. Problem

In an obscure provision of the bill (Section 121(c)), there is added to Section 513 a new subsection (c) entitled "advertising activities." This is apparently intended to give statutory support to the regulations which imposed the unrelated business tax on the advertising revenue received by an exempt organization in connection with publications, radio stations or other media. The provision, however, is stated in general terms which may have application well beyond the concept of taxation of advertising revenue proposed in the regulations. It states:

"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."

This rule would apply with respect to "any activity which is carried on for the

production of income from the sale of goods or performance of services." The provision is so vague as to permit application of the unrelated income tax to integral parts of a single activity solely on the basis of return of income and without application of the general concepts with respect to unrelated trade or business. The provision should be narrowly confined to the provisions of the regulations. It is to be noted that, under the present regulations, an exempt publication which is published at a loss would not be subject to the tax. Such an interpretation of the proposed statute might not be warranted.

K. INCOME TAX RETURNS

I. Problem

Under Section 101(d) of the bill subsection (a) of Section 6033 would be amended to remove the exemption from filing returns which now obtains in the case of certain organizations, including churches and colleges and universities. Thus, colleges and universities would be subject to the same reporting requirements that now apply to all 501(c)(3) organizations unless the Secretary determines that "such filing is not necessary to the efficient administration of the Internal Revenue laws." (Pages 57 through 60.) If the Committee deems it necessary that colleges and universities and similar organizations file returns, it should not impose upon such entities the same requirements with respect to reporting as are imposed upon private foundations. In particular, such entities should not be required to make public the additional data which is now to be required of private foundations, namely, the names of substantial contributors and the compensation of trustees and highly compensated employees. The publication of such data could seriously affect the fund raising activities and operations of such entities without any real benefit accruing to the public.

Under Section 101(d) of the bill *all* 501(c)(3) organizations would have to report the "names and addresses of all substantial contributors" and the "compensation and other payments made * * * to 'foundation managers (trustees and the like) and highly compensated employees.'" The relevance of such information insofar as "private foundations" are concerned is clear. There seems to be no purpose in requiring churches, colleges, hospitals and similar public entities to include such information in the returns to be filed by them. The requirement that such information be made public under Section 6104 could be very detrimental not only to the operation of such enitles but also to their fund raising activities. While it is appropriate to talk in terms of "highly compensated employees" of private foundations, the term has little or no meaning if used in connection with a college or university. Publication of the names of the substantial contributors (presumably those making gifts of more than $5,000) would deter such gifts since such donors are notably reluctant to have such information made available to the public for no other reason than the demands of other organizations. It is suggested that the increased reporting requirements not apply in the case of institutions which are not "private foundations" within the meaning of the new bill.

II. Proposal

1. Subparagraph (2) of Section 101(d) of the bill (page 58) be amended by deleting subparagrpah (C).

2. Subparagraph (d) of Section 101 of the bill be amended by renumbering subparagraph "(3)" as subparagraph "(4)" and inserting as subparagraph (3) the following:

"(3) Section 6033 is amended by adding the following:

"(C) Certain organizations described in Section 501(c)(3) (other than organizations described in 509(a) (1), (2) or (3)). Every organization described in Section 501(c)(3) (other than an organization described in Section 509(a) (1), (2) or (3)) which is subject to the requirements of subsection (a) shall furnish annually additional information at such time and in such manner as the Secretary or his delegate may by forms or regulations prescribe, setting forth:

"(1) the total of the contributions and gifts received by it during the year, and the names and addresses of all substantial contributions,

"(2) the names and addresses of its foundation managers (within the meaning of section 4946(b)(1)) and highly compensated employees, and

"(3) the compensation and other payments made during the year to each individual described in paragraph (2)."

L. TAX EXEMPT MUNICIPAL BONDS

I. Problem

State institutions of higher learning have for many years been dependent on the issuance of tax exempt bonds for the financing of dormitories and all kinds of facilities. The issuance of similar bonds by state authorities has played an increasingly important role in the financing of dormitories and educational facilities at private institutions. Any change in the tax law which would materially affect this source of financing could be extremely detrimental to the future of all institutions of higher learning, public and private.

Under the bill, individuals who would be indirectly taxed on their exempt income to the extent that such income is included in computing the "Limit on Tax Preference" and the "Allocation of Deductions" provisions. After a ten-year transitional period, all interest on otherwise exempt obligations would be included for the purposes of computing the "Limit on Tax Preference." After a similar ten-year transitional period, interest on all Government obligations issued after July 12, 1969, would be taken into account for the purposes of computing the "Allocation of Deductions." (The Administration is opposed to the inclusion of tax exempt interest on state and local bonds as "preference income" for the purposes of the "Limit on Tax Preference" in part because of Constitutional objections.) Under the bill, corporations, including banks, would not be subject to a direct or indirect tax with respect to tax exempt state and municipal bond interest.

Under Sections 601 and 602 of the bill (pages 317 through 321), states and municipalities would be encouraged to elect to issue fully taxable bonds in lieu of bonds, the interest of which is exempt from Federal income tax under Section 103. Under Section 602, the Federal Government would provide the state instrumentality with an interest subsidy of a fixed percent of the interest yield on each issue of obligations with respect to which such an election is made. The subsidy would be not less than 30 percent nor more than 40 percent until 1975 and not less than 25 percent nor more than 40 percent thereafter. The interest subsidy percentage would be established on a regular basis by the Secretary of the Treasury before each calendar quarter to which it applies.

II. Proposal

It is difficult, if not impossible, to estimate the effect of either the bill or the Administration proposal on the capacity of colleges and universities, public and private, to finance essential dormitories and facilities through the issuance of tax exempt bonds or, in the alternative, Federally subsidized bonds. However, any change in the law with respect to the exemption should be made only if the Committee is satisfied that it will not inhibit the ability of educational institutions to raise such funds at low interest cost.

APPLICATION OF THE LIMIT ON TAX PREFERENCES TO CHARITABLE GIFTS OF APPRECIATED PROPERTY

This memorandum deals with the calculations required by the Tax Reform Act of 1969 as passed by the House (H.R. 13270) on August 7, 1969 (the Bill) with regard to (i) application of the "limit on tax preferences (LTP) to gifts of appreciated property to charity and (ii) the allocation of charitable deductions.

Section 301(a) of the Bill adds a new Section 84 to the Internal Revenue Code of 1954 (IRC) listing five "items of tax preference" (Sec. 84(c)(1)), as follows:

(i) charitable contributions of appreciated property;

(ii) the excess of accelerated over straight-line depreciation;

(iii) interest on certain governmental obligations otherwise exempt from taxes;

(iv) certain excess farm losses;

(v) and the ½ of long term capital gains deductible from gross income.

These items of tax preference are to be added to the taxpayer's adjusted gross income (computed without regard to LTP) and one-half of this sum then establishes the taxpayer's "limit on tax preference" (LTP) except that in no event will this limit be less than $10,000. (Section 84 (b) and (d) of IRC.) To the extent the sum of the "items of tax preference" exceed the "limit on tax preference" the excess is treated as a "disallowed tax preference" and is included in the taxpayer's gross income (section 84(a), (b) of IRC). The amount so included in the taxpayer's gross income Section 84(a), (b) of IRC). The amount so included is to be considered derived proportionately from each "item of tax preference" (Section 84(e) of IRC), while the total of tax preferences up to the "limit," are denominated "allowable tax preferences."

However, not all of the appreciation in property donated to charity must be treated as an "item of tax preference" in the year of gift. It is only that part of the appreciation that is equal to:

> the amount of the deduction (determined without regard to Section 277) for charitable contributions under Section 170 or 642(c) allowable for the taxable year . . . (Section 84(c)(1)(A)).

Thus, before it can be determined how much of the appreciation given to charity is "preferential," it is necessary to ascertain the amount of the deduction to which the gift gives rise. In this respect, the parenthetical phrase—"determined without regard to Section 277"—is important. Section 277 is a new provision in the IRC (Section 302(a) of the Bill) providing for the allocation of certain deductions, including charitable deductions between the taxpayer's adjusted gross income (i.e. income subject to tax) and his allowable tax preferences (i.e. exempt income or deductions giving rise to exempt income). By bypassing the allocation calculation, the Bill has the effect of rendering all of the appreciation given to charity within the Section 170 percentage ceiling on charitable deductions as a "item of tax preference," even though the taxpayer may not be entitled to deduct all of that appreciation because of the allocation requirement. This would seem to be an important conceptual error in the Bill.

Leaving aside this problem of the allocation by-pass, the first step in determining how much of a gift of appreciation to charity is preferential is to ascertain how much of the appreciation is potentially deductible under the Section 170 ceiling on deductions. Section 170(a) of the IRC will remain unchanged, and it simply permits the deduction of charitable contributions. Section 170(b), which establishes limits on the deduction, is substantially revised to permit a taxpayer to deduct all of his gifts of appreciated long-term capital assets (held for 12 months or more) up to 30% of his "contribution base." Thus, it is obviously necessary to compute the taxpayer's "contribution base" before it is possible to determine how much of his gift of appreciated property is in the words of the new Section 84 within the Section 170 deduction ceiling and hence an "item of tax preference."

"Contribution base" is defined as "adjusted gross income" increased by the "allowable tax preferences" as determined under Section 27(c)(2). Under Section 277(c)(2), "allowable tax preferences" are the total of all "items of tax preference" determined under Section 84(c) not included in the taxpayer's gross income (i.e. not disallowed), provided they exceed $10,000.

So here we are. In order to determine his "limit on tax preferences" (LTP), the taxpayer must first know the total of his "items of tax preference." In the case of a gift of appreciated property to charity, he cannot determine this until he knows how much of that gift is deductible under the Section 170 ceiling. To ascertain this deductible amount, however, he must first compute his "contribution base." But he cannot compute the "base" until he knows what part of the donated appreciation is within his LTP and hence an "allowable tax preference." The circle is complete. Neither the Bill nor the Committee Report gives us any clue to avoiding this circle.

An explanation for this circularity can perhaps best be found in the concepts that seem to have guided the thinking of the House Ways and Means Committee on the matter of "tax preferences" and in the Committee's failure to distinguish between gifts of appreciated property and the other four "preferential" items. This discussion will also explain why the policy objective sought by the Bill cannot be achieved by simple arithmetic calculations of the type traditionally used in the Tax Law. Rather, a complex of three and perhaps four simultaneous algebraic calculations are required.

The Committee Report is cognizant of the close inter-relationship that exists between the limit on tax preferences and the allocation of deductions. It states:

> "Under the bill, individual taxpayers may be subject to the limit on tax preferences, as well as being required to allocate their deductions. The bill provides in effect that (1) such a taxpayer is to first apply the limit on tax preferences (that is, to add back to taxable income that part of non-taxable income in excess of 50 per cent of total income), and (2) he then is to allocate deductions between adjusted gross income as modified in step (1) and the allowed tax preference items." (Committee Report, p. 83.)

This statement is revealing for it establishes that in the Committee's mind, all five of the "items of tax preference" are tantamount to items of "non-taxable income," event though this is only strictly true of the tax exempt bond income and the one-half of long term capital gains that is deducted (excluded) in the computation from gross to adjusted gross income. The Committee explains:

> "Under present law, there is no limit on how large a part of his income an individual may exclude from tax as a result of the receipt of various kinds of tax exempt income. Individuals whose income is secured mainly from tax-exempt State and local bond interest, for example, may exclude practically all their income from tax. Similarly, individuals may pay tax on only a fraction of their economic income, if such income is derived primarily from long-term capital gains (only one-half of which are included in income) or if they enjoy the benefits of accelerated depreciation on real estate. Individuals may also escape tax on a large part of their economic income if they can take advantage of the present special farm accounting rules or can deduct charitable contributions which include appreciation in value which has not been subject to tax."

In the terms of reference used by the Committee, there is a certain similarity between gifts of appreciated property and the other items of "tax preference," in that they all directly or through deductions may give rise to what the Committee characterizes as "tax exempt income." But the difference is much more fundamental. All of the other "items of tax preference," except gifts of appreciated property, arise out of transactions by which "economic income" flows to the taxpayer. In the case of tax exempt bond income and the capital gains deduction, the economic income is simply not taxed. In other cases, such as excess farm losses and accelerated depreciation, the economic income is partially or wholly off-set by deductions which bear no reasonable relationship to the costs of producing that income.

Thus, by treating these other items as "preferential," the Bill is designed to capture for tax purposes some part of this otherwise tax-exempt economic benefit, either directly or through adjusting the deduction to more nearly reflect the actual costs of producing the associated income. And in all cases the "preferential" amount is susceptible of measurement by an independent standard. In the case of exempt bond income and the excluded capital gains, the total amount of exempt economic benefit is the measure of the preference; in the case of accelerated depreciation and excess farm losses, the "preference" is the difference between the depreciation or farm expense deduction actually claimed and the more accurate measure of straight-line depreciation or the current costs of farming.

None of this holds true for gifts of appreciated property. In making the gift the taxpayer has not produced any economic income. He has given away irrevocably the economic benefit in the donated property without any economic return. There is no "tax-exempt" income associated with the gift which LTP can capture.

Because of this fact, there is no other measure of the amount of "preference" except the amount of the deduction to which the taxpayer is actually entitled by reason of the gift. In the case of the other "preferential deductions" the fact that the transactions in question give rise to economic income means that the preference can be measured by reference to an independently determined standard representing the reasonable costs of producing that income. In the case of appreciated property, there is no economic income, so that the only standard available for measuring the taxpayer's preference is the amount he could otherwise *actually deduct* were LTP not in the picture.[1]

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[1] Parenthetically, it might be noted that because a gift of appreciated property represents in its entirety an economic loss to the donor-taxpayer, the deduction for that gift reflects a government decision to partially compensate him for his loss. This is quite unlike the exemption and deductions associated with the other preferences which are measures to increase the taxpayer's economic gain from certain types of transactions. This governmental compensation for loss could be provided directly—by paying the taxpayer—or indirectly through the tax laws (i.e. shifting some part of the economic loss from the taxpayer to the government in the form of a revenue loss). But if the government chooses the deduction mechanism, it must of necessity permit the donor-taxpayer to take his deduction entirely against income unrelated to the gift transaction. To not allow this is simply another way of saying that the taxpayer should bear the whole cost of the gift. And to apply LTP to gifts of appreciated property is simply a device for reducing the compensation the government is prepared to give the taxpayer as an incentive to making the gift. Now obviously, the government could achieve its cost reduction purpose directly by simply reducing the amount that may be deducted in respect of gifts of appreciated property. But it has already done this by the special 80% ceiling. It apparently wants a second crack through LTP, a most anomalous position when the Committee justifies its own proposal to increase the deduction ceiling in order:

> ". . . to strengthen the incentive effect of the charitable contributions deduction for taxpayers generally."

Apparently taxpayers who give appreciated property do not qualify as "taxpayers generally" although they may provide a very substantial portion, if not the predominate portion, of the private support of some of the most important of the Nation's charitable enterprises.

It is this fundamental fact that produces the circularity in the Bill.

For in addition to taxing some part of a taxpayer's exempt income through LTP, the Bill also seeks to require taxpayers to allocate some part of their deductions against the exempt income not reached by LTP (i.e. throw that deduction away). However, in the case of gifts of appreciated property it is the deduction alone that determines how much exempt income is in the picture, yet because of allocation the amount of the deduction cannot be determined without knowing the amount of exempt income. In short, the Bill has produced a tax-scheme containing two wholly interdependent variables.

Quite clearly it is the recognition of this circularity of calculations that led to the stipulation in this Bill that a donor of appreciated property is to determine his LTP without going through the step of allocating his deductions (Section 84(c)(1)(A)). But as already stated this means that he is forced to treat as preferential all of the donated appreciation up to the percentage ceiling on deductions, regardless of how much of an actual preference he has as measured by the actual amount he can deduct. Quite clearly this expedient can produce some serious distortions.[2]

However, even if the Bill's by-passing of the allocation requirement is retained, there is a further circularity in the calculations which continues to make the Bill unworkable. It is still necessary under the Committee Bill to determine the donor-taxpayer's percentage limitation on charitable deductions. Calculation of this maximum deduction would be quite straightforward were the percentage simply applied against adjusted gross income as under current law. But—for obviously correct reasons—the Bill applies the percentage against a new expanded base, called the "contribution base," which is the total of adjusted gross income and "allowable tax preferences." Hence, another circle. Before you can compute the "Limit on Tax Preferences" you must at least know the maximum deduction even if you do not known the actual deduction after allocation. But the maximum deduction depends upon the "contribution base," and this latter is dependent upon knowing how much of the appreciation is within the "Limit on Tax Preference." The Bill provides no avenue of escape from this circularity of calculations.[3]

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[2] This can be demonstrated by the example of two donors, each with income of $50,000 who make identical gifts of $100,000 of zero basis property. Assuming next that the income of one donor is divided $30,000 in the form of tax exempt bond income and $20,000 in the form of salary, while in the income of the second donor is entirely in the form of salary. Now, of course, because of the circularity of the "contribution base" calculation, it is not possible to make an exact computation for these two taxpayers. However, in order to understate the distortion we will assume that the second donor, with $50,000 of salary income, has the higher contribution base and hence, the larger charitable deduction as well as a larger tax preference because of his gift. Actually the first donor has a maximum deduction of $40,000 (30% of $120,000) and the second donor a maximum deduction of $45,000 (30% of $150,000). After computing LTP and ascertaining the allowable peferences, it will be found that the donor 3/5 of whose income in the form of tax exempt interest ends up with a taxable income of only $3,620 less than the donor whose income is 100% in the form of salary. While part of the explanation for this extraordinary result lies in the fact that the first donor has a lower maximum deduction than the second, the bulk of the discrepancy can be attributed to the fact that while the adjusted gross income of the donor with tax-exempt income is being increased through LTP by more than 200%, allocation has reduced his deduction to less than 45% of his modified adjusted gross income. While in the case of the donor with all of his income in the form of salary, his deduction is about 45% of his adjusted gross income even after allocation.

[3] It is not possible, for example, to avoid the problem by computing the maximum deduction as a percentage of adjusted gross income—as under current law. For, as the Treasury recognized when it first suggested these ideas to the Committee, the moment the allocation of deductions principle was introduced it became necessary to expand the base for this percentage calculation to include any exempt income against which part of the deduction was to be allocated. In the Treasury's words, this measure was necessary:

"In order to prevent the distortion which would result from measuring the percentage limitation for the maximum charitable contribution deduction by reference to adjusted gross income while at the same time disallowing part of that deduction on the basis of excluded items which are not part of adjusted gross income."

The Treasury's point can be illustrated by the case of a donor with AGI of $10,000 and exempt income of $10,000 who makes a $10,000 gift of zero basis stock. If the deduction ceiling were computed as a percent of AGI alone, he would have a maximum deduction of $3,000 to be allocated 50/50 against AGI and exempt income, so that his actual deduction would be $1,500 or 15% of his income subject to tax. Another donor with $20,000 of AGI and no exempt income who makes the same gift would have both a maximum deduction and an actual deduction of $6,000 or 30% of his income subject to tax. By including the exempt income in the base for computing the first donor's percentage ceiling, the first donor becomes entitled to a maximum deduction of $6,000 (30% of $20,000) which after allocation results in an actual deduction of $3,000 or 30% of his income subject to tax.

In sum, as applied to gifts of appreciated property, the three interrelated provisions of the Committee Bill—the Limit on Tax Preferences, the percentage limitations on charitable deductions and the allocation of deductions—suffer from two basic defects:

(i) The calculation of LTP without going through the allocation procedure can produce serious distortion in measuring the extent of preference associated with a gift of appreciated property; and

(ii) The calculations called for by the Bill—even permitting the distortion in (i) to stand—are unworkable by ordinary arithmetical means.

Point (ii) is best illustrated by taking the simple case of a donor with salary income of $30,000, tax-exempt interest income of $20,000 who gives $100,000 of long-term capital assets to charity in which his cost basis is $10,000. As can be seen in Appendix A, it is totally impossible to follow the language of the Bill step-by-step and determine his "contribution base" or his LTP.

Now, of course, there is at least theoretically a way out of this dilemma. It is to recognize that in principle a gift of appreciation is to charity "preferential in nature" only to the extent it gives rise to a charitable deduction against other income and that, under allocation, the deduction cannot be ascertained without knowing how much of the gift is "preferential." Or, in other words, the solution, if any, lies in recognizing that the combination of LTP and the allocation of deductions pose a problem in the simultaneous resolution of three, and perhaps four, unknowns which are completely interdependent; a calculation carried out, if at all, by the use of some highly complex algebraic equations.

Appendix A

Assume donor has: salary income of: $30,000; tax exempt interest income: $20,000; makes gift of approximately: $100,000 ($10,000 over).

(1) Determination of the Items of Tax Preference (Sec. 84(c) (1) (A) & (C)):

Gift of appreciated property

Step 1.—Section 84(c) (1) (A) defines as an "item of tax preference": "The amount of the deduction (determined without regard to section 277) for charitable contributions under Section 170 . . . allowable for the taxable year which is attributable to appreciation in the value of property not included in gross income (determined without regard to this section).

Step 2.—Next Step is Obviously to Look at Section 170.

Section 170(a) (1) states:

"There shall be allowed as a deduction any charitable contribution (as defined in subsection (c) payment of which is made within the taxable year...

(We assume that in this example the donor's gift is a charitable contribution under subsection (c)).

Section 170(b) (1) (A) states:

"In the case of an individual, the deduction provided in subsection (a) shall be limited as provided in succeeding sub-paragraphs of this paragraph.

Sub-paragraph B establishes a limit of 30% of "the taxpayer's contribution base" for contributions to six different categories of charitable institutions.

Sub-paragraph C establishes a general limit of 20% of the "taxpayer's contribution base" and provides that the 30% limit in sub-paragraph B is on top of the 20% limit in sub-paragraph C for a potential of 50%.

Sub-paragraph J states: "(i) In the case of appreciated property to which subsection (e) does not apply [subsection (e) is not applicable in our example], the total deductions for contributions of such property under subsection (a) for any taxable year shall not exceed 30 per cent of the taxpayer's contribution base." "(ii) [contains special rules for carryover of deductions in excess of 30%.]

Step 3.—Next step is obviously to determine 30% of the "taxpayer's contribution base"

Section 170(b) (6) states:

"*Contribution base defined*—for purposes of this section, the term 'contribution base' means adjusted gross income . . . increased by the allowable tax preferences as determined under section 277(c) (2)."

Thus, ignoring the effect of LTP on adjusted gross income (see also parenthetical phrase under section 84(c)(1)(A) above), the taxpayer in our example has a "contribution base" of $30,000+allowable tax preferences.

Step 4.—Next step is obviously to determine the taxpayer's "allowable tax preferences."

Section 277(-)(2) defines "Allowable Tax Preferences":

"(A) *General Rule*—The term 'allowable tax preferences' means the excess (if any) of the total items of tax preference determined under section 84(c) (but only to the extent that such items are not included in gross income under section 84) as modified in paragraphs (B), (C) and (D), over $10,000 ($5,000 in the case of a married person filing a separate return).

Since we are still trying to calculate LTP, no part of the appreciation given to charity has been included in gross income under section 84, neither are subparagraphs (B), (C) & (D) applicable, hence we must return to section 84(c) to ascertain the amount by which the "items of tax preference" exceed $10,000, but if we return to section 84(c), we are referred to §170(b)(1)(J), under which we must know the contribution base. This, in turn, refers us to section 170(b)(6), where we are referred back to section 277(c)(2)(A), and the circle continues.

The CHAIRMAN. I am going to go out of order at this point because Senator Byrd of Virginia will not be able to be here all morning. I understand he has a very important appointment that has to do with business of the State of Virginia and his Governor. That being the case, I would like to ask consent of the committee to call out of order Mr. Robert E. Huntley, president of Washington and Lee University who will testify on behalf of the Association of Independent Colleges of Virginia. I am going to call on Senator Byrd to interrogate you before anyone else does so that he can do whatever is necessary to save the great Commonwealth of Virginia.

Senator BYRD. I greatly appreciate that, Mr. Chairman.

STATEMENT OF ROBERT E. HUNTLEY, PRESIDENT, WASHINGTON AND LEE UNIVERSITY

Mr. HUNTLEY. I am Robert Huntley from Washington and Lee University and I am here representing the 26 private institutions in the State of Virginia.

You have just heard from the American Council on Education. We endorse their presentation in every detail.

Recognizing, Senator Long, your earlier statement, I do not intend to be repetitious. I do not intend to read portions of the statement we have already submitted.

The CHAIRMAN. That is one thing that does help me, may I say. When you take a look at, say, here is what the other witnesses are testifying and you see what these fellows have been saying here day in and day out all day yesterday and today, there is no particular point in your printed statement, is there, for everybody that agrees with you, and there is no particular point in saying this over and over again. We know that what you ought to do is hit the point that hasn't been made.

Mr. HUNTLEY. I agree, sir.

The American Council's presentation is, as I say, one which we endorse completely. We are represented in fact by the American Council on Education. My principal purpose then would be to say just a word about the special impact which this bill would have, we believe, on

institutions such as those represented in our group, independent institutions in Virginia which are institutions the like of which are found throughout the country, the special impact. On these institutions which the, some of the, provisions of this bill, we feel, would have upon us.

We think that it is not an overstatement of the issue to put it as bluntly as this. If this bill in its present form is passed we think, by the Congress, even the strongest private institutions will be threatened, we believe, with a reduction to a level of mediocrity, and we think that many of us will be faced with a question of true survival.

The specific points that are included in our written presentation and which have been already iterated to you by the American Council on Education I shall not attempt to reiterate unless there are specific questions. I would like to add that we applaud and endorse the efforts which the Congress is making to achieve significant tax reform and to correct the inequities and abuses that occur. We endorse the provisions which are carefully designed to prevent the giving privilege being used as a shelter for profit taking. Specifically, we encourage passage of those proposed parts of the bill which would eliminate the tax advantage of giving appreciated property which if sold would produce ordinary income or short-term gains. We are not in other words, encouraging you to alter that portion of the bill.

On the contrary, we encourage you to pass it and the provision in the way that it has been proposed.

We do not oppose, we accept, the proposed provisions concerning elimination of the unlimited deduction, for example. It is those provisions, however, that strike hard at the gift of appreciated long-term assets about which you have heard so much. It is that, those provisions, both as they appear in the limited tax preference and as they appear in the allocation of deduction provisions with which we are most concerned.

We feel that in the case of the schools I represent the majority of the gifts we received in the past fiscal year and in fiscal years theretofore have been in the form of appreciated properties, long-term assets. We are convinced, we don't know precisely what the impact can be, if one can compute that, but we are convinced it will result in a significant diminution in that giving at a time when we must have an increase in that giving and we feel that such a diminution this committee and the Senate should be aware will truly threaten the survival of the institutions like those represented in this association.

We are also concerned, as others have been, about the provisions referring to charitable remainder trusts and other forms of deferred giving. I would not purport before this committee to be an expert on the precise meaning of all these provisions, and although I am an attorney, I have somehow slipped into the business of being a college president, and even tax attorneys with whom I have discussed these questions have had some trouble in explaining to me the precise impact of the deferred giving proposals.

I think all would agree and it certainly seems to me this would be the case that the immediate impact the proposals have been to bring to a screeching halt all deferred giving programs. That is true with

us and it is true with all educational institutions, public and private, in the country.

The CHAIRMAN. Has it already done that?

Mr. HUNTLEY. It has already done that because of the uncertainty of what will be the law in succeeding years and whether or not the provisions concerning retroactivity will be in the bill, for both of those reasons.

In addition the complexity of the provisions will even if it will be enacted now thus removing uncertainty, with its fate in the Congress, even if it were enacted now the complexity of it would, I think, add to the problems we have now in explaining deferred giving programs to potential donors, and beyond that, the thing that bothers me, I think, is that I am unable to discern precisely the purpose that would be achieved in terms of reform with respect to these deferred giving provisions. It may well be there, but I have difficulty in discerning it, and I wonder if the purpose is being achieved to justify the additional complexities which I think would result.

I wish I could be more specific on those provisions. I cannot be, and it would be out of place for me to pretend to have a knowledge I don't have on this subject.

Senator, if there are any questions I would be pleased to try to answer them, if I can. You have had before you already some truly good tax experts, but if there is anything I can add that might be helpful I would be pleased to try to do so.

Senator ANDERSON. Senator Byrd.

Senator BYRD. Thank you, Mr. Chairman.

Mr. Huntley, how many independent colleges are there in Virginia?

Mr. HUNTLEY. There are 26 represented in this group, Senator, 26 senior colleges and junior colleges, that do not rely upon State support for their financing. These 26 educate roughly a third of the undergraduate enrollment in our State at no cost whatever to Virginia taxpayers. The tax saving implications are suggested by the State legislatures appropriations of slightly more than $250 million to support the State system of higher education, the current biennium. This means, we think, that the State would have to collect from the taxpayers more than $100 million in additional public revenues if these collegiate institutions now under private control in Virginia and depending almost exclusively on voluntary private support were the responsibilities of the State government. The Virginia situation might not be typical but I think it is representative of most States, so what we are talking about then is a multibillion-dollar tax burden removed from State taxpayers when the aggregate tax saving values are projected across the entire Nation.

Senator BYRD. What you are saying is there are 26 independent colleges in Virginia? And a comparable number in the other States?

Mr. HUNTLEY. In other States.

Senator BYRD. So Virginia is not isolated insofar as having a large number of independent colleges that exist all over the United States?

Mr. HUNTLEY. That is correct, sir, and these institutions, as I have already mentioned, rely almost exclusively on private philanthropy to close the increasingly large margin between the income we receive

from tuition and endowment and the annual budgets we must meet, a margin that frequently approaches the halfway mark and a margin which must be closed if it is to be closed at all with private philanthropy and is now being done.

Senator BYRD. It seems to me the independent colleges play a vitally important role in the various States and localities, and in whatever we do in the Congress we want to be sure, it seems to me, that we do not cripple the independent colleges.

I was a little concerned when this morning an individual came to my office and said it has been his policy for the past 10 years to give $10,000 a year to a certain independent college of Virginia but he said if this bill goes through in its present form that he feels that he would not be in a position to make such a contribution. So I am trying to understand this bill as well as I can, so that we do not cripple our colleges.

Let me ask you another question: You made a survey, I believe, in which you indicate what support for the colleges in Virginia was obtained from private contributions—and what part of those contributions were in cash and what in noncash.

Mr. HUNTLEY. Yes, sir.

We did that just very recently. For the most recent fiscal year in these 26 schools the results of the survey have been distributed now, I think, and added to our written statement. The principal feature of it, which is pertinent to this discussion during the last year, last fiscal year, about $58 million in gifts and grants of all kinds from private sources came to those 26 institutions, gifts and grants of every category. Gifts and grants from individuals were about $48 million of that, a very, very large fraction of the total amount needed to operate these schools.

The noncash portion of these gifts, the noncash portions which would be the portion most directly affected by the allocation of deductions provisions and the LTP provisions, 90 percent or so of the total amount given. Whether or not last year was a typical year, one can look at earlier years in the giving of these colleges and find that it is generally a half. At least a half of the amount received by these schools in their annual giving programs as well as their capital giving programs is received in property gifts, usually securities, and usually securities with a significant appreciation element included. The figures that we have submitted to you we think are indicative of the great impact, perhaps fatal impact, this bill would have upon us.

Senator BYRD. You mean to say that of the total gifts received that the noncash gifts amounted to 88 percent, almost 90 percent?

Mr. HUNTLEY. Yes, sir, they did. That is correct, Senator.

Senator BYRD. I see.

It is an astonishing figure.

Senator BENNETT. Senator, maybe we have gone into the credit card world. [Laughter.]

Senator BYRD. I would like, Mr. Chairman, if I may to just ask one additional question. It has been published before but it still is not completely clear to me. Could you illustrate, Mr. Huntley, how the allocation of deductions provision in the bill adversely affects the

fundraising efforts of the colleges? I am not clear as to how that exactly does affect it.

Mr. HUNTLEY. I can say the allocation of deductions provision hurts us, as has been explained by other witnesses, in two very distinctive ways. It requires the inclusion of appreciations on donated property, including long-term assets, that is what we are referring to now, appreciation of which in turn becomes a part of the formula which is used to reduce all allowable deductions. So the donor of appreciated long-term property creates for himself a category of preferred tax income by making the gift which, in turn, becomes a part of the formula which reduces not only the charitable deduction itself but other deductions, and secondly, by including the charitable deduction among those itemized deductions to which the formula is applied, the charitable deduction is reduced by the very formula which the gift gave rise to. So we have gotten in a sense on both sides of the formula.

We most strongly urge the committee and the Senate to consider eliminating the appreciation on donations of long-term property from the definition of tax preferred income in both the allocation of deductions provision and in the limited tax preference provisions of the bill.

Senator BYRD. Thank you, Mr. Huntley, thank you, Mr. Chairman.

Mr. HUNTLEY. That is all I have, thank you very much.

Senator CURTIS. Mr. Chairman, what college did you say you were president of?

Mr. HUNTLEY. Washington and Lee University in Lexington, Va.

Senator CURTIS. And the independents carry a third of the load in Virginia?

Mr. HUNTLEY. A third of the load in Virginia, Senator.

Senator CURTIS. Isn't it true that in most of our foreign countries they have no such thing as the independent or church college?

Mr. HUNTLEY. I think the distinction is certainly harder to make in most foreign countries, yes, sir.

Senator CURTIS. And isn't it true that all of their schools, including their theological seminaries, are supported by tax funds?

Mr. HUNTLEY. I believe that is the case, Senator.

Senator CURTIS. Now, isn't it also true that if the changes made in the House bill are carried through and no contributions are made or that they are very materially cut down the Treasury doesn't gain anything?

Mr. HUNTLEY. It doesn't gain very much, Senator, according to the revenue projections that the committee report, the House committee report, itself contains, the revenue gain for the Federal Government would be de minimis.

Senator CURTIS. It seems to me that the decision facing this committee is one that has little reference in the final analysis to saving the taxpayers money because very definitely they will increase the costs of public education, publicly supported education, and get very little revenue, but what we do here will have a great impact on American education.

Mr. HUNTLEY. Indeed it will, sir. As I have understood, the principal objective is not revenue production, but the correction of certain points of unfairness or inequity that may exist with respect to

some taxpayers; for example, the situations where a taxpayer might under the present law gain a profit from his giving. As I have said we support changes that would abolish any such possibility.

I might add one other point just as an aside, Senator, the institution I represent received its first gift or endowment in 1797 in the form of securities from one George Washington.

Senator BENNETT. So you named the college after him?

Mr. HUNTLEY. Yes, sir.

A pattern which has been pursued occasionally since. Thank you, sir. Thank you, Senator.

(Mr. Robert E. Huntley's prepared statement follows:)

ASSOCIATION OF INDEPENDENT COLLEGES IN VIRGINIA—FOR SENATE HEARINGS SEPTEMBER 18, 1969

(Presented by Robert E. R. Huntley, President, Washington and Lee University, accompanied by Eugene H. Stockstill)

SUMMARY

1. The importance of stimulating private philanthropy, which alone assures the private sector of its independence, is emphasized.
2. H.R. 13270, if enacted in its present form, would be Congress' first major retreat from the time-honored principle that the voluntary benefactors of society and socially useful institutions should be recognized and rewarded in the tax laws. The bill would strike a crippling blow financially to innumerable educational, health, religious, civic, and community organizations that are dependent on voluntary gift support.
3. Tax avoidance can be stopped without damage to the practice of philanthropy and to privately supported education.
4. Tax reform is imperative and the higher education enterprise applauds Congressional acknowledgment of this fact and the determination of the Congress to act constructively.
5. Concerning the charitable deduction and tax exemption provisions of H.R. 13270, colleges endorse some of the concepts without reservation; they accept others; but they are strongly opposed to those which would deprive institutions dependent upon private gift support of substantial sums of money.
6. Colleges in Virginia particularly oppose those provisions which:
   (a) alter the tax treatment of gifts of appreciated property where the appreciation is long-term capital gain;
   (b) classify the appreciation on donated property as tax-exempt income;
   (c) group charitable contributions with "allocable deductions" with respect to Section 302 of the bill;
   (d) jeopardize long-established methods of charitable giving, such as charitable remainder trusts, life income agreements, and gift annuity agreements;
   (e) place a tax of 7½ percent on the investment income of private foundations;
   (f) drastically alter the tax treatment of state and local bonds, through which colleges in some states are enabled to finance capital construction.
7. Putative gains in tax revenues created by the above provisions are negligible by comparison with the financial hardship such provisions would impose on American education and philanthropy.
8. The bill penalizes the whole of private philanthropy for the abuses of the unconscionable few.
9. Under present law, a donor cannot escape taxes through making charitable contributions.
10. Those retroactive provisions which would alter the tax treatment of already existing trusts and gift agreements seem especially unfair.
11. In considering this bill, the Senate is asked to remember the cardinal principle of educational and charitable fund raising: in any fund-rasing effort, a few large donors always give far more than all remaining donors.
12. The real danger posed by some sections of this bill would be to the pluralistic vigor of American society and thus to the national interest.

13. Attention is called to the attached document describing private support of independent higher education in Virginia.

STATEMENT OF THE ASSOCIATION OF INDEPENDENT COLLEGES IN VIRGINIA CONCERNING TAX REFORM ACT OF 1969 (H.R. 13270) AS PASSED BY U.S. HOUSE OF REPRESENTATIVES ON AUGUST 7, 1969

INDEPENDENT INSTITUTIONS OF HIGHER EDUCATION IN VIRGINIA

(Not including theological or religious seminaries)

Senior (Four-Year) Institutions

Bridgewater College, Bridgewater
Eastern Mennonite College, Harrisonburg
Emory and Henry College, Emory
Hampden-Sydney College, Hampden-Sydney
Hampton Institute, Hampton
Hollins College, Hollins College
Lynchburg College, Lynchburg
Mary Baldwin College, Staunton
Randolph-Macon College, Ashland
Randolph-Macon Woman's College, Lynchburg
Roanoke College, Salem
Saint Paul's College, Lawrenceville
Stratford College, Danville
Sweet Briar College, Sweet Briar
University of Richmond, Richmond
Virginia Union University, Richmond
Virginia Wesleyan College, Norfolk
Washington and Lee University, Lexington

Junior (Two-Year) Institutions

Averett College, Danville
Bluefield College, Bluefield
Ferrum Junior College, Ferrum
Marymount College, Arlington
Shenandoah College, Winchester
Southern Seminary Junior College, Buena Vista
Sullins College, Bristol
Virginia Intermont College, Bristol

Private philanthropy must be stimulated and promoted as the underlying foundation of the independence and integrity of our privately supported institutions—churches, colleges, hospitals, etc.—and many charitable causes and agencies. The primary support of these institutions, causes and agencies has traditionally come from private sources stimulated by tax laws which were designed to encourage philanthropic actions and develop a sense of civic responsibility.

The Tax Reform Act of 1969 (H.R. 13270) is the first significant step backward with respect to the provisions for charitable contributions during the past 56 years of income tax history. Shall the Congress, which has historically sustained and enlarged the incentives for charitable giving, now reverse its field and, in so doing, increase the financial problems of already hard-pressed institutions and organizations which depend upon voluntary support? There are literally thousands of institutions and agencies operating in the private sector that vigorously oppose such a development.

Congress has recognized that legislation is needed to remedy tax abuses to simplify the tax code. Some of the major changes proposed by this bill fail on both counts.

The main avenues now open for tax avoidance can be closed off without affecting incentives for legitimate voluntary gift support. Could not the Congress focus its attention on abuses and not use a meat-ax when a small pruning knife would be more effective for cutting out the trouble spots?

Higher education and organized charities should not be victims of the reformers' zeal simply because they do not have the "influence" to defend themselves.

It is clear that there will be, as there should be, some kind of tax reform legislation. Tax reform is urgent; no one can condone the abuses which have existed; it is to the credit of Congressional leaders that corrective measures have been proposed. Abuses, however, are not connected with the legitimate charitable deduction provisions of the present law.

It is noteworthy that we have *not* taken exception to this bill in its entirety nor even to all of the provisions related to tax exemption and charitable deductions. Colleges are willing to sacrifice some of the traditional methods of giving if necessary to preserve others which are essential to institutions dependent upon private gift support. Indeed, the authors of this bill deserve applause for provisions to tax organizations on income received from debt-financed investments and to extend the unrelated business income tax to cover all organizations

now exempt, and it is hoped the Senate will enact such provisions. And, needless to say, we support the provision to increase the ceiling on deductibility as being consistent with the need to stimulate private support of education and social and human betterment.

1. This bill dilutes the strength of the private sector of our national life and of state and local governments through provisions that:

(a) discourage charitable gifts of appreciated property and, in some cases, completely eliminate the tax incentives for making gifts of appreciated property;

[One of the most harmful elements of the entire bill is that many critics of the charitable contributions aspects of the bill are looking only at *Title II, Subtitle A, Section 201.* By far, the aspect of the bill most damaging to colleges and other gift-supported institutions is to be found in the provisions of *Title III, Subtitle A, Sections 301* and *302*—the limit on tax preferences (*LTP*) and the *allocation of deductions.* The provisions in these sections reduce the advantage of making gifts of appreciated property by at least 50 percent. Furthermore, they would have a generally damaging effect on gift support because they disallow large portions of charitable deductions for certain donors. The *LTP* section provides that taxpayers must pay a "minimum tax" on all economic income, including so-called "tax-exempt" income. No more than 50 percent of total income can escape taxes. *And the appreciation on donated property is classed as tax-exempt income.* In *Section 302* the bill disallows portions of non-business personal deductions (including charitable deductions) where the taxpayer has what the drafters of this bill consider to be disproportionate tax-exempt income. The Congress should remove the appreciation on donated property from the classification of tax-exempt income and remove charitable contributions from "allocable deductions" with respect to *Sections 301* and *302.*]

(b) jeopardize time-honored methods of charitable giving, such as charitable remainder trusts, life income agreements, and gift annuity agreements;

(c) drastically alter the tax treatment of state and local bonds;

[In a growing number of states, colleges and universities use this source of credit to great advantage. Again, most of the damage to the sale of local bonds is obscurely tucked away in the *tax preferences* and *allocation of deductions sections* of the bill (*Title III*), *Subtitle A, Sections 301* and *302*).]

(d) place a tax of 7½ percent on the investment income of private foundations.

[The primary effect of this tax will be to cut back funds available to colleges, churches, hospitals, and other operations in the private sector. Such a tax has no real validity, especially in view of other restrictions on the operation of foundations as provided in the bill (self-dealing, distribution of income, ownership limitations, etc.). In view of the innovative and creative contributions foundations have made and will continue to make to the national life, it makes little sense to tax their resources and then have government replace the lost dollars with tax funds.]

2. Putative gains in tax revenues created by the restrictions on contributions deductions ($5 million in 1970, according to the official report of the committee) are negligible when compared to the financial chaos that will result for churches, schools, colleges, hospitals, and innumerable public charities that depend on gift support to continue their services.

[One Virginia college reports that 70% of its gift receipts in a current campaign has come in the form of appreciated property. At another Virginia college, the two largest gifts (both record gifts in their respective categories) last year were made with appreciated property. And at a third Virginia institution, what has been called the largest single gift in the history of private education was made with appreciated property. The proposed regulations on donating appreciated property will not substantially increase tax revenues.]

3. The bill penalizes the whole of private philanthropy for the abuses and excesses of the unconscionable few.

4. A basic consideration in drafting the bill was the measures thought to be used by wealthy citizens to avoid taxation. Contributions deductions in the present law are not used to *avoid* taxes. Within carefully defined limits, donors may *reduce* their taxes by virtue of the deductions for charitable contributions. Certainly the tax rewards alone cannot move anyone to give to his favorite college.

There must be a donative disposition on the part of the donor. Deductions only lower the cost of charitable gifts. We fully support provisions in H.R. 13270 that would eliminate any possible profit motive for making donations—e.g., the "Clay-Brown" provision (*Title I, Subtitle B, Section 121*) and the provision relating to property gifts where any portion of the gain on the property (had it been sold) would have resulted in either ordinary income or short-term capital gain (*Title II, Subtitle A, Section 201*).

5. The allocation-of-deductions requirement in the bill would be a major factor in diminishing voluntary support of education.

6. A source of grave concern to all educational institutions and publicly supported charities is the possible impact of retroactive features of the bill, *particularly those provisions which would alter the tax treatment of already existing trusts and gift agreements.*

7. *Title II* (Individual Deductions), *Subtitle A* (Charitable Contributions) was written with a view toward removing from the contributions section of the code those "loopholes" that supposedly enable the wealthy to avoid payment of taxes through donations to charity.

Wealthy individuals do not *avoid* taxes through charitable gifts. Conforming to public policy established by the architects of the contributions deduction feature of the present code, such donors simply *reduce* their tax liability.

Present tax incentives which appeal to the wealthier donor should be considered with extreme care before changes are enacted. Any competent survey of giving patterns reveals that a few major donors always give far more than all remaining donors. Therefore, diminishing incentives for wealthy donors will cripple the fund-raising efforts of many a community, church, school, hospital, or college because the pacesetting gifts will be drastically cut back.

* * * * * * *

While the restrictions on charitable giving would have a devastating effect on many institutions and organizations, the real threat in this bill is to the nation and to the pluralistic vigor of American society. A real effect of these changes and even broader changes that will likely follow would be to pull more power away from the private sector and place it in the public sector.

SUMMARY

1. The importance of stimulating private philanthropy, which alone assures the private sector of its independence, is emphasized.

2. H.R. 13270, if enacted in its present form, would be Congress' first major retreat from the time-honored principle that the voluntary benefactors of society and socially useful institutions should be recognized and rewarded in the tax laws. The bill would strike a crippling blow financially to innumerable educational, health, religious, civic, and community organizations that are dependent on voluntary gift support.

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12. The real danger posed by some sections of this bill would be the pluralistic vigor of American society and thus to the national interest.
13. Attention is called to the attached document describing private support of independent higher education in Virginia.

Senator GORE. Mr. Chairman, I would like to introduce this witness from the State of Tennessee; a very distinguished member of the faculty of Vanderbilt University and a very able lawyer.

Senator ANDERSON. We are glad to have you.

STATEMENT OF HERMAN L. TRAUTMAN, PROFESSOR OF LAW, VANDERBILT UNIVERSITY

Mr. TRAUTMAN. Mr. Chairman, and gentlemen of the Senate, I would like to make three points and only three points in the presentation that I make here. One of these is that H.R. 13270 with respect to its provisions concerning charitable remainder trusts should not be made retroactive to April 22, 1969, on the ground that in neither the President's tax message of April 21, 1969, nor the releases of the Ways and Means Committee was there an adequate indication to the public that charitable remainder trusts would be a subject of proposed tax reform, and I may say that in behalf of Vanderbilt University, I closed a gift of a farm in middle Tennessee to Vanderbilt University in trust to pay the income to the retired donors for their lives, remainder to Vanderbilt, in July. It was the life income-remainder trust and not either an annuity trust or a unitrust and, therefore, if this bill did become the law all of the careful research upon which this transaction was closed would be for naught.

Quite aside from the constitutional issue involved, I am sure that other speakers have made the point effectively and that the fairness of this Senate can be depended upon to do justice in that regard.

I should like then to deal with my other two points which are, the second point, that the deduction for gifts of charitable remainder trusts should not be limited to the two forms specified in H.R. 13270; namely, the dollar annuity trust and the unitrust.

I may say that there is no need to postulate the traditional life income-remainder concept of our anglo-American heritage against these two. There is room for all three of these if they are properly protected so that the values of our society are realized, namely, that a tax deduction shall not be allowed for an amount that the charity does not receive. This tax policy value stated in the House report and in the Treasury studies of the Johnson administration, can be readily agreed to. It does not follow, however, that to accomplish those tax policy values all deferred giving must be allocated to those two forms.

Third, since most charitable remainder gifts involve gifts of appreciated property, too, I want to say something about that.

Now, I do not need to remind the Senate of the United States that financing private universities is increasingly difficult in our society. Certainly with inflation, world involvement, and dramatic developments in both the social revolution and the scientific revolution require behavior on the part of colleges and universities which cannot be financed by the tuition that the students pay. These institutions are simply dependent upon the gifts of donors, and one of the very most attractive entres to a potential donor is the inter vivos gift to a university in trust, to pay the income to the donors for life, with the remainder to the university. And when this is properly protected there really isn't anything wrong with it.

Now, I want to call attention to two sources of ideas and arguments in respect to this proposal, with respect to charitable remainder trusts. One is the discussion in the Treasury studies of the Johnson administration dated February 5, 1969 under the heading of split income trusts, and the second is the House report that was issued by the House of Representatives, this is House Report No. 91-413, part 1, at pages 58 to 61.

Now, both of these documents postulate misconduct which constitutes a breach of trust under the law of trusts of every State in our country. I should like to turn to page 58 of the House report under the paragraph entitled "General Reasons for Change," where it is said:

> The rules of present law for determining the amount of a charitable contribution deduction in the case of gifts of remainder interests in trust do not necessarily have any relation to the value of the benefit which the charity receives. This is because the trust assets may be invested in a manner so as to maximize the income interest with the result that there is little relation between the interest assumptions used in calculating present values, and the amount received by the charity. For example, the trust corpus can be invested in high income, high risk assets. This enhances the value of the income interest but decreases the value of the charity's remainder interest.

Now, can you just postulate for a moment this typical hypothetical as I have experienced it and as I believe represents the great majority of instances in America? And you can picture your own college here. I will pick mine.

> To Vanderbilt in trust, pay the income to mama and to me for life, and at the death of the survivor remainder to Vanderbilt.

Now, let's just stop there and let me quickly agree that if anybody puts contingent gifts into charities let's disallow them, and if anybody puts invasion of corpus provisions for mama and me, let's disallow it in that instance.

Now, if we eliminate those two things we have got a situation where there is no possibility that this farm or this General Motors stock or whatever it is we are talking about will not pass to the university.

Now, we have three different kinds of taxes, an income tax, and a gift tax, the deductions for which are based upon values at the date of gift. We have a third tax called the estate tax which is based upon value at date of death. No human being alive today can predict what the value of a General Motors share or a farm will be worth at the death of mamma and me but we can have an appraisal made for the

gift tax purpose or we can look in the Wall Street Journal for the average of the high and low on the date of the gift for both the income tax and the gift tax.

Now then, can you just imagine Vanderbilt or Harvard or Louisiana State or whatever your college is as trustee investing in high-risk investments in which this corpus would be dissipated, and the charity would not receive anything?

Really, gentlemen, there is scant evidence of abuse, if any.

Now, suppose that the typical arrangement is not the case. Suppose, for example, that the donor serves as trustee. Now, I have to say this to you, that the law of trusts in our society is one of the most beautiful, most coherent bodies of law in our Anglo-American tradition. The beneficiary of a trust or the remainderman can go into chancery at any time and say "I don't think I am getting a fair deal" and it is just unimaginable to me for a charity to allow its gift to be dissipated by a trustee; but if that is a problem, we can write a tax law that says to the Secretary of the Treasury, in a case where he is convinced that this is true, he can do two things: He can recapture from the donor or his estate the charitable deduction received for his gift, and we can penalize the charity for not protecting its gift in the courts. It doesn't seem to me that we need to indulge in what Mr. Justice White called in another case, the "overkill," because of an isolated case, if there is such an isolated case.

I call your attention to the fact that the Treasury study on page 185 concludes this discussion with this sentence:

> The changes recommended involve generally available abuse situations.

I think that is calling it a dirty name. I think that is saying that abuse seems to us to be possible here, but note the next sentence:

> And it is impossible accurately to calculate the extent of their use. It is unlikely that the correction of these abuses will have a significant revenue effect.

So, gentlemen, as I have summarized in the statement to you, our people understand the life income-remainder arrangement. I think it will be good to tighten it up, to eliminate the situations, if there are any, for contingent gifts to charity, and I think that invasion of corpus provisions should be disallowed to correlate the income and the gift tax with the estate tax. I do not see any need to eliminate this traditional concept, and I must say to you that each, the dollar annuity and the unitrust has its own "can of worms." The unitrust requires an annual appraisal of the trust property, and it also postulates an independent trustee. Think about that a minute, an annual appraisal of a farm is expensive and this independent trustee, who is this fellow? Can he be a friend of the donor and can his appraisals be unreal. And then the dollar annuity. Why pin a beneficiary to the dollar with all of the pressures on the dollar as a source of international balance of trade at the present time. I really think that the proposals will offer more gimmickry and greater administrative problems than the traditional life income-remainder trust which is well understood, and has the background of the State law of trusts behind it, and I think that if any charity is conniving with someone who is dealing fraudulently, that it ought to be penalized.

Now, I would like to make my third point quickly on the gift of appreciated property.

Senator GORE. Excuse me, you included depreciated as well as appreciated property?

Mr. TRAUTMAN. Yes, I will do this, and am happy to.

Senator GORE. It is the same principle.

Mr. TRAUTMAN. Right.

Let me say first that this is not the first time in our tax history that the problem of the so-called double blessing rule of gifts of appreciated property has come before this Senate. In 1938, the House of Representatives passed a bill——

Senator GORE. May I interrupt?

The CHAIRMAN. Yes.

Senator GORE. There is still the other matter of gifts of articles which are neither appreciated nor depreciated. Let me give you a hypothetical example. Suppose that I were in the 70-percent bracket, which I regretfully say I am not, but suppose that I am well into the 70-percent bracket. I have on my farm a tobacco crop that has been harvested, it is in the barn. When I put it in the warehouse ready to sell I give the receipts to Vanderbilt University. I have the choice on this tobacco crop of selling it or giving it away, I neither smoke nor chew so I can't use it that way, and I can't eat it very well, so really, I have a one hundred percent normal income crop.

Now, if I give it to Vanderbilt, and it is worth $10,000, the Nashville Tennessean might put my picture on page 1. If they would guarantee that I would consider doing it. But instead of this having the nobility of charity under the present law, assuming I am in this fortunate financial bracket, I would receive a tax benefit of $15,400 from giving my tobacco crop to Vanderbilt. Now, would you include that also?

Mr. TRAUTMAN. Senator, perhaps I should say I am glad you asked that because I was distressed that my predecessors did not field that curve ball as well as I thought they——

Senator GORE. That is not a curve ball.

Mr. TRAUTMAN. I don't mean to say that it is. It is a question.

Senator GORE. I object to the curve ball.

Mr. TRAUTMAN. I withdraw it.

Senator GORE. The U.S. Treasury has taken such cases to court and has lost them.

The CHAIRMAN. May I just say your illustration is bad. You don't field a curve ball, you hit a grounder or topped ball or a fly, you hit a curve ball or you miss it but——

Mr. TRAUTMAN. I think it has got some—I think it has got some twists.

[Laughter.]

Senator GORE. There is also a fast hard one.

Mr. TRAUTMAN. Senator, no offense intended, but I think that ball has got some curves on it for the reason I am about to say.

Senator GORE. I use to be a curve ball pitcher, and I got $5 a game.

Mr. TRAUTMAN. Because this is crucial and you have asked the question I would like to respond to it. First let me define the nature of a charity. The very definition of a charity is an institution that serves a public purpose. Now, unless you start there you are going to get in trouble. The very nature of a charitable trust, by the definition of the

law of trusts in our Anglo-American society is an institution that serves a purpose that the public would otherwise perform.

Senator GORE. I don't argue that.

Mr. TRAUTMAN. No.

Senator GORE. I not only consider Vanderbilt a great institution, my wife and daughter are both graduates, I consider it the best.

Mr. TRAUTMAN. Yes, sir; and I understand that and I agree with them, and I appreciate it.

Senator GORE. And I may give you my tobacco crop.

Mr. TRAUTMAN. But now, if I might, if I may lay that basis for what I am about to say, I would take a balance sheet approach to your hypothetical: This is assuming that you have got an item that is worth $10,000.

Senator GORE. Well, that is approximately what it is worth.

Mr. TRAUTMAN. Now, a gift to charity has been made analogous to the payment of taxes. In other words, a gift to charity is an alternative in our Anglo-American values to paying taxes, because the charity performs a purpose that the Government would otherwise perform, a gift to charity is in a sense a payment of taxes to an organization which performs a service that the Government performs and, therefore, the Government doesn't have to do that.

Now, then, using a balance sheet approach, what is wrong with that hypothetical is that the man has made a gift now of $10,000; debit him and decrease his net worth by $10,000. So his net worth is now X minus $10,000. But because he made that gift of $10,000, he gets to set it off against $10,000 of other ordinary income, and to postulate your very high tax bracket of 77 percent, it saves him $7,700 in taxes he would otherwise have to pay. Therefore, instead of getting $15,400, the answer is that his gift of $10,000 has cost him out of pocket only $2,300.

Now, that hypothetical, which the Treasury Studies and the House Report all set up, begs the question in my opinion, Senator, because it assumes the very thing we are talking about; the question is whether the guy who paid his gift to the charity ought also to pay the Government, and thus pay twice. Instead of a double tax benefit, as you suggested, the Tax Reform Act of 1969 proposes a double tax burden on the donor. It misses the whole background of the law of trusts and charitable trusts that a gift to charity is an alternative to the payment of taxes, and that is the root of all these problems.

Senator GORE. Well, Doctor, there is no question of a trust involved here. I am neither trustor or trustee, I am a farmer, and I have been very fortunate, that is according to this assumption, and I am in the 77 percent bracket, and I have a product which is harvested on my farm, which rapidly deteriorates. I have the choice of selling it, of giving it to charity or of letting it rot.

Mr. TRAUTMAN. Yes, sir. But a gift to charity is a payment for a public purpose.

Senator GORE. So under the present tax law I can give it to a charity and be acclaimed as a great philanthropist, but receive $5,400 more benefit than if I sold it or ate it.

Mr. TRAUTMAN. I believe—I hope that my explanation has shown that that is not true.

Senator GORE. It is true. The two cases in court have been lost by the Government.

Mr. TRAUTMAN. Well, I have to say that from a balance sheet approach I cannot understand it that way because it assumes that a tax should have been paid; the only reason, the only way you can get $5,400 more out of that is to assume, the very thing that you are talking about, that he ought to have paid tax on it and then given it to charity, too. It misses the point that paying to charity is an alternative to paying taxes, and that he really is $2,300 out of pocket.

Senator CURTIS. May I ask a question?

Mr. TRAUTMAN. Yes, sir.

Senator CURTIS. In this giving agricultural products already harvested, and taking a deduction for their fair value for charitable deduction but not included in income as Senator Gore contends, my contention is that that is not the law that is being carried on in most of the jurisdictions. The Supreme Court has never ruled on it, they will deny this, but the general rule of the Treasury and Internal Revenue is that they, if a circuit court rules a certain thing they will follow that in that circuit but not elsewhere in the country, but assuming that Mr. Gore is right, when did that start?

Mr. TRAUTMAN. Well, Senator, I believe Mr. Gore is right; that is the present law, whether it is ordinary income property or capital gain property, simply deals upon the principle of tax law that a gift is not a realization of income and we have never drawn——

Senator CURTIS. I understand that.

Mr. TRAUTMAN. We have never drawn the distinction between ordinary income and capital gain and I would like to say that—as far as the charitable institutions that I am interested in, it would be possible to draw a distinction between ordinary income assets and capital gain assets because the great majority of our donations are capital gain concepts.

But the answer, in response to your question, is that whether it is a gift of ordinary income or capital gain, the deduction is allowed for the fair market value of it.

Senator CURTIS. I understand that.

Mr. TRAUTMAN. And there is no—there has been no inclusion in gross income of the difference between its cost and its fair market value. And that has been just as true with respect to ordinary income assets as capital gains assets, but the important thing is that in the great majority of instances of human experience here it is capital assets that are given.

Senator CURTIS. Well, I understand that, and there is a vastly different reason for the capital assets situation, because there is no gain until it is sold.

Mr. TRAUTMAN. Yes, sir.

Senator CURTIS. And it might be sold at a loss. But if this is what they say the law is, I still question whether it is in all jurisdictions, and I also question it whether or not it is within the intent of Congress, because Mr. Gore can give his harvested tobacco away and take a charitable deduction and not include it in gross income. A lawyer can divest himself of a fee earned and have it passed directly to the charity, and do the same thing, and that can't be done. It is an elemental principle of tax law that you can't transfer income.

Mr. TRAUTMAN. The Wilkinson case agrees with you with respect to a lawyer. There is an actual case on that by Mr. Wilkinson who handled an Indian reservation case in about 1962 or 1963.

Senator BENNETT. Who was a witness here yesterday.

Mr. TRAUTMAN. No, I was not.

Senator BENNETT. Yes, sir, he was.

Mr. TRAUTMAN. Are you talking to me? I did not know that Mr. Wilkinson was a witness here yesterday.

Senator CURTIS. But you don't know how long this thing existed with reference to the illustration in regard to tobacco, how long has that been the rule?

Mr. TRAUTMAN. I am not in a position to answer that.

Senator CURTIS. It arose in the last few years, didn't it?

Senator GORE. Mr. Chairman, I ask unanimous consent to have the citation of the cases inserted in the record at this point.

Senator WILLIAMS. I would ask that the staff put a memo in at the same time because some of the staff members in the colloquy here indicated that they think this example may not be exactly correct as related to existing law. As I understand the problem in this assumption of giving this $10,000 tobacco would be that it cost $10,000 to produce it, and, therefore, the cost of production would be written off as a deductible item. If you give it away at the $10,000 and you get the $10,000 deduction and that would give you, if you are in the 77 percent bracket a total of 7,700 each way or the $15,400. But the staff seems to feel that in the cases like that you would have to reduce your deductions accordingly which would mean your production costs would have to be eliminated. I am not well versed in this in the court cases, and I would merely state that we ask the staff put this memo in the record.

Mr. TRAUTMAN. I believe that is accurate.

Senator WILLIAMS. And whichever way it may be and we could proceed to discuss it further.

Senator ANDERSON. Without objection that will be done.

(The information follows:)

(The following was later supplied for the record by the staff:)

Authority for dissallowance of a deduction for costs and expenses incurred by a farmer in producing or acquiring a crop that is contributed to charity and

claimed as a charitable contribution deduction is found in Treasury Regulation § 1.170-1(c), which reads in pertinent part as follows:

"Costs and expenses incurred in the year of contribution in producing or acquiring the contributed property are not deductible and are not a part of the cost of goods sold. Similarly, to the extent that costs and expenses incurred in a prior taxable year in producing or acquiring the contributed property are reflected in the cost of goods sold in the year of contribution, costs of goods sold must be reduced by such costs and expenses."

The substance of this rule formerly appeared in Rev. Rul. 55-138, 1955-1 C. B. 223.

The rule in the quoted Regulation applies to a farmer regardless of whether he uses the cash or the accrual method of accounting. However, if a farmer is on the cash basis and does not use an inventory method of accounting, the provisions of the quoted Regulation do not require the disallowance of any deduction he may have claimed for costs and expenses that were incurred by him in producing or raising the crop prior to the year in which he contributes it to charity. (Such expenses in prior years were disallowed as a deduction by Revenue Ruling 55-138 cited above (see p. 226 of 1955-1 C. B.)). The present position of the Internal Revenue Service regarding deductibility of such prior years' expenses is expressed in the *Farmer's Tax Guide* (1969 edition, IRS publication 225), where it is stated (at p. 44) as follows:

"Expenses applicable to donated property which were properly deducted in prior years do not have to be subtracted from your contribution deduction. If you use an inventory method of accounting, however, and the cost of the donated property was in your beginning inventory, such costs must be removed from beginning inventory."

MEMORANDUM

OCTOBER 14, 1969.

To: The Senate Finance Committee.
From: Professor Herman L. Trautman, Vanderbilt University.
Subject: Gifts of agricultural and manufactured products to charity—present income tax law.

During the course of my testimony before the Senate Finance Committee on September 18, 1969, both Senator Gore and Senator Williams asked the Chairman for unanimous consent to have the citations of cases put into the record of my testimony concerning the above subject, which was implicit in the hypothetical case put to me by Senator Gore. While it is probable that the Committee Staff has prepared such a memorandum, the following are the relevant authorities on the subject.

A charitable contribution of agricultural, manufactured, or other products held for sale presents a special problem: in addition to claiming a charitable deduction for the fair market value of the property, it was feared that the taxpayer may seek either to deduct the cost of raising or manufacturing the property as a business expense, or to treat the inventory value thereof as part of the cost of goods sold. In I.T. 3910, 1948-1 C.B. 15 the Internal Revenue Service sought to meet this problem by ruling that the fair market value of such property at the time of the contributions was taxable as income, and that it was deductible as a charitable contribution only to the extent of the percentage limitations of § 170 (b). (See Bittker, Federal Income, Estate and Gift Taxation 177 (3rd ed. 1964)). Under this ruling a contribution would have produced the same tax result as a sale of the property followed by a donation of the sale proceeds to charity. (See Griswold, Charitable Gifts of Income and the Internal Revenue Code, 65 Harv. L. Rev. 84 (1951); Bittker, Charitable Gifts of Income and the Internal Revenue Code: Another View, id. 1375 (1952); Griswold, In Brief Reply, id. 1389; Roehner and Roehner, Realization: Administrative Convenience or Constitutional Requirement?, 8 Tax L. Rev. 173 (1953)). I.T. 3932, 1948-2 Cum. Bull. 7 also adopted this technique of dealing with what was thought to be a possibility of both a charitable deduction and a business deduction.

The courts in several cases simply rejected the proposal in these two revenue rulings that a gift of property is a "*realization*" of gain or loss. (See Campbell v. Prothro, 209 F2d 331 (5th Cir. 1954); White v. Broderick, 104 F. Supp. 213 (W. Kan. 1952); Estate of Farrier v. Comr., 15 T.C. 277 (1950); So Relle v. Comr., 22 T.C. 459 (1954).)

After losing these cases the Treasury revoked I.T. 3910 and ruled that the taxpayer must make appropriate adjustments, either to inventory or to business expense to prevent the feared double deduction. (See Rev. Rul. 55-138, 1955-1 C.B. 223). I.T. 3962 was later revoked in Rev. Rul 55-531, 1955-2 C.B. 520. The substance of these rulings is now embodied in Treasury Regulations § 1.170-1 (c)(1) which provides that costs and expenses incurred in the year of the charitable contributions in producing or manufacturing the product are not deductible and are not a part of the cost of goods sold.

This is the status of the law at the present concerning gifts to charity of agricultural or manufactured products. The fair market value of the gift property is a deductible charitable contribution, but the expense of producing the gift property is not deductible. The gift is not considered to be a realization of gross income. A distinction is made between a gift of property, including ordinary income property, on the one hand, and the assignment of earned income such as a lawyer's fees. See Wilkinson v. United States, 304 F2d 469 (Ct. Cl. 1962).

Respectfully submitted,

Herman L. Trautman,
Professor of Law.

Senator Gore. I think the cost of production is an item but if you increase the amount until you arrive at the same net above cost you still arrive at the same sums in the case of tobacco, the instance I was giving, the prevailing practice in this particular agriculture is a farmer-tenant divisionship where the cost of production is borne by the tenant, and so if you increase the amount of the sale you arrive at the same amount.

What I am trying to do, Doctor, with this exchange with you is to illustrate that the Government and the Congress must recognize that some provisions of law have been interpreted and been stretched into meanings which, according to Senator Curtis, would be contrary to the intent of Congress, but which have resulted in a rather widespread practice of profiteering under the banner of charity, and I think all witnesses thus far have indicated that at least the profit should be removed, but I haven't been able to get anyone yet to indicate to what extent the donor should benefit, whether he, as you say, has a clear choice between giving to charity or paying taxes and, whether this should be up to 100 percent of his tax liability or just where do we stop this free choice?

Mr. Trautman. The limit is 30 percent of his adjusted gross income. I would like to suggest a philosophy or a policy value that might be helpful. One, I think we can have no difficulty in correcting the areas of—to whatever extent there are evidences of abuse. I think we can correct this. I think the staff is correct that production costs in that hypothetical are disallowed.

I think the basic question that we have talked about is the thing that I have tried to present here, that a gift to charity is a form of paying tax, as an alternative to that.

The Chairman. If I may just suggest this, the debate going on here is one with which I am not competent to contend. The two gentlemen from Tennessee have so much more competence in this field than does the Senator from Louisiana that they are absolutely beyond my ability to keep up with them, or even engage in them.

Senator Gore. Are you suggesting we retire to the hall? [Laughter.]

The Chairman. I have arranged to get, for one of our secretaries to

continue this debate between the able Senator from Tennessee and the able representative of the University of Vanderbilt in our conference room here. I would like to get down to that debate, but I also want Clarence Schaps to testify after a while because he comes from Louisiana, so what I am going to ask is that the Senator from Tennessee and the witness from the University of Vanderbilt permit one of our secretaries to take down the questions and answers and we will put all of this in the record. I will come back and ask a few questions myself. But meanwhile I want to get Tulane University here. Is that all right with the Senator?

Senator GORE. I will call it a draw.

The CHAIRMAN. I would like very much for it to be continued because I think the witness is extremely articulate and well informed and so is the Senator from Tennessee.

Mr. TRAUTMAN. As I leave to confer further with my esteemed friend, the Senator from Tennessee, I would like the Senators from Louisiana and Delaware and other States to understand that a gift in our law has never been a realization of income, and if we make it a gift to charity as a realization of income, look out. The next step will be a gift to your daughter is——

The CHAIRMAN. I want to ask the witness some questions but meanwhile I want to move on with the witness list.

Senator GORE. Let me say for the record that this is precisely one of the things we want to correct. Now this does prevail, so that what you said should never be permitted is not possible——

Senator BENNETT. Let's not start all over again here.

(Mr. Herman L. Trautman's prepared statement follows:)

STATEMENT OF DR. HERMAN L. TRAUTMAN, PROFESSOR OF LAW, VANDERBILT UNIVERSITY

I. Introductory

Section 201(e) of H.R. 13270—The Tax Reform Act of 1969, amends section 170 of the Internal Revenue Code of 1954 by providing a new subsection (h) which provides that no income tax deduction is to be allowed under section 170 for charitable contributions of a remainder interest in trust, unless the trust is cast in the form of either (1) a specific dollar *annuity trust*, or (2) a *unitrust*. These concepts are defined in a new code section 664(d) proposed in 201(i) of H.R. 13270.

Subsection (h) of section 201 of the Tax Reform Act of 1969 would amend code section 2055 to deny the *estate tax* charitable deduction for gifts of remainder interests to educational and other qualified charitable institutions unless the gift was cast in the form of either (1) a *dollar annuity trust*, or (2) a *unitrust*. It also would amend code section 2522 to deny the *gift tax* charitable deduction for any gift which did not qualify as an income tax deduction under code section 170 as amended.

Thus subsections (e), (h) and (i) of Section 201 of H.R. 13270 amend all three types of Federal taxes—the income tax, the estate tax, and the gift tax—so as to deny a charitable deduction under each tax for contributions of vested remainder interests in all types of property, including farms, business buildings, stocks and bonds, unless cast in the limited forms of either a dollar annuity or a unitrust. Importantly, the typical gift of a farm, a business building, stocks or bonds to a University in trust to pay the income to the donor and his wife for life, remainder to the University in fee simple would not qualify as a charitable contribution under either of the three Federal taxes if subsections (e), (h) and (i) of Section 201 of the proposed bill are enacted into law.

Section 201(j) provides that the above proposed amendments shall be retroactive to transfers in trust made after April 22, 1969 with respect to the income tax and the gift tax, and that the estate tax amendment shall be applied in the case of decedents who die after the date of enactment of the bill.

II. The effective dates stated for subsections 201 (c), (h) and (i) should not be approved

In early July, 1969 a retired couple in Middle Tennessee made a gift of their farm to Vanderbilt University in trust to pay the income to them for their lives, and the life of the survivor of them, the trust to terminate at the death of the survivor, with a gift of the legal remainder to Vanderbilt University in fee simple absolute. This gift was closed only after the most careful research in the current law concerning charitable remainder trusts, and special provisions were included to assure that the complete corpus of this trust principal would become available for the educational benefits of Vanderbilt University at the death of the survivor. Under no circumstances can there be any invasion of corpus for the benefit of the income beneficiaries, and there are no contingencies which might possibly cause this trust estate to pass to anyone other than Vanderbilt University. This was an irrevocable trust, so that it cannot be changed to adapt to the forms provided in H.R. 13270. It is the typical charitable remainder trust, reserving a life income interest to the donors, which is used so frequently by colleges, universities, hospitals and other charities across the United States for their development programs. Because it is neither a specific dollar annuity trust nor a unitrust it will not qualify for either an income tax deduction or a gift tax deduction if the retroactice date of April 22, 1969 is approved; nor will it qualify as an estate tax deduction upon the deaths of the donors in the years ahead, because it is an irrevocable trust, and as such, the terms of the gift cannot be changed.

In my weekly reading of tax loose-leaf reports and current tax literature there was no mention made to my knowledge prior to the introduction of H.R. 13270 that charitable remainder trusts would be a subject of proposed tax reform.

Since the introduction H.R. 13270 we have examined the announcements and proposals of the President and those of the Ways and Means Committee with respect to public notice concerning charitable remainder trusts. On April 22, 1969 the Treasury published a pamphlet entitled "*Tax Reform Proposals Contained in The Message from The President of April 21, 1969*". We are unable to find any reference in the Treasury's tax reform proposals of April 22, 1969 which would put one on notice as to charitable remainder trusts.

On May 27, July 11, and July 25, 1969 we now find that the Ways and Means Committee announced tentative decisions on tax reform subjects. The release of May 27 makes the following statement, which is certainly not a suggestion that charitable remainder trusts would be allowed only if cast in the form of a dollar annuity trust or a unitrust:

"(7) Split-Interests Trusts.—The Committee tentatively decided in the case of split-interest trusts (a trust under which the income is paid to provide persons and the remainder to charity, or vice versa) to adopt a provision under which the charitable contribution deduction would be recaptured in whole or in part where the investment policies of the trust—as between the income and the remainder beneficiaries—are not consistent with the assumptions on which the deduction was originally computed, and also to adopt a provision disallowing a charitable contribution deduction for a gift to charity in the form of an income interest in trust where the remainder is to go to a non-charitable beneficiary."

There was apparently no reference to the subject in either the July 11 or July 25 releases.

III. The deduction for charitable remainder trusts should not be restricted to only two forms of the gift—the dollar annuity or the unitrust

Financing the private university is increasingly difficult in these days of inflation, world involvement, and social and scientific developments. The work of the great private universities and colleges of America cannot be financed by the tuition paid by their students; such schools must rely upon the gifts of donors. A popular form for such gifts is the charitable remainder trust made during the lifetime of donors, reserving to them a life income interest.

Under present tax law a charitable contribution deduction is generally available for the remainder interest given to charity. This is true with respect to the income tax and the gift tax for values determnied at the date of the gift. Because of the retained life estates, such gifts are also included in the gross estates of the donors upon their deaths, but the values included are not those at the date of the inter vivos gift, but rather those at the deaths of the donor. A charitable deduction is also allowable under the estate tax, however, for the date of death value at which the trust property was included in the gross estates of the donors. The amount of the charitable deduction for income and gift tax purposes is based upon the application of actuarial tables published in the

Treasury Regulations to market or appraised value of the property at the date of the gift. For estate tax purposes the full value of the property at date of death is included in the gross estate and deducted as a charitable death gift.

The policy statement concerning the limitations proposed in H.R. 13270 for charitable remainder trusts appears on pages 58 and 59 of House Report No. 91–413 (Part I) as follows:

"General reasons for change.—The rules of present law for determining the amount of a charitable contribution deduction in the case of gifts of remainder interests in trust do not necessarily have any relation to the value of the benefit which the charity receives. This is because the trust assets may be invested in a manner so as to maximize the income interest with the result that there is little relation between the interest assumptions used in calculating present values and the amount received by the charity. For example, the trust corpus can be invested in high-income, high-risk assets. This enhances the value of the income interest but decreases the value of the charity's remainder interest.

Your Committee does not believe that a taxpayer should be allowed to obtain a charitable contribution deduction for a gift of a remainder interest in trust to a charity which is substantially in excess of the amount the charity may ultimately receive."

One may agree wholly that a charitable deduction should not be allowed "which is substantially in excess of the amount the charity may ultimately receive" and yet be shocked at the proposal to limit the charitable remainder gift to those which are cast in the form of a dollar annuity or a unitrust. I submit the following comments and suggestions for improving the present law and rejecting the proposals of H.R. 13270 with respect to the charitable remainder trust:

(a). There seems to be scant evidence of abuse in this area of tax law. The typical arrangement is a gift to the university as trustee to pay the income to the donors for life, with a legal remainder to the university. Thus the university is both the trustee of the trust for the lives of the donor and the owner of the legal remainder interest. Typically there are no contingent gifts to charity. Occasionally there are invasions of corpus provisions for the support of the donors. The present tax law can be adequately improved by expressly disallowing a deduction for contingent remainder gifts to charity, and also disallowing a charitable remainder trust which is subject to any power to invade the corpus of the trust for any purpose.

(b). The "general reasons for change" stated in House Report No. 91–413 (Part 1) at page 58 postulate a breach of trust by the trustee of a charitable remainder trust in the management of the funds, for which there is an adequate remedy in the state chancery courts.

1. It is basic trust law that a trustee must make only those investments which a prudent man would make consistent with both *the production of income* and *the preservation of capital.*

2. The House Report states that the present law for determining the amount of the charitable deduction in the case of gifts of remainder interests "do not necessarily have any relation to the value of the benefit which charity receives" because "the trust assets may be invested in a manner so as to maximize the income interest with the result that there is little relation between the interest assumptions used in calculating present values and the amount received by charity" See pg. 58. This is contrary to the prudent man rule, stated above, which is basic to the law of trusts. It is also highly unlikely in the typical case where the university serves as trustee and is also the owner of the remainder interest. There is little evidence, if any, that universities and other charities are allowing their remainder gifts to be squandered by investments in high income, high risk assets to the detriment of the interest which finally passes to charity. If the donor serves as trustee, or, if there is an independent trustee, the charity as owner of the remainder has a remedy in the chancery courts which it can be expected to manage responsibly.

3. The Treasury Department, *Tax Reform Studies And Proposals*, issued February 5, 1969, prepared by the Johnson Administration without recommendation before it left office, in effect admits that the postulate upon which Section 201 (e) (h) and (i) of H.R. 13270 and House Report 91–413 (Part 1) at 58 is based is not supported by actual evidence; that instead it represents what is imagined to be a "generally available abuse situation", i.e., that "the trust corpus can be invested in high-income, high-risk assets" which "enhances the value of the income interest but decreases the value of the charity's remainder interest" See House Report, p. 158. The Treasury Department, *Tax Reform Studies and Proposals* at p. 185 state the following:

"The changes recommended involve generally available abuse situations and

it is impossible accurately to calculate the extent of their use. It is unlikely that the correction of these abuses will have a significant revenue effect."

4. To the extent that there is any basis in fact for the indulgence of a breach of trust law as postulated by the House Report, the present tax law can be adequately amended to provide for the recapture of the Charitable deduction from the donor and for a penalty to the charity which condones a breach of trust by allowing the dissipation of its remainder gift.

(c). Neither the fixed dollar annuity trust nor the unitrust proposed in H.R. 13270 "necessarily have any relation to the value of the benefit which the charity receives". Both schemes assume a rate of discount for determining the value of the charitable remainder gift which is arbitrarily selected, and not likely to be consistent with economic reality. Indeed, the rate assumption made may be more than the income actually received, so that the charity would receive less than the deduction allowed.

(d). The American people understand the life income-remainder concept much better than they do the unitrust and the dollar annuity. Our courts understand the life income-remainder concept, too, and they have done a good job in protecting the respective interests.

(1) The proposals in H.R. 13270 discriminate against the gift of a farm, business building, or other non-liquid asset where the distinction between the income-interest and remainder interest is simple and will be understood.

(e). The unitrust has its own complexities which far out-weigh anything in the traditional life income-remainder trusts. Among these are the following:

1. Annual appraisals must necessarily be made to determine the distributions for the next year to the beneficiary. These are expensive.

2. How could you distribute 6% of a farm each year? The unitrust requires liquid assets such as stocks and bonds. In effect the H.R. 13270 would forbid charitable remainder gifts in anything other than liquid assets.

3. An independent trustee must be the sole party responsible for making the annual determination of value in the case of trusts having real estate or closely held stock. This is very expensive. How is this a help to our people?

(f). It may well be desirable to tighten up the present rules to deny a charitable deduction for contingent interests, and trusts subject to invasion of any kind. There could also be penalties against both the donor and the charity for condoning a breach of trust. It does not follow that the deduction for all charitable remainder trusts should be denied except those cast in the form of a fixed dollar annuity or the unitrust.

(g). The proposals in H.R. 13270, Section 201 (e), (h) and (i) represent a clear case of "overkill". The economic interest which the charity will receive from a gift of a vested remainder interest which is prudently managed under the law of trusts, when there is no possibility of invading corpus, is much more readily ascertainable than can possibly be true under either the fixed dollar annuity or the unitrust. This is true because of the international pressure on the dollar as a currency and our world involvements.

IV. The tax policy of the United States should continue to reject the idea that a gift to charity is a realization of gain

A gift of a charitable remainder interest is a present gift of a future interest to charity. Such gifts usually consist of property which has appreciated in value in the hands of the donor. Section 201 (c) of H.R. 13270 proposes to amend Code section 170 (e) to provide that in the case of gifts of a future interest in appreciated property the donor must elect to treat either his adjusted basis in the property or the fair market value of the property as the amount of his contribution. In the latter event he must treat the contribution as if it has been a sale, and recognize any gain which he would have realized if he had sold the property at the time of the contribution for its fair market value. This will drastically curtail the charitable remainder trust as a form of life-time giving, much to the financial detriment of the colleges and universities of America.

A taxpayer who contributes property which has appreciated in value to charity generally is allowed a charitable contribution deduction for the fair market value at the time of contributing and because a gift has traditionally not been regarded as a realization of income, the appreciation in value has not been included in the gross income of the donor. The combined effect of not taxing the appreciation in value and at the same time allowing a charitable contribution deduction for the fair market value of the property produces a tax benefit which is greater than that in the case of contributions of cash gifts. This is true because of our traditional principle that a gift is not a realization of income, a principle which is much broader in its significance than gifts to charity. If the Senate approves the House proposal in Section 201(e) that a gift of appreciated

property is a realization of income, the next tax bill to come before you will surely propose that a gift of appreciated property to your wife and your children will be both a taxable gift subject to the gift tax and a realization of income subject to the income tax. Likewise, upon this hypothesis, the death of an owner of appreciated property will result in both a death tax and an income tax. The American people will have the good sense to reject this idea emphatically, when they understand it, and it is unnecessary to correct the problem of the stepped-up basis provision of Code section 1014.

The tax benefit involved in the gift of appreciated property to charity is ordinarily the capital gains tax that would result if the property had been first sold for cash and the proceeds given to charity. The great majority of gifts to colleges and universities consist of property which would have resulted in a capital gains tax if it had been sold prior to the gift. It would be possible to make a distinction between gifts of capital gain property and gifts of ordinary income property if that is considered necessary.

While the gift of appreciated property is often referred to as a double-blessing rule, this is not a "tax loop-hole" that should be corrected by the 91st Congress. Instead, it represents a conscious tax policy decision of the Congress of the United States in 1938. In that year a subcommittee recommended a change to limit the charitable deduction to the cost of the donated property, and this was adopted by the House. (See H.R. Rep. No. 1860, 75th Cong., 3d Sess. 20 (1938). But the change was rejected by the Senate Finance Committee, and it was not enacted. (See S. Rep. No. 1567, 75th Cong., 3d Sess. 14 (1938); H.R. Rep. No. 2330 (Conference), 75th Cong., 3d Sess. 35 (1938). Trautman, *Taxation Of Gifts In Trust To Charities Reserving A Life Income Interest*, 14 *Vanderbilt Law Review* 597, 598–99, footnotes 11–13 (1961). Thus, the decision that a gift shall not be considered to be realization of income, and that a gift to charity shall not be considered to be a realization of income even though the donor receives the tax benefit of a deduction for the full market value represents a conscious tax policy decision by the Congress of the United States which defines the scope of the policy to encourage gifts to established colleges, universities, and other recognized charities. It is not an unintended or inadvertent tax loop-hole.

The Congress having consciously established the existing tax policy in 1938, it is understandable that gifts of appreciated property have become a major source of development funds to private educational institutions since that date. If it were completely eliminated, Federal funds would be needed to support these colleges, raising constitutional questions regarding the use of Federal funds because of the traditional separation of Church and State.

To distinguish between gifts of present interests in property and gifts of vested future interests is purely arbitrary and unreal, and it will severely restrict the development efforts of colleges and universities will respect to the solicitation of any gifts from donors. The gift of a charitable remainder trust is an attractive leader for the college development office because it assures the donor of his life-income interest.

The Congress ought not at this time attempt to deal with the delicate and far-reaching implications of changing a tax policy decision which it made consciously in 1938 concerning gifts of appreciated property to operating charitable institutions. The impact of a hurried and unwise decision upon some of the greatest charitable institutions in America is much too important to act upon in an effort to correct tax loop-holes and untimely tax benefits such as the investment credit, excessive depreciation allowances, rules concerning the unrelated business income and other activities of private foundation, etc. If there is a desire to change the tax policy decision of the Congress in 1938 concerning gifts of appreciated property, it ought to be considered and debated thoroughly, and the public should be given an adequate opportunity to consider it and participate in the tax policy decision.

The CHAIRMAN. The next witness is Mr. T. W. Van Arsdale, president of the Federation of Independent Illinois Colleges and Universities. Mr. Van Arsdale. We are pleased to have you, sir.

STATEMENT OF T. W. VAN ARSDALE, PRESIDENT, FEDERATION OF INDEPENDENT ILLINOIS COLLEGES AND UNIVERSITIES

Mr. VAN ARSDALE. Mr. Chairman, my statement will be very brief. I represent a federation of 70 independent colleges and universities. The federation endorses in every respect the American Council on Education position paper as my own will indicate.

Second, I would like to say, comment on Senator Ribicoff's statement to the effect that, or his question, are gifts dropping off demonstratably. Yes, indeed they are. We have sensed it in at least five institutions which are presently conducting fund drives.

Anything else I would say would merely be repetitious, and unless you have questions I will ask to be excused.

The CHAIRMAN. Thank you very much, sir.

Any questions.

Thank you very much, sir.

(A statement of Mr. T. W. Van Arsdale follows:)

STATEMENT OF DR. T. W. VAN ARSDALE, JR., PRESIDENT, FEDERATION OF INDEPENDENT COLLEGES AND UNIVERSITIES OF ILLINOIS

1. It is our contention that gifts to colleges and universities should be excluded from "tax preference income" and "allocations for deducations." In this Nation, about thirteen billion dollars are given annually to colleges and universities, churches and charities. Analysis of gifts to colleges and universities, whether independent or tax-supported, in our State, indicate that annual support from gifts of such nature range from 5 percent to 20 percent of the annual operating budgets of those institutions. Apprehension of passage of the Senate of H.R. 13270 has already reduced demonstrably such annual support. Without which, such institutions, already hard-pressed for funds, conceivably could face extinction or, perhaps even worse, diminishing quality of education. Candidly, if this bill is enacted, private giving would indeed be drastically curtailed, with the inevitable result of the Federal Government's necessary replacement of honest philanthropy with additional tax dollars. How else can the public-private diversity in higher education, which I truly believe all of us endorse, prevail?

2. We applaud and endorse the objective of H.R. 13270 to eliminate "tax loopholes" of certain foundations. Clearly, there are abuses exercised but certain foundations,—but these are few in number—both financially and philosophically, which should be eliminated because they are inherently conceived as "tax dodges," nonetheless, as H.R. 13270 is presently written, correction of or elimination of such "loopholes" are realistically unenforceable, will involve remarkably increased bureautic investigate expenditures. Further, the restrictions which the bill proposes to impose upon foundations will inevtiably result in curtailment of research, innovative programs and major capital gifts for facilities which are desperately needed by colleges and universities.

3. The implications for the future which result from passage of the bill are indeed frightening and inimical to contemplate. While the aims of H.R. 13270 are stated as "tax-reform", the implementation of them could well mean bureaucratic manipulation of the educational direction and destinies of our youth through denial of adequtae voluntary financial support to our institutions of higher education, whether public or independent. Put in another milieu, passage of this legislation could well mean that we have "big brother"; or, if the bill is thoughtfully and realistically rewritten, we can retain and sustain the freedom indigenous to higher education which have, historically, given these institutions the opportunities to seek and receive funds which provide for innovation, relevant social responsibilities and increasing quality in their educational programs.

The CHAIRMAN. Now we will call Mr. Clarence Scheps, executive vice president of Tulane University.

Mr. SCHEPS. Thank you, Senator Long.

STATEMENT OF CLARENCE SCHEPS, EXECUTIVE VICE PRESIDENT, TULANE UNIVERSITY

Mr. SCHEPS. Thank you, Senator Long.

The CHAIRMAN. We are pleased to have you testify.

Mr. SCHEPS. Gentlemen, I am the executive vice president of Tulane University, and am testifying on behalf of Tulane University.

I think it would be presumptuous for a single institution to testify on its own behalf were it not for the undisputed fact that what we

have to say, what our story is with respect to the fears and concerns that we have over this legislation would apply with equal weight to hundreds of private institutions throughout the United States, virtually all the private institutions of the United States, and I think also to an increasing number of State institutions.

I think that probably no time in history could there have been a more critical time for legislation to come up involving what is really the lifeblood of the private institutions, and that is the encouragement of private philantrophy to give to higher education.

As I am sure you are aware, many of the private institutions of the Nation, as well as a growing number of State institutions are finding it difficult to maintain their quality in the face of these mounting difficulties.

Tulane's case is particularly critical. For the past 5 years this institution has been forced to operate on a deficit basis, using up its unrestricted endowment funds to balance its operating budget each year.

Tulane has no parent body to turn to to help. It receives no State appropriations at all. Tuition to the individual student has already been increased almost to the point of diminishing returns, and we have only one real choice and that is to turn increasingly to our alumni, private individuals, and foundations for support.

In the last 5 years Tulane has received some $16 million of foundation support for its operations. If the House bill prevails and a tax of 7½ percent were applied to each one of those grants you can readily see what it would have meant to Tulane during this period of time. We would have suffered a loss of well over a million dollars.

If Tulane is to survive, and it is a real question, gentlemen, of survival, and is to contribute, continue to contribute to the State of Louisiana, to its region and to the Nation, not only must it maintain its present level of giving from private sources, but it must increase this level by at least the factor of two or probably three.

The CHAIRMAN. You mean a factor of two—would you explain what you mean by that?

Mr. SCHEPS. Double. In other words, we think our level of annual giving which is now about 10 percent of our operating budget is going to have to be doubled and probably tripled in the years immediately ahead if we are to continue to make progress or even to hold our own. And based on years and years and years of experience in actually contacting generous donors who might be interested in giving to higher education, we are absolutely convinced that without the full incentives, and without the encouragements of philantrophy that have been in the tax laws ever since Congress first enacted the income tax statutes, the level to private giving to Tulane could be reduced from its present levels, and this could be a threat to the very continued existence of the institution.

The CHAIRMAN. Let me just ask you one question. Tulane almost has a common boundary with Loyola University, doesn't it?

Mr. SCHEPS. Yes, sir.

The CHAIRMAN. As a practical matter is it not true the Stearn family is one of the best donors to Tulane University?

Mr. SCHEPS. The Stearn family has been very generous to Tulane.

The CHAIRMAN. Well, the Stearn family owns WDSU-TV down in New Orleans which is the biggest TV station there and right next door to you is Loyola University, and they own, that is, the religious

order that runs Loyola University owns WWL right next door and those are the two principal television stations there. Now, what they are making on their television stations is one of their principal means of support. So when you really get down to it here are two private institutions where if we up the taxes on private donations on the one end or we deny this religious order exemption on what they are making in income on the other, in both instances a heavy obligation is then imposed on the State to pick up the job that those two universities would then be unable to achieve.

Is that not correct?

Mr. SCHEPS. I think there is no question about it, Senator. Between these two institutions we are educating some 15,000 youngsters a year and somebody will have to pick up that burden if we are not able to carry it on.

The CHAIRMAN. So it will have to be either the Federal Government, the State government, the city government—the city has no money to do this either; does it?

Mr. SCHEPS. Not at all.

The CHAIRMAN. And the State is hard up for money?

Mr. SCHEPS. Correct.

The CHAIRMAN. So as a practical matter if you are to be denied what income you have you will be in bad shape and so will the fellow next door.

Mr. SCHEPS. Correct.

The CHAIRMAN. Thank you. Any further questions?

Well, thank you very much, Mr. Scheps.

Mr. SCHEPS. Thank you, very much.

(Dr. Clarence Scheps' prepared statement follows:)

STATEMENT BY DR. CLARENCE SCHEPS, EXECUTIVE VICE PRESIDENT, TULANE UNIVERSITY, SUBMITTED ON BEHALF OF TULANE UNIVERSITY BY DR. CLARENCE SCHEPS, EXECUTIVE VICE PRESIDENT

Our testimony is limited to those provisions of the House Bill which we believe will be directly and seriously harmful to the welfare of Tulane University.

The provisions which concern us are as follows:

I

(a) *The inclusion of the appreciated value of real property and securities contributed to charity within the definition of tax preferences. (Sec. 301(a), p. 165)*

(b) *The inclusion of the appreciated value of property contributed to charity in the itemized deductions to be allocated between taxable and nontaxable income. (Section 302, p. 173)*

The foregoing provisions would result in serious detriment to the giving program of Tulane University because:

(a) The donor would lose a large part of his incentive for making a gift.

(b) The larger the gift, the less in percentage terms can be taken as a deduction.

(c) The more tax preferences a donor has, the more costly his gift would be.

(d) The complicated provisions in the House Bill would lead to an uncertainty on the part of the donor as to what effect the gift would have on the donor's tax picture. Such complicated provisions run completely contrary to two avowed principles of tax reform—that is, simplification and clarification.

A substantial percentage of the donations made to Tulane University by individuals consists of property and securities which have substantially appreciated in value in the hands of the donors. Of the total of approximately $5,000,000 in gifts that individuals made to Tulane between 1966 and 1969, more than $1,000,000 was in the form of securities, the vast majority of which were given on the basis of appreciated value.

II

The elimination of a charitable deduction for the type of charitable remainder trust currently in use, and the deduction for the gift of an income interest

In the past two years, Tulane like many other institutions of higher learning has worked out several plans for this kind of giving, which plans have been carefully tailored to take advantage of present tax incentives. Such gifts are just beginning to result in significant increases in the endowment funds of the University. Without the tax benefits now being permitted, together with the doubts which the provisions of the House Bill cast upon the ultimate tax treatment of such plans, this phase of our program would be destroyed.

III

The 7½% on foundation investment income

Foundation support has played a vital and definite role in the development of Tulane University since pre World War I days and has been a significant factor in raising the character of the institution from a small, primarily local institution to one of some importance to the region, to the Nation, and in international affairs—particularly Latin America. In the past five years foundation gifts and grants have amounted to approximately $16,000,000. If all of these grants had been reduced by the amount of the proposed 7½% tax, the loss to Tulane would have been considerable.

The so-called tax reforms applicable to higher education could not have come at a more critical time in the life of American colleges and universities. Many of the private institutions of the Nation as well as a growing number of state universities are finding it difficult to maintain their quality in the face of mounting financial difficulties. In Tulane's case the problem is particularly critical, for in the past 15 years this institution has operated on a deficit basis using up its unrestricted endowment funds as we went along. Tulane has no parent body to turn to for help, nor does it have recourse to state appropriations for support. Tuition has already been increased to a point of diminishing returns. It has been increasingly necessary for Tulane to turn to its alumni, private individuals, corporations, and foundations for support. If Tulane is to survive, it must not only maintain its present level of giving but it must increase this level by at least the factor of two.

Without the full incentives which have been in the tax laws ever since Congress first enacted an income tax statute, the level of private giving to Tulane could be reduced and this could be a threat to the continued existence of the institution.

The CHAIRMAN. Now, the next witness will be Dr. C. Thomas Spitz, Jr., who is general secretary of the Office of Public Affair of the Lutheran Council in the United States of America.

Please have a seat, sir.

STATEMENT OF HOWARD HOLCOMB, ASSISTANT EXECUTIVE SECRETARY, DIVISION OF EDUCATIONAL SERVICES, LUTHERAN COUNCIL IN THE UNITED STATES OF AMERICA; ACCOMPANIED BY SIDNEY RAND, PRESIDENT, ST. OLAF; AND DAVID JOHNSON, VICE PRESIDENT, ST. OLAF, NORTHFIELD, MINN.

Mr. HOLCOMB. I am Howard Holcomb, assistant executive secretary, Division of Educational Services, Lutheran Council in the United States of America.

Dr. C. Thomas Spitz, general secretary, was in this room until a few minutes ago. I can sum up inside of 2 minutes and beat your egg-timer, I think——

The CHAIRMAN. Go right ahead.

Mr. HOLCOMB. With the statement the council would like, Dr. Spitz said before he left, to stress two points to the committee.

I think I can do each in one sentence.

No. 1, that the committee be encouraged to consider the whole area of voluntarism, and secondly, that the committee give favorable treatment toward charitable giving when considering deductions against taxable income.

Dr. Spitz indicated when he left that he would be willing to return to the committee to discuss at length the concept of voluntarism with you.

I have with me on my right——

Senator BENNETT. Pardon me, when you say later, do you mean today or some other day?

Mr. HOLCOMB. Some other day. He will be in the city next week and available at your mutual convenience.

I have at my right President Sidney Rand of St. Olaf College, Northfield, Minn., who is also chairman of the Associated Colleges of Midwest and chairman-elect of the Council of Protestant Colleges and Universities and on my left, Dave Johnson, vice president of St. Olaf College.

In the few years I have been in the city representing the Lutheran colleges, I have not been asked by the member institutions to try to arrange for testimony for them on the various matters affecting higher education, and it has been only upon the introduction of the tax reform bill that the colleges have wanted to make a statement, concerning the implications of the tax bill. So I would like at this time for just a minute or two to defer to Dr. Rand for any observations he may wish to make.

Before I do I would like to say that our testimony refers to an oral statement made yesterday by the Committee of Gift Annuities, and also to a written statement which is in yesterday's committee print from the Lutheran Educational Conference of North America. Dr. Rand is also President of that latter organization. So the Council had intended to speak mainly on the philosophical issues, that of voluntarism and careful consideration of charitable giving and I think the technical aspects will be covered in these other two reports, and if I could just defer a minute to Dr. Rand.

Senator WILLIAMS. The statement will be printed in the record in its entirety.

Dr. RAND. Gentlemen, the Lutheran Educational Conference of North America is a group of educational institutions having affiliation with Lutheran churches, and in its organization it is affiliated with the Lutheran Council, and that is why we are here today, identifying our testimony with that group.

We would like to underline the principle of voluntarism which is stressed in the Lutheran Council's statement. We believe beyond any financial problem or any financial matter that is involved in the testimony being received by this committee, or in the implications in the tax bill that are financial in nature and which are surely essential ones, there is this basic American principles of the involvement of people voluntarily in the support of institutions which are a part of the structure of our society, and whether these be colleges and schools, hospitals, or any other kind of institution we believe the principle is the same, and we would like to underline, therefore, that this principle is a vital matter to be considered when discussing tax reform, so that we don't only look at the financial side of what is accomplished by this kind of reform, and this is rather carefully spelled out

in the council's statement which we, as a Lutheran Educational Conference would like to endorse.

Thank you.

Senator WILLIAMS. Thank you.

Any questions?

Thank you very much.

(The statement of the Lutheran Council in the United States of America, follows:)

STATEMENT OF THE LUTHERAN COUNCIL IN THE UNITED STATES OF AMERICA

SUMMARY OF PRINCIPAL POINTS

The church bodies participating in the Lutheran Council in the U.S.A. are concerned about both the philosophical and practical aspects of the Tax Reform Act of 1969. Since other witnesses will be testifying extensively on the practical dimensions of the proposed legislation, our testimony will focus largely on the philosophical issues.

1. Voluntary associations are basic to democracy

Democracy depends upon the presence, the activity and the reality of free associations within society. There can be no democracy without a genuine and lively pluralism. It was not by chance that your legislative predecessors established the concept of tax exemption for contributions to charitable, educational and religious organizations. This concept grew out of the basic principals which underlie our entire government and the whole of our society.

2. A healthy democracy depends upon rich pluralism

A healthy democracy requires a wide variety of free associations that are not creations of the state nor completely dependent upon it. Such free associations, supported by the private donations and commitments of individual citizens, are a power within democratic society. Their presence is a principal safeguard against totalitarianism. In a society where such organizations are paid for by the state and come under its control, it is too easy for the state to control every aspect of life.

3. Private initiative should be encouraged by tax policy

The nature of man is such that he must always have a relationship to associations which center on his concerns and interests. The United States Government is confronted with the alternative of encouraging the private support of free associations or of itself supporting these associations directly, in which case they would not long remain free.

If we want a democratic society and a democratic state, every effort must be made to encourage the private initiative of citizens to maintain and strengthen the rich diversity and pluralism of free associations and organizations. This has been done and can in the future be done by giving citizens tax relief to support such organizations.

4. Free associations are necessary to a vital democracy

Unless free associations remain vitally alive and active within American society, it will lose the basis for its pluralism and, hence, the bedrock for its own democracy. These associations remain the training ground for the democratic process in our society. Within them people are trained in the election of representative government, in debate over issues, in the toleration of the minority by the majority, and in the acceptance of democratic process for decision making. We should not take any action to undercut or weaken such associations at the very time in which our society seeks desperately for means to enhance pluralism and to develop private centers of initiative.

5. Religious institutions provide a moral basis for society

The Founding Fathers of our nation valued the role of religious institutions. They wanted to make certain that citizens would have the freedom and the encouragement to support such institutions to their fullest capability.

It is still the prerogative and the responsibility of religious institutions to provide a moral base for decency and honesty within our society and the government must continue to encourage the support which interested citizens provide for such religious institutions.

6. Tax relief is not subsidy

It is in the best self interest of the democratic society to encourage private support of free associations. If it represents any kind of subsidy, it is a subsidy to help guarantee the democratic state and a democratic society. It is a safeguard against totalitarianism.

7. The nature and structure of our society is at stake

The philosophical question which we raise is not primarily one of dollars and cents but a question of basic principal involving the nature and structure of our society and of our government.

8. Practical considerations

We concur with the expressions on technical aspects of the proposed legislation made to your committee by the COMMITTEE ON GIFT ANNUITIES and in the written testimony submitted by the LUTHERAN EDUCATIONAL CONFERENCE OF NORTH AMERICA.

Specifically, we affirm that gift annuities and life income agreements are in the pattern and spirit of the American way of life. These voluntary giving plans have for many years provided important support for a great number of distinguished institutions and organizations. In the past fifty years they have come into new and broader acceptance among the constituencies of our church bodies and of their institutions.

In general, giving should be pleasurable and it will not be if legislation makes it either difficult or unduly complicated to give.

Finally, persons who give to churches, colleges, hospitals, and institutions which serve human need are not motivated by profit but chiefly by generosity. Therefore charitable gifts should not be treated and lumped together with other types of tax deductions.

In summation, the Lutheran Council in the U.S.A. on behalf of its participating church bodies and their supporting relationship to more than 550 colleges, seminaries, hospitals, welfare agencies and institutions, respectifully urges that the new tax law continue the long established and essential tax incentive to charitable giving.

STATEMENT

I. ABOUT THE LUTHERAN COUNCIL IN THE U.S.A.

1. Introduction

I am C. Thomas Spitz, Jr., general secretary of the Lutheran Council in the United States of America. I appear before you at the request of the Lutheran church bodies participating in the council. Those church bodies are identified in a subsequent paragraph of this testimony.

2. Appreciation

The Lutheran Council in the U.S.A. expresses appreciation on behalf of its related church bodies for the privilege and opportunity of making this presentation to the Senate Finance Committee.

The council is mindful of the problems and perplexities that must surely confront members of the Senate Finance Committee, both individually and collectively, as you seek to come to a wise decision on a difficult and complex matter. We thank and commend you for the deliberate consideration being given to all aspects of the problem with which you must deal, and for your willingness to hear the points of view of all interested parties. We trust and hope that the presentation which follows may be helpful to you in finally making right judgments about it.

3. Constituency of LCUSA

This testimony is submitted by the Lutheran Council in the U.S.A. on behalf of its participating bodies which include:

	Membership
The American Lutheran Church	2,576,027
Lutheran Church in America	3,288,037
The Lutheran Church-Missouri Synod	2,847,425
Synod of Evangelical Lutheran Churches	21,453

This council was organized in 1966 and has among its functions, as stated in its constitution:

To represent the interest of the council, and the interests of a participating body so requesting, in matters that require common action before

(2) the national government. . . .

The church bodies listed above desire to register their conviction that certain aspects of proposed legislation concerning tax reforms would have a serious negative effect upon giving to and through the churches.

We have sought opportunity to testify not out of concern for the support of religion in a narrow sense, but because substantial support for welfare agencies and institutions, hospitals, colleges and universities is provided through church channels. Church bodies related to the Lutheran Council in the U.S.A. have a supporting relationship to:

47 colleges and universities
14 theological seminaries
96 hospitals
514 welfare agencies and institutions

Our participating church bodies have two aspects of concern which might be described as *philosophical* and *practical*. Knowing that others presenting testimony will focus on the practical and technical aspects of the legislation, we hope you will find it helpful if we concentrate on the philosophical consideration.

II. PHILOSOPHICAL CONSIDERATIONS

1. Voluntary associations are basic to democracy

It was not by chance that your legislative predecessors established the concept of tax exemption for contributions to charitable, educational, and religious organizations. No political pressure forced this decision. It grew out of the basic principles which underlie our entire government and the whole of our society.

Democracy depends upon the presence, the activity, and the reality of countless free associations within society. There can be no democracy without a genuine and lively pluralism. A society which exists for the sake of the state has no such pluralism. In a non-democratic state and society the state organizes, pays for, and controls all forms of association. Everything exists for the sake of the state, including the individual human being. Social organizations for children, young people, and adults, all schools and education, all health programs and activity, all churches and religious organizations are paid by the state and are dimensions of the state.

2. A healthy democracy depends upon a rich pluralism

A healthy democracy depends upon the rich pluralism of a wide variety of free associations that are not creations of the state nor completely dependent upon it. Organizations such as Boy Scouts, Y.M.C.A., C.Y.O., garden clubs, camera clubs, private elementary and secondary schools, colleges and universities, churches and religious organizations, fraternal organizations—all of these are free associations supported by the private donations and commitments of individual citizens. Each of them represents a quite different free center of association and power within a democratic society. It is the presence of a wide diversity of such organizations which is one of our chief safeguards against totalitarianism and the destruction of democracy. In a society where all such organizations are paid for by the state and are under control of the state, it is very easy for the state to control every aspect of life.

Without the rich diversity and pluralism of free associations, it is dubious that democracy could long exist. The question is what kind of society and government a particular state wants at a given moment in history.

3. Private initiative should be encouraged by tax policy

The nature of man is such that he must always have a relationship to associations which center on his concerns and interests. Human beings are always organizing into interest groups. This is true in a totalitarian society as well as in a democratic society.

The United States Government is confronted with the alternative of encouraging the private support of free associations or of itself supporting these associations directly, in which case they would not long remain free. This is not simply a question of tax dollars; it is primarily a question of the nature and dynamics of American society and of American democracy itself.

If we want a democratic society and a democratic state, every effort must be made to encourage the private initiative of citizens to maintain and strengthen the rich diversity and pluralism of free associations and organizations. This has been done and can in the future be done by giving citizens tax relief to support such organizations.

4. Free associations are necessary to vital democracy

Unless free associations remain vitally alive and active within American society, it will lose the basis for its pluralism and, hence, the bedrock of its own democracy. It is within these free associations that children and young people are trained in the democratic process in the election of officials, debate over differing issues, the toleration of the minority by the majority, and the view that the democratic process is itself the basis of all decision-making. Free associations remain the training ground for a democratic society. Their importance lies both in the fact that they embody pluralism and in the fact that they remain the daily training ground for the democratic process in American society. The United States government should not take any action that would undercut or weaken these associations at that very moment in history when our society is searching desperately for means to enhance pluralism and private centers of initiative in our society.

5. Religious institutions provide a moral basis for society

The organizations contribute much to American society currently and historically. The founding fathers of our nation valued the role of religious institutions very highly. While they opposed state support for religious organizations, they wanted at the same time to make certain that churches would have the freedom and the encouragement to support such institutions to their fullest capability.

Religious institutions have traditionally provided a moral basis for decency and honesty within a society. This still remains the case. The state must not take on the primary responsibility of inculcating these virtues. It could not do so without introducing a different set of mores or conceptions of honesty and decency in order to serve the self-interest of the state alone.

6. Tax relief is not subsidy

Tax relief for private donations to private associations is not subsidy of those organizations. It is a practical and effective way of encouraging and sustaining the pluralism that is brought to society by free, strong private associations. It is in the best self-interest of a democratic state to encourage private support of free associations. If it represents any kind of subsidy, it is a subsidy to help guarantee the democratic state and a democratic society. It is a safeguard against totalitarianism.

7. The nature and structure of our society is at stake

We are fully in favor of constructive tax reform by the United States government. It is long overdue. However, we think this ought to be done only after a thorough study and analysis of the implications which a reduction of charitable contributions would mean to American Society today.

Above all, we respectfully suggest that you include in your consideration of tax reform legislation the implications of the destruction or the control of our free associations by the government. This question is not primarily one of dollars and cents, but a question of basic principle involving the nature and structure of our society and our government.

III. PRACTICAL CONSIDERATIONS

1. Concurrence with others on technical considerations

Regarding specific proposals of the House-passed bill, the Lutheran Council in the U.S.A. would have your committee note that it concurs with the expressions on legislative matters made to the Committee yesterday by the Committee on Gift Annuities in which several institutions and agencies of our church bodies participate.

It concurs also in the written testimony submitted by the Lutheran Educational Conference of North America.

2. Some observations about life income giving

As it considers revisions of presently existing tax-reducing incentives for charitable and philanthropic giving, the Senate Finance Committee will want to be mindful of these facts about the persons who make deferred or life income gifts.

(a) Annuity and life income contracts have been written for a half century or more by some of the church bodies and institutions which we represent. They are in established use and are favorably regarded by them and by donors as a proper method of securing and making gifts.

(*b*) When a person enters into a life income agreement with a religious, charitable, or educational institution, he is actually doing two things: namely, he is making a gift to the institution and is also providing income for life. If he could afford to do so, he would probably turn over the entire amount of principal to the organization as an outright gift; in many cases, however, he needs to make some provision for income during his lifetime.

(*c*) Studies over the years have substantiated that the typical first-time contributor under one of these plans is a person in the late 60's or early 70's, more likely a woman than a man, comfortably circumstanced but by no means wealthy, quietly dedicated and committed to the cause or purpose being supported.

(*d*) Instances of multiple gifts over a span of years from the same donor are numerous. They give persuasive evidence that life income giving arrangements do two important things for the parties involved: (a) they meet a practical need for persons in their retirement years, through the prospect of assured income for life; and (b) they afford generously inclined individuals the satisfaction of relating themselves through their gifts to a high purpose in life.

(*e*) Some organizations accept income gifts in the minimum amount of $100. Others have $500 as their minimum amount. Gifts of this character to religious organizations typically range in amounts of from $1000 to $10,000.

(*f*) The cumulative support derived over a period of years for a great number of noteworthy religious and charitable interests in our country through life income gifts has been impressive. It has seemed to an increasing number of church organizations that "deferred giving" may be the means of overcoming the inadequacies of current giving toward the ever mounting human needs these organizations are seeking to meet.

(*g*) Mindful that the typical life income donor, especially under life gift, is apt to be advanced in years, and more often than not unsophisticated in financial matters, it is desirable that tax implications of these arrangements be easy to explain and simple to understand.

IV. CONCLUSION

In summary, the Lutheran Council in the U.S.A., on behalf of its participating church bodies and the more than 550 colleges, seminaries, hospitals and welfare institutions which they support, respectfully urges that the new tax law continue the long established and essential tax incentives to charitable giving which undergird our nation's educational, religious, hospital, health, social welfare and other charitable organizations.

The CHAIRMAN. Our next witness will be Mr. Louis J. Fox, president of the Council of Jewish Federations and Welfare Funds.

STATEMENT OF LOUIS J. FOX, PRESIDENT, COUNCIL OF JEWISH FEDERATIONS AND WELFARE FUNDS; ACCOMPANIED BY PHILIP BERNSTEIN, EXECUTIVE VICE PRESIDENT; AND MR. GOLDBERG, HEAD OF RESEARCH AND BUDGET DEPARTMENT

Mr. FOX. As the Chairman has said, I am Louis J. Fox.

This is my executive vice president, Philip Bernstein, and the head of our research and budget department, Mr. Goldberg, on my right.

The council is a national association of Jewish united fund raising organizations in over 200 major cities of the United States and we are responsible for the financing of the health and welfare and educational needs of hundreds of thousands of people.

I am testifying also for a number of our major beneficiary national organizations such as the American Jewish Committee, the American Jewish Congress, the Antidefamation League of the B'nai B'rith, Hadassah, National Council of Jewish Women, United Israel Appeal, Joint Distribution Committee, and the Natonal Jewish Welfare Board.

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The CHAIRMAN. That is all shown in the record, the record shows that.

Mr. FOX. Yes.

My role here today is as a volunteer. In my business life I am president of Fox Chevrolet Sales in Baltimore, but I am testifying here today and speaking from 37 years of experience as a volunteer solicitor of many thousands of contributors in Baltimore and across the entire United States.

I know the motivations which encourage people to give of their substance, to help those people who are less fortunate, and conversely, and possibly more important, are those roadblocks and excuses which discourage these givings.

In the past our Congress has set up wonderful incentives to encourage people to give. They have developed the finest instincts of our U.S. citizens, to where we have in the United States the most generous voluntary giving to private philantrophy of any country in the world's history. But the proposed House bill which we are discussing today, would set back these programs immeasurably.

Now, one of our main concerns is the proposed taxing of gifts of appreciated property. Here we had as much as 50 percent of our total receipts in the form of appreciated property, and the theory that has been advanced in the support of the House bill is that the U.S. Government would get substantial amounts of tax receipts from taxing the capital gains on these appreciated gifts and, gentlemen, this is just not so. It will not happen. It sounds good on paper, but in effect, out in the field when we solicit the people will just keep these certificates in their safe deposit box, they will keep the ownership of the stocks, they will give little or substantially less to charities, and the effect on our total fund raising will be devastating.

What will actually happen is that we will have to curtail a number of our essential programs or look to the Government for help. So what then would actually happen would be that the Government rather than have income from taxes would be, I think, in a position of probably paying out to support these additional programs.

Now, in this connection, we have the bargain sales of securities, and other properties, which we say should be continued practically in its present form.

A man who can only afford to give part of this property and is not in a position to give his entire property, should be allowed to make this gift without being penalized by eliminating this technique.

Now, the part that we do think is wrong, and it has been referred to in a number of cases today, is where the wealthy few can make a profit out of a gift to charity. The law was not made, and the gifts were not solicited to provide a profit to anybody, especially those people who are tremendously wealthy to start with. But this is such a simple thing, it is such an easy thing to cure, that it is a wonder to me that it hasn't been done a long time ago.

The simple enacting of a statute which would provide for a minimum cost out of pocket to a contributor to charity so that he would have less than he started with. In the cases that we have talked about, if a man gives $10,000 to charity, and he saves 77 percent, he is still out of pocket $2,800, I mean no matter how you look at it he has got

$2,300 less than he started with, unless he had the intention to sell that property anyhow which most people do not.

I must admit, I came here very disturbed by the laws that have been proposed, I was very impressed as I sat here and listened to the questions of the now diminishing group of the witnesses who preceded me, I was impressed with the obvious sincerity of the Senators who are doing the interrogation to find out what can be done to be beneficial to the charity organizations or the universities or what not and, at the same time, see to it that the Government got a fair shake.

I am disurbed, though, having sat through so much of this, that there has been so much attention on these few people who have in the past made a profit and who should not in the future and I say can be so easily changed, and I am hopeful that with the balance of the time that is devoted to this there will be real attention given to what will the effect be on the development of the philantrophic spirit in the United States to provide the money for the work that is being done which does so much good in all phases, for example, in the appreciated securities. The second major concern which I would like to spend just a minute on, and that is the inclusion of charity in the allocations of deductions category which was mentioned earlier in the morning.

Now, we, our organization, applaud the principle that no one should evade paying his proper share of taxes, and this handling of these tax preferences and the way it has been proposed is great. I think where a man is making investments, where he is going to make a profit on them, he should not get out of paying his income taxes by reason of all these deductions he accumulates. But, at the same time, to lump charity in with these business investments means that the man is going to kick the charities out the back door because his business preferences will use up probably his full 50 percent under the proposed set-up and he will get very little relief on his charities. What we are asking is that the charities be taken out of the list of preferences, out of the allocation of deductions category, but, as with the margin sale technique, that here, too, when a man has all these preferences, and he has this charity deduction he still must be out of pocket something for giving to charity. We urge very strongly this point.

Our third major concern is the impact of the proposed changes of the standard deduction on the gift to charity.

Here, too, lumping charity with taxes and interest and everything else does not encourage giving and it will seriously damage our campaigns and the campaigns of all philanthropic organizations in the United States.

For example Mr. A. who uses a standard deduction but doesn't give to charity, Mr. B has the same standard deduction and the same figures but he gives $200 to charity and under the standard deduction procedure he gets no relief.

Now, we applaud the standard deduction because this simplifies the tax return for everybody, the Government and the individual, but we feel that the charity should not be one of these items that is in the standard deduction. It should be taken out of this category and a man who gives to charity should be encouraged to give, he should get some tax relief, just as the wealthy do, and his charity deductions should be over and above the standard deduction.

Now, the last item that I have is, has been referred to, but not, I don't think as seriously as it should have been, and that is that any changes, whatever changes are made in the tax law, should be prospective, and not retroactive.

We are already feeling the effect of this in our present situation.

People who made gifts to us during the summer and are now being told that even though they made it in good faith they are going to lose them as a deduction, feel that they are not being treated fairly and we are already feeling this effect that they will not give us additional pledges or additional payments until these things are clarified.

Now, all have been talking dollars, I have been mentioning dollars, and I heard mostly dollars today, but underlying all of this is our concern for people, people who depend on our voluntary agencies. We are talking about individuals, we are talking about the aged, we are talking about the sick, and we are talking about the handicapped.

The proposed House bill would be nothing short of disastrous for our ability to help these people, and I urge you to implement the changes that I have proposed, to the end that private philanthropy shall continue its never-ending efforts for a better life for all.

Thank you.

The CHAIRMAN. Mr. Fox, if you had been listening to the hearings as they went along, and you say you have been listening to them here today, you are aware of the fact there are some people who have been using these foundations for their own selfish advantage and not for the benefit of the people you are trying to help.

Mr. Fox. There is no question, sir. I would be glad to discuss foundations with you but I left that out of the testimony because that had been covered.

The CHAIRMAN. They had been amply covered and there is no sense in going into it again.

Mr. Fox. May I say to you, Senator, to interpolate to you, that in my opinion there are many cases where the advantages that you are saying in foundations work to the detriment of the charities.

The CHAIRMAN. Yes.

Mr. Fox. So we are in the same field now.

The CHAIRMAN. We now look ahead here. Senator Talmadge started out this morning by saying in light of the testimony that has been received on this subject there is little change that new thoughts will be developed today. We have your printed statement right here, and we have all your addendum to that and that will all appear in the record in addition to your verbal statement so that those who support your position will agree, and I find much merit to what you have said here.

Now, one point that hasn't been brought out today that I think is worthwhile, and that is that initially the church and the state were all the same thing, and this old Biblical concept of the tithes were supposed to be what the tax, in fact, that you were paying to support both the church and the state and it was supposed to be all the same.

Mr. Fox. That is right.

The CHAIRMAN. The fellow who was the head of the church was also the head of the state. It is only when we got into disagreement on who the head of the church actually was that we decided we had to separate church and state to stop all these religious wars, I sup-

pose, and to give everybody a right to go his own way and worship in a different church and separate them.

But the witness who said this is quite correct in saying that this contribution to the church initially was the contribution to the state. It was all the same thing, and all the functions that the church and the state saw fit to sponsor and to promote were one and the same, and we ought to keep that in mind as we proceed with this.

Now, what the House became concerned about we have been concerned about many years, the use of foundations to do things that we never intended for them to do or else keep the money, keep the deductions and the savings and keep the money.

Mr. Fox. That is right.

The Chairman. You are not for that?

Mr. Fox. That is right.

The Chairman. Insofar as we can correct that.

Mr. Fox. I am only sorry this was broken down so we could not get into that because I have very strong feelings.

The Chairman. It is a very interesting subject.

Mr. Fox. May I just say this because you brought up this church-state approach, and I say that I am afraid that what this House bill proposes gets us back toward that concept, and I have spent most of my life in this philanthropic atmosphere and seen more and more people develop this desire to help people through voluntary agencies and I am hoping that this will be encouraged, this separation of voluntary work for charities, rather than go back to the Government for support.

The Chairman. If I might just say one thing, I am not sure I have any influence around here but if I do, if we have the time it is my judgment we ought to sit down and completely rewrite this whole bill. You are talking about the LTP, if I have any influence around here we will start all over again and write our own bill. My guess is we would be better advised than the House was because we have had opportunities to hear witnesses like you and many other fine organizations explain this and explain how it affects them, and that is something the House didn't have the opportunity to do.

After they wrote that thing and brought it under a closed rule people had to vote up or down. My guess is if they had a chance to vote on an amendment that affected all your problems, all the fund-raising organizations and the universities I think they would have given you some relief. You will get your chance in the Senate.

Senator Williams.

Senator Williams. No questions.

Senator Miller. Yes, I particularly appreciated your comment about making the charitable contributions deduction separate from the general category of the standard deduction. As you know, now we have a 10 percent up to $1,000 standard deduction. The House bill provides for 15 percent up to $2,000 by stages. I take it that what you are suggesting might be something like cutting the House bill back to, say, 12 percent.

Mr. Fox. That is right.

Senator Miller. Which may be a $1,400 maximum, plus the charitable contributions deductions.

Mr. Fox. That is right.

Senator MILLER. Or suppose we just leave it as it is, 10 percent with a thousand dollars maximum plus the charitable contributions.

Mr. FOX. Senator, I am not trying to make myself a tax expect, I have had a little experience, of course, as a businessman, but what you are saying really is what I am saying, whether you make it 10 percent or 12 percent or 15, that charities should be out of it because what is being done when we raise the standard deduction it is adjusting the income-tax base for those lower income people, and I think this is good. I think it is giving them a break. But what I am really saying is that whatever in Congress' wisdom it decides that standard deduction should be, whether it is 10 percent or 12 percent or 14 percent, that the charities should not be one of those items. It should be a separate deduction.

Senator MILLER. You think that is a defect in the present law?

Mr. FOX. Yes, sir.

Senator MILLER. So that, on the one hand, two individuals——

Mr. FOX. I think it is compounding the difficulty.

Senator MILLER. Two individuals using the same 10 percent up to a thousand dollars standard deduction——

Mr. FOX. Yes.

Senator MILLER. One makes no contributions at all, the other makes some contributions. The one who makes some contributions should have a little better tax benefit than the first one?

Mr. FOX. They should have it, No. 1, and No. 2, I am a salesman, and I am going out selling a person on giving more to charity. Unless I can honestly look him straight in the eye and say, "Look, you gave us $200 last year, we need more money this year; give us $250 and you are also going to get a little tax relief," I have lost one of my best arguments.

Senator MILLER. Yes, and your point, I suppose, is that charitable giving should be encouraged according to means, in the case of the lower-income groups just as in the case of the large-income people.

Mr. FOX. The small giver can be tomorrow's big giver; I can give you many examples.

Senator MILLER. I suppose just like a person running for political office would rather have a thousand $1 contributions rather than one $1,000 contribution.

Thank you. I have enjoyed your testimony.

Mr. FOX. Thank you.

(Mr. Louis J. Fox's, prepared statement follows:)

STATEMENT BY LOUIS J. FOX, PRESIDENT, COUNCIL OF JEWISH FEDERATIONS AND WELFARE FUNDS

My name is Louis J. Fox of Baltimore. I am President of the Council of Jewish Federations and Welfare Funds. The Council is the national association of Jewish united community funds in over 200 cities in which 95 percent of the Jewish population of this country resides. The Federation in each city conducts a combined campaign for a network of welfare, health, and educational organizations and services. They include hospitals; clinics; nursing institutions, homes for the aged; family welfare agencies; treatment of emotionally disturbed children, vocational training, guidance, and placement; community centers; summer camps; and other services under Jewish auspices. The number of philanthropic agencies that depend on each community federation for support range up to 130 or more, and are national as well as local services.

Altogether, our associated Federation and Welfare Funds and other major Jewish agencies raise about $400 million annually from more than a million contributors.

Hundreds of thousands of persons depend upon these contributions to meet their vital needs—of sickness, old age, mental disturbance, dependency, and others.

Our primary concern is the needs of these people. It is to help them that the philanthropic gifts are obtained. If gifts are impaired it is these beneficiaries who suffer—and they are the people who can least afford to suffer. The only alternative is a shift of financing from voluntary contributions to government through tax support.

CHARITIES FAVOR EQUITY

Charitable agencies are not opposed to minimum taxes. They are not in favor of any tax arrangement involving contributions which would result in total tax avoidance. They are certainly in favor of tax equity. It should be clear that tax reform does not hinge upon the retention of the proposals in the House bill (HR 13270) which are harmful to charities.

The charities recognize the desired impact of some provisions of the bill, such as those adjusting the taxes for persons in poverty. But other elements of the bill could do great damage to these persons, in deterring voluntary contributions upon which many sick, disabled, and others critically depend.

DONATIONS OF APPRECIATED PROPERTY

Our concern is with those provisions of the House bill which would reverse the historic policy of our nation to encourage people to give their funds for welfare needs through tax incentives, and instead would deter gifts by tax impositions.

The House bill would impose taxes on appreciation in securities and property donated to charities if the securities or property had been held by the donor less than one year; and on property and securities held a year or longer if the taxpayer came within the "minimum tax" or "allocation of deductions" proposals. These gains are not taxed now when given to charities. They should not be taxed in the future.

The proposals to tax such gains in gifts can be eliminated from the lists of tax preferences in the "minimum tax" and "allocation of deductions" proposals without negating or weakening the desirable purposes of the two proposals.

Charities have nothing in common with the list of "tax preferences" with which they have been lumped in the House Bill—such as excess depreciation, hobby farm losses, tax free interest on municipal bonds, untaxed capital gains. Charitable gifts should therefore be deleted from that list. The other items can be dealt with on their own merits.

Gifts of appreciated securities and property are vital to charities. A major portion of the income of a number of voluntary, charitable, educational and similar organizations, is in the form of gifts of appreciated securities and property. Any deterrent to such gifts would have most serious effects. The gifts involved are often the largest gifts.

Gifts to charity represent out of pocket decreases in the net worth of the contributors—these gifts or donations are different from the other items called "tax preferences" which actually benefit the taxpayers involved and not charitable beneficiaries.

The beneficiaries of the gains in securities and property given as charitable donations, rather than the taxpayers, are the people who depend on these gifts. They are the aged and the sick, families in trouble or already broken, emotionally disturbed and retarded children, and others.

The Senate Finance Committee in the past has recognized the harm in the House proposals. In 1938 the Committee eliminated such tax proposals from a House bill because "the Committee believes charitable gifts are to be encouraged." That position is equally valid now.

Analysis of the gifts to our associated community Federations and Welfare Funds indicates that 3 per cent of our contributors provide 70 per cent of the income and that as much as one-half of this income is in the form of appreciated property.

The inclusion of charitable contributions, particularly in the form of appreciated property, in the proposals for minimum tax and for allocation of deductions cannot be defended on the basis of logic or equity.

Any quirks in the tax laws which, under some unusual and infrequent circumstances, can result in gain to the individual taxpayer, can be corrected by a simple provision of a percentage or dollar tax floor for each individual above an agreed level. All that is sought by way of minimum tax can be obtained with-

out including the donation of appreciated property with whatever list of "tax preferences" (those proposed or others that might be considered) are selected.

The objective of the companion proposal for "allocation of deductions" can be attained while eliminating appreciated securities from the list of "tax preference." The charitable deduction (in whatever form it is paid, cash or otherwise) should not be reduced as a result of this proposal—such reduction would sill result even if donated appreciated property were not in the tax list of "tax preferences." The present proposal in effect constitutes double jeopardy for charitable gifts where there should be no jeopardy at all.

We recognize that the proposals are designed to tax some forms of donated property at full rates and to tax other forms at partial rates under the minimum tax and allocation of deductions proposals. While the exceptions which have been proposed for partial tax involve mainly appreciated securities and realty given to publicly supported charities, this is still a major reversal of the current policies which emphasize the incentives that have helped attract generous gifts in very substantial amounts.

It would be harmful to charities to virtually bar "bargain sales" of stocks to charity; nor should there be a retroactive effective date. It would discourage the gift where the donor wishes to contribute the gain and recover his investment in his stock. If some form of minimum tax is enacted, there need be no concern regarding abuse of such arrangements.

The owner of donated realty should not be required to give the entire property, when he might be willing to give a partial interest in the property. He might choose not to give at all if the conditions in the bill are made too onerous.

An underlying and critically important fact is that no man is forced to give—that, whatever the tax incentive, the individual is still giving away something he is not compelled to give. Regarding appreciated securities, the potential giver can simply retain his security and pay no tax during the retention. Thus the government would receive no revenue, and all that is accomplished is to deprive charity of the potential gift.

Another injury to charity in the House bill is that even where donated property gifts are taxed at less than the full rate, the amount of such donations would be restricted. Thus, the ceiling on tax-deductible giving would be raised to 50 per cent, but gifts of property would be restricted to 30 per cent. This will hurt charities precisely with regard to their very largest gifts.

EFFECTIVE DATES

Charities are already beginning to feel the pinch of the House proposal regarding effective dates of the proposed changes. The series of *past* effective dates proposed for most changes involving charitable contributions, particularly those involving donation of appreciated property and "bargain sales", jeopardizes many gifts because no contributor can know with assurance how the tax rules will affect his giving. This is grossly unfair, whatever the final form of the bill. It has a paralyzing effect on giving. Not only should the changes in the bill in themselves not discourage charitable gifts, but the provisions of the bill as a whole should be prospective, not retroactive.

STATUS OF LOWER INCOME TAXPAYERS

We are concerned with the full income spectrum of giving and not with the largest givers alone. The income from small contributors is crucially needed in itself and today's small giver, given the motivation and the resources, can be tomorrow's medium or large size giver.

Charities will be affected also by the proposed extension of the standard deduction. This proposal will apply mainly to people in the $10,000 to $15,000 income bracket who reported gifts of $2.1 billion of the total of $9.1 billion donated by all itemizers in 1966. Instead of building greater tax inequity by permitting the same deduction for people who do not have expenses as for those who do, Congress can achieve the purpose of greater tax equity by changing the tax rates that apply to the income levels involved. It can also phase in any change in the standard deduction over a longer period than three years, as in some other proposed changes in the bill. And whatever else Congress may do about the standard deduction, it should permit charitable deductions outside the standard deduction to encourage charitable gifts. Other considerations in the standard deduction, such as tax payments, mortgage interest charges, and the like, are costs the taxpayer must pay. The charitable gifts are different. They are volun-

tary acts. The gifts should be encouraged by permitting deductions for them outside the standard deduction—and the standard deduction itself can be set at ceilings to take that into account.

GIFTS FROM FOUNDATIONS

Most agencies depend on individual benefactions for their support. For many, foundation gifts are an important source of income. While we are not testifying on the question of abuses affecting foundations, our agencies are concerned that the proposed tax of 7.5 per cent of income of foundations will be passed on to them in the form of reduced contributions.

Here again, the ultimate impact of the tax proposals would fall not on the individual taxpayer but on the persons in need of health, education and welfare services.

CHARITY IS NOT A "LOOP-HOLE"

The tax incentives for philanthropy with which we are concerned are not "loop-holes". They benefit people other than the taxpayers. They reflect the American commitment to voluntary contribution-supported welfare, health, and education programs—programs which the government otherwise would have to support.

This vital difference needs to be recognized in considering possible changes in the tax law. Charitable contributions are *distinctive* because they are discretionary expenditures. They are *constructive* acts of citizenship. They are *unselfish* and designed to help other human beings.

If a number of the provisions of the House bill were to be enacted by the Congress, the inevitable result would be pressures for government to fill the gaps for human needs which must be met. Government would have greater tax burdens, with no real revenue gain, and with a consequent loss also in citizen participation in welfare programs at a time when the Administration is advocating the increase of voluntary citizen effort and support.

This need not happen. Tax equity can and should be achieved without harm to charities.

In sum, we urge that the Senate should:

(1) Delete *all* references in the bill to tax gain on donated property, whether it be direct or indirect.

(2) In addition, charitable deductions in any form (cash or otherwise) should not be subject to allocation or reduction under the Allocation of Deductions proposal.

(3) Reconsider the standard deduction with a separate provision for the charitable deduction outside the standard deduction, so that charitable incentives are retained and simplification can also be attained.

(4) Delete the provision for a 7.5 per cent tax on foundations.

(5) Make effective dates of tax changes prospective, not retroactive, so that current giving decisions are not delayed nor gifts thereby endangered.

(6) Allow sufficient time for a careful review of all provisions affecting philanthropy to avoid irreparable harm to the persons dependent on charities.

This statement was also approved by:

American Committee for the Weixmann Institute of Science
American Friends of the Hebrew University
American Jewish Committee
American Jewish Congress
American ORT Federation
American Technion Society
Anti-Defamation League of B'nai B'rith
Hadassah
Hebrew Union College—Union of American Hebrew Congregations
American Jewish Joint Distribution Committee
National Committee for Labor Israel
National Council of Jewish Women
National Jewish Community Relations Advisory Council.
National Jewish Welfare Board
United Hias Service
United Israel Appeal
Women's American ORT

Yeshiva University including Albert Einstein College of Medicine and Hospital
Other agency names to be added.

Senator WILLIAMS. The next witness will be Mr. George H. Heyman, Jr.

STATEMENT OF GEORGE H. HEYMAN, JR., PRESIDENT, FEDERATION OF JEWISH PHILANTHROPIES OF NEW YORK

Mr. HEYMAN. Mr. Chairman, my name is George H. Heyman, Jr., and I am president of the Federation of Jewish Philanthropies of New York.

We are, we believe, the largest single voluntary philanthropic complex in the United States. We raise from public and private support about $20 to $23 million a year, and we distribute it within New York to 138 agencies consisting of hospitals, homes for the aged, child care institutions, community centers, et cetera.

We believe we contribute 23 percent of the philanthropic quotients which is contributed by private voluntary agencies in New York City, and we serve about a million and a half people a year.

We are particularly troubled by those provisions of the House bill 13270 which affect charitable contributions, and we are convinced if they are enacted into law our ability to serve these people will be seriously curtailed, and that the public, that is municipal and State agencies will be completely unable to fill that void.

Now, much of what I have to say has been submitted to you in a summary of points and a statement, and I shall not indulge upon the committee at this time to labor those points.

I should, however, like to make several observations which I don't believe have been made or adequately stressed by previous witnesses.

The first of these is that it is our opinion that to the extent that the House bill equates charitable contributions as well as taxpayer preference treatment of appreciation of long-term capital-gain property with other forms of tax preferences it develops a sense of moral values in this country which would lead the country to believe that it is the congressional intent to consider that charitable giving is no better than any other form of tax savings. And we think that it is not the intent of Congress. Congress did not propose to do such a disservice to the spirit of voluntarism by equating charitable giving on any other form of tax saving.

In that respect, I would like to say that we wholeheartedly endorse the provision to increase the standard deduction and give relief to the lower- and middle-class taxpayer. But we would certainly like to make it apparent that in our opinion, it is not likely that that group of taxpayers will make up the void which would be created by the disappearance of contributions from large-scale contributors. As a matter of fact, I am constrained to observe to this committee that by increasing the standard deduction we would in effect be rewarding the taxpayer for giving when, in effect, he would not have to give.

I would also like to make the point to the committee that it appears to us that the very strength which we receive from gifts of appreciated securities ought not to be discriminated against in the sense that there is a limitation of 30 percent on gifts of appreciated securities, with

the incremental 20 percent up to the maximum of 50 percent only being accorded to cash contributions.

I should also like the committee to consider the tremendous inequity which would be wrought by the enactment of this legislation retroactively. I think that point has been labored by other witnesses but I assure this committee that it is a matter of real concern to us.

Of additional concern to us is the definition of a disqualified person appearing on page 41 of the House report. This is not only troublesome but I am quite sure that it is probably an unintended arbiguity on the part of the draftsmen in the House.

Nevertheless, among our 138 agencies are agencies with relatively small budgets. If they were the legatee of a particularly large gift for capital purposes by one donor in one tax year under the definition on page 41 that donor would become a disqualified person, and that public charity would become a private foundation subject to all the infirmities and liabilities which that connotation implies.

I don't think that the House intended it, and I would entreat the Senate subcommittee to consider a correction so that that unintended effect was not to be accomplished.

I should like for a moment also to advert to a point which Senator Ribicoff raised in his questioning of a previous witness and that was the question of whether or not a one-shot deal would be of great value to an organization such as ours. I think there is considerable merit in that proposal and I would urge that the committee consider that in any one tax year in the lifetime of a taxpayer he be permitted to make a gift in excess of the 50 percent maximum without regard to the 50 percent maximum for capital purposes only. I think if such a gift is hedged with the requirement that it be upon application to the Secretary of the Treasury, that Congress will have built into the law sufficient safeguards to insure that there is no abuse.

I should lastly like to make the point that the proposed seven and a half percent tax on investment income of private foundations would yield $65 million to the Treasury, and cost the public-supported charities the same amount of money. I am sure that the Senate will feel, as we do, that the cost of foundation surveillance can be accomplished at a cost of less than the seven and a half percent.

Lastly, I would like to urge the committee to consider the point made by previous witnesses that the entire spirit of voluntarism may well be destroyed by many of the provisions of this bill. Admittedly there must be a correlative tax incentive, but I would like to point out to the committee that the large donors who form the backbone of philanthropic support not only for our agencies but for universities and hospitals, are people who are committed and involved, and that commitment and involvement spurred as it has been by tax incentives must be maintained if we wish these institutions to survive.

I thank the committee very much for this audience, and I am at their disposal for any questions.

Senator WILLIAMS. Thank you.

I have no questions.

(Mr. George H. Heyman, Jr. prepared statement follows:)

TESTIMONY OF GEORGE H. HEYMAN, JR.

Gentlemen: My name is George H. Heyman, Jr., and I am a senior partner in the stock-brokerage firm of Abraham & Co., located at 120 Broadway, New York City. I appear here today as President of the Federation of Jewish Philanthropies of New York, an organization which raises in excess of $20 million per year from private donors, which it distributes among more than 130 beneficiary agencies.

In its 53 years of corporate existence, the Federation of Jewish Philanthropies of New York has raised $1¼ billion from private donors for the capital and maintenance needs of its constituent societies. It is our belief that we are the nation's largest private voluntary philanthropic complex. Our agencies serve the community of Greater New York, providing a wide and comprehensive range of health and welfare services, including hospital care, nursing-home care, care of the aged, child care, family counseling, vocational rehabilitation, sheltered workshops, day camps and summer camps for children and adults, and community centers. About one and one half million people of all races and creeds are served annually by such well-known organizations as Mt. Sinai Hospital, Jewish Child Care Association, Lexington School for the Deaf, Federation Employment and Guidance Services, Blythedale Children's Hospital, the Jewish Family Services of Long Island and Westchester, the Asociated YM–YWHA, and many others.

The Federation of Jewish Philanthropies is but one of a number of similar federated charitable organizations in New York. There are the Federation of Protestant Welfare Agencies, the Catholic Charities of the Archdiocese of New York and the Catholic Charities of the Diocese of Brooklyn-Queens. The existence and availability of the services provided by these major networks of voluntary agencies are indispensable to the provision of adequate health, welfare and social services to the millions of people resident in New York City and its contiguous counties. The extent of the City's dependence upon these services is measured not merely by the professional skill of the thousands of workers engaged in these activities, or by the financial contribution of the agencies to the cost of the services, but by the tremendous capital investment in plant and equipment owned by the voluntary agencies and utilized for the benefit of the community.

Thus, in New York City, voluntary agencies provide 33,198 hospital beds (including both acute and chronic care) as against 15,804 beds provided by the municipal hospital system. Capitalizing this at current construction costs in our area, the replacement value of the hospital and nursing-home beds under philanthropic auspices comes to almost $2 billion, as against less than half that for the public institutional facilities.

On a national scale, 49.8%, or almost exactly half of all beds constructed under the Hill-Burton program since 1947, are in voluntary, non-profit facilities, and the Hill-Burton program, as we know, provides no more than one-third of all project costs. In New York State, the Hill-Burton contribution has been closer to 17%.

In the field of child care, there were 24,567 dependent and neglected children being cared for in foster homes and institutions in New York City as of June 30th. Of these, 21,109, or 86%, were under the care of the voluntary agencies. While the City provides funds for the maintenance of these public charges, the rate is fixed at 90% of cost, with a ceiling on top of that, so that for many of the agencies their share of maintenance costs is far in excess of 10%.

The partnership of government and voluntary philanthropy in providing health, welfare and other social services is well established in our American society. While the ratio of government funds has, in certain areas such as hospital care, grown larger over the years, the voluntary contribution has in absolute terms also grown progressively greater. The importance of private philanthropy is paticularly manifest in such voluntary agencies as community centers and our summer camps for both healthy and handicapped children, for which there is virtually no government funding. If the millions made available for these purposes by our contributors were withdrawn, these services would either be sharply curtailed or completely terminated and the pressures on government to fill the gap would be both instantaneous and overwhelming.

I come here this morning to express my opposition to some of the proposals contained in H.R. 13270, the Tax Reform Act of 1969, and to give you my reasons for this opposition. First, let me say that I am in full agreement with any measure which will improve the fairness of our tax laws, or which will correct any

demonstrated abuse. I am, however, deeply concerned with any proposed legislation which, suggesting that contributions by large donors to private philanthropy constitute a form of tax evasion, seeks to remake the basic tax incentives upon which rest the financial basis for the nation's private philanthropic effort. If tax incentives have been subjected to abuse, then the abuse should, of course, be controlled. But, in seeking to control the abuse, we must not make the fatal error of attacking the incentive itself. I believe that in some of its provisions, H.R. 13270 seriously threatens private philanthropy in this country.

1. GIFTS OF APPRECIATED PROPERTY TREATED AS TAX PREFERENCE

The first of these provisions is Section 301, which deals with the limit on tax preferences. Among the five items listed therein as preferences we find the following: "Any appreciation in the value of property donated to charity which is deducted as a charitable contribution, but is not included in gross income."

In my judgment, the inclusion of this item is not only unwarranted, but potentially destructive in its effect on charitable organizations such as the one I represent. Philosophically, I find it difficult to comprehend why a gift to a charity should be placed in the same category as income from tax-exempt bonds, or from capital gains, or equated with the excess of the amount of accelerated over straight-line depreciation, or so-called uneconomic farm losses. A gift to charity is not a business loss or a business gain. The reasons which prompted Congress in the first instance to allow deduction of appreciation as an incentive to charitable giving were wholly unrelated to any business consideration. To include it with deductions of a purely business or commercial character is to place the charitable contribution within a totally foreign context and to ignore the motivations and consequences which surround a gift to a school, a church or a charity.

If the Congress enacts this bill in its present form, it will in effect propound a distorted view of private philanthropic giving as a form of tax shelter with no greater social importance than the other taxpayer preferences with which it is grouped.

The thousands of successful and eminent men and women who serve on the boards of our voluntary agencies and give generously of their time, their energies, their skills *and* their money are clearly not motivated primarily by hope of gain. It is chiefly from these communally-minded citizens that we receive the greatest part of our financial contributions. It is true that in making a large contribuiton, the expectation of a correlative tax benefit is not ignored, but this does not warrant the treatment of these individuals as mere entrepreneurs whose sole involvement is pecuniary. If that were the fact, voluntary philanthropy would in truth be doomed.

It would be of inestimable damage to the very fibre of voluntarism in the United States if the Congress were eventually to enact a tax bill from which the citizenry could infer that Congress considered private philanthropy of less social value than the tax allowance for oil and gas depletion. Yet, in its present form, the Tax Reform Act of 1969 legitimizes the view that oil and gas depletion allowances are tax incentives of greater national interest than the private support of hospitals, churches and universities, and in so doing, raises questions relative to the validity of the broad range of social responsibilities which we have been urging our fellow citizens to assume in this nation.

2. ALLOCATION OF DEDUCTION FOR CHARITABLE CONTRIBUTIONS

For the same reasons, I take exception to Section 302, the provision relating to the Allocation of Deductions. The inclusion of all types of charitable contributions in this category creates a second penalty, in addition to the taxpayer preference, and as such both constitute disincentives to giving, affecting chiefly the large d[illegible]or, the wealthy individual who is subject both to the limit on tax preferences [illegible] the allocation of deductions. Large donors are the chief source of the funds ra[illegible] by the Federation of Jewish Philanthropies. Such individuals make gifts of $5[illegible]o $100,000 or of even $1 million or more to our building-fund campaigns.

In our last annual maintenance campaign for funds to distribute to our 130 agencies, about 74% of our money was contributed by a little over 5% of our contributors. In other words, out of more than 81,000 persons who have made contributions to our organization during this campaign year, 4,300 have accounted for $14,400,000 of the $19,250,000 so far received. This experience is typi-

cal and represents that of other federated fund raising organizations. Clearly, therefore, the large donors are the backbone of voluntary philanthropy, and without their support no major philanthropic effort such as ours can succeed.

I know this is not the intent of the bill, but if the inclusion of charitable contributions as both a taxpayer preference item as well as a deduction subject to allocation results in any substantial diminution in gifts the effects will be just as disastrous. Even a minor decline in the number or dollar value of gifts from this 5% would seriously impair our ability to function in the face of rising costs and increasing demand for our services.

It has been contended by some proponents of this bill that its sections relating to charitable contributions provide an impetus to increased philanthropic giving, principally by increasing the limitation on charitable deductions from 30% to 50% of the taxpayer's adjusted gross income. This view does not recognize the realities of modern economic life which generally finds that the incomes of large philanthropic donors contain capital gains or other elements of taxable income which the bill now proposes to include among taxpayer preference items. Thus, the bill, by not distinguishing between the social value of taxpayer preference items, may well provide such high-income taxpayers with every incentive to choose the preference item of the greatest economic gain to the individual and of the least social value to the nation.

Additionally, the bill actually provides a disincentive to increased charitable giving by medium-income taxpayers through Section 801 of the bill which increases the standard deduction. While we certainly favor this section of the bill as long overdue relief for this class of taxpayer, we are constrained to observe that its effect will be to discourage increased philanthropic support from this group for the simple reason that they will be getting the tax benefit of implied additional charitable contributions without having to make them.

3. THIRTY-PERCENT (30%) LIMIT ON DEDUCTION OF GIFT OF APPRECIATED PROPERTY

A third provision of the bill to which we take exception is the 30% limitation on deduction of contributions of appreciated property which, if sold, would give rise to a capital gain. For other types of charitable contributions, the limit is raised to 50%. Taken with the inclusion of this type of gift in tax preferences and the allocations of deduction, it would seem to indicate a desire to eliminate, or at least seriously curtail, the donation of appreciated property. This view is strengthened, of course, by the treatment, in other sections of the bill, of tangible personal property, short-term gains and bergain-sales. In this respect, the bill, however, completely ignores the existence of the philanthropic recipient and solely addresses itself to the question of whether the taxpayer is deriving too great a benefit from the transaction. The charitable organizations of this country are also vitally concerned and it might well be asked whether the benefit to them, and through them to the community as a whole, is sufficiently great to warrant the continuation of an established tax incentive or inducement to giving. My experience confirms my position that the damage inflicted by this combination of restraints and penalties will, in the long run, be more damaging to the country than the benefit which may be derived from denying certain tax advantages to a relatively small number of taxpayers.

4. RETROACTIVITY

Aside from the merits of the provisions relating to charitable contributions, I observe that in certain instances, as, for example, bargain-sales, the effective date of the proposed legislation is retroactive. While for most provisions of the bill, the changes do not go into effect until the end of 1969, they become effective with respect to bargain-sales on May 26, 1969, and for other changes dealing with charitable contributions, the date is even earlier.

The Committee will, I hope, conclude that this is inequitable. Gifts have been made in good faith which will now be taxed under entirely new provisions. Apart from the injustice to the actual donor is the fact that persons contemplating gifts between now and the final enactment of this legislation will simply postpone such giving until the final bill is enacted. In the meantime, private charities will lose unknown amounts of desperately needed money with dire consequences to their programs and their needy clients. At the very least I urge you to remedy this most obvious inequity.

5. DEFINITION OF DISQUALIFIED PERSONS

It is not my purpose to propose technical changes in the bill. However, I must observe that there is a certain amount of ambiguity around the meaning of the phrase "disqualified person" under Sections 101(a) and 101(b) of the bill. Clearly the intent is to control self-dealing transactions between individuals and private foundations. The concept of "disqualified person" as now spelled out in the bill, however, may do unintended damage to institutions which are truly publicly supported. Thus, if a community center with a relatively small budget should receive a large donation for a new dormitory or a swimming pool, it may arbitrarily be reclassified as a private foundation if the one gift is more than twice as much as all the other contributions.

I would respectfully suggest that the definition of "disqualified person" be revised to preclude any such unintended consequences. In any event, gifts for capital purposes, as distinguished from gifts for operating purposes, made to organizations normally considered to be publicly supported, should be excluded in determining the proportion of support obtained from so-called disqualified persons.

6. UNLIMITED CHARITABLE DEDUCTION

I would like to allude briefly to repeal of the unlimited charitable deduction effected by Section 201(a) of the bill. Recognizing the rationale for the elimination of this privilege, I would nevertheless venture to suggest a modification which I believe would be of great public benefit and would not do violence to the basic intent of the bill in this area. In the course of a lifetime, many people acquire large sums at certain times either through fortunate investment, or through inheritance or other circumstance. Some of these feel impelled to share their good fortune by making a large gift to a favorite philanthropic enterprise to build a hospital wing, or a staff dormitory, or for some other worthwhile purpose.

It would be regrettable if these substantial donations, generally intended for capital rather than operating purposes, were to be discouraged. In many instances, they take the place of government funds which would otherwise be required for the same purpose. I would therefore propose that, subject to appropriate regulation, every person be allowed one opportunity during his lifetime to make a gift, for capital purposes, over and above the 50% limitation on charitable contributions.

7. TAX ON PRIVATE FOUNDATIONS

I cannot conclude my presentation here today without some reference to Section 101(a) of the bill, calling for a tax of 7½% of the investment income of private foundations. The House concluded that this tax was desirable in part as a user fee to defray the costs of administering those sections of the bill relating to foundations and in part as an expression of the belief of the House Ways and Means Committee that private foundations should defray some of the costs of government. This tax is expected to yield about $65 million which would almost entirely be otherwise contributed to public philanthropies, such as the one I represent. I mention this to emphasize the point that the Committee cannot concern itself exclusively with the revenue-raising aspect of these proposed amendments. It must also weigh very carefully those clearly anticipated consequences which may adversely affect other valid public objectives, and then decide on balance where the public interest lies.

I am very gateful to this Committee for the opportunity you have afforded me to appear before you this morning and to express the great concern which all of us who have been engaged in voluntary philanthropy feel as we contemplate these proposals. It is my sincere wish that this Committee will view this problem, not from the relatively narrow viewpoint of individual benefits, but from the much broader perspective of the desirability of the continued participation of the private sector of our society in providing health, welfare and education services. Your Committee has a unique opportunity to give visible expression to the American tradition which continues to look to the private citizen for involvement, personally and financially, in these voluntary communal services which improve the life of his fellowman.

Thank you.

Senator WILLIAMS. Mr. C. Stanley Lowell?

STATEMENT OF C. STANLEY LOWELL, ASSOCIATE DIRECTOR, AMERICANS UNITED FOR SEPARATION OF CHURCH AND STATE

Mr. LOWELL. Mr. Chairman, I am associate director of Americans United for the Separation of Church and State, which is an organization concerned with church-state problems. My testimony has already been submitted, and I will comment on two or three points. It is concerned solely with the problems of religious exemptions in this legislation.

I should like, Mr. Chairman, to submit along with my statement a statement of O. K. Armstrong, who was a former Member of the House, one of the editors of Reader's Digest, which reached me yesterday. I think it would be helpful to the committee.

Mr. WILLIAMS. Thank you. The statements will be printed in the record and you may highlight it.

Our organization has just completed a study of "The Churches: Their Riches, Revenues and Immunities." In this study we show that the total church wealth in the United States, assets and income is $164 billion. This is an immense enterprise, a vast combination of wealth and power. We feel that some of the immunities which are in the present proposed tax bill are inappropriate in view of the rapidly expanding wealth of the churches which is enlarging at the rate we estimate of $5 billion a year.

It is interesting, Mr. Chairman, 14 years ago we appeared and gave testimony before a House committee. We urged the elimination at that time of tax exemption on the profits of unrelated business of churches which is contained in section 511 of the Code. We predicted at that time that this exemption would lead to great abuse, that it would draw the churches into commercial activity, into unrelated business in a way that would be inappropriate for their proper funding, and we submit, Mr. Chairman, that exactly this thing has happened.

We predicted at that time if the churches really put their back into commercial activity they could own the whole country in 60 years. Well, it hasn't worked out quite that way yet, but they have done very, very well indeed.

I notice that in the House bill the exemption at 511 on income of the unrelated commercial business of churches has been removed, and I certainly hope that this will continue in the Senate version of the bill.

I think that the public is ready for this. I think that the leaders of the church themselves are desirous that this be done. I am, however, disturbed by the watering down of the effect of this action. For example, in section 121, subsection 16 of the House bill there is provided a moratorium of 5 years on the profits from the unrelated commercial activities business of churches. I see no reason for this. I note that California just last week, the legislature lifted this exemption and voted a 7-percent tax on the profits from "unrelated" business of churches. I think this is a wise move. I see no reason why the churches should continue to have a tax shelter on this kind of commercial activity for another 5 years.

Then at section 514 the bill appears to provide churches with a 15-year moratorium before they shall be taxed on income from debt financed investments. I see no justification for this. I feel that the

churches should be paying the same taxes on income from such investments as competitive groups.

Finally, I would like to express disappointment in the fact that the House bill provides for no auditing, for no public report of finances by churches when they engage in commercial activity unrelated to their functions as churches. I feel that they should be subject to the same requirement of disclosure as competitive corporations, and that section 605(c) of the House bill is therefore inadequate.

Thank you, Mr. Chairman.

Mr. WILLIAMS. Thank you very much.

(Mr. Stanley Lowell's prepared statement and O. K. Armstrong's previously mentioned statement follow:)

STATEMENT BY C. STANLEY LOWELL, ASSOCIATE DIRECTOR, AMERICANS UNITED FOR SEPARATION OF CHURCH AND STATE

Mr. Chairman, Members of the Committee:

My name is C. Stanley Lowell. I am associate director of Americans United for Separation of Church and State. This organization has been appearing for more than a decade at hearings of the Congressional committees, the Treasury Department and the Internal Revenue Service concerning tax reform, particularly in the area of religious exemptions. In order to provide guidance as to the nature and scope of this problem, our organization recently completed and published a 300-page study "The Churches: Their Riches, Revenues and Immunities." This is the first systematic endeavor of which I am aware to provide the answer to such questions as the following:

How much tax-exempt property and business investments do the churches have?

How much does this cost the average taxpayer?

What is the complete record of all the exemptions and immunities which the churches enjoy?

What reforms in this area seem to be needed?

On the basis of our study of religious exempt property in 14 typical American cities and extrapolations therefrom, we have concluded that the assessed value of religiously used exempt property in the United States now stands at about $102 billion. If one adds to this the voluntary contributions, passive income, active business income, government subsidies, and also such church assets as stocks, bonds, investment real estate, commercial business property, et cetera, he confronts a total of nearly $164 billion. All of this, with the exception of some real estate, is tax-exempt. Since real estate exemption for churches is a matter for local authorities, we shall confine our attention to problems arising from provisions of the Internal Revenue Code as established in 1950 and amended in 1954, and also the Regulations based thereon.

As early as November 19, 1956, this organization in testimony before a House Subcommittee on Internal Revenue urged the deletion of the exemption from income tax on "unrelated business" of churches and associations of churches as contained in Section 511 of the Internal Revenue Code. The present exemption constitutes an open invitation to churches to embark upon ventures in commercial business for profit and to operate under the shelter of the religious exemption. We warned at that time of the unfortunate consequences of such an exemption and these consequences have certainly been realized. The acquisition of commercial businesses by churches is further encouraged by the fact that at Section 6033(a)(1) religious organizations are specifically exempted from filing returns. Some of these organizations operate in complete secrecy, not even reporting to their own members.

This tax-exempt domain is expanding at the rate of about $5 billion annually. The existence of such a large private entity immune to tax within a nation has given rise to many problems in many lands. The church never dies: hence, there is no redistribution of its holdings between generations as is the case with individuals and their estates. While we have not yet reached it, we may be actually approaching such a predicament as France faced in the eighteenth century, Britain in the sixteenth, and Mexico and Russia in the nineteenth, when a condition of "religious inflation" could only find its correction in revolution and expropriation of church property. As I said, we have not yet reached this predica-

ment, but we are approaching it and should take steps to prevent such a denouement.

AN INVITATION TO AFFLUENCE

It is evident that the churches are using the religious exemptions in various ways to enhance their wealth. Indeed, the present legal situation constitutes an open invitation to do so. A church may borrow funds which it uses to purchase a business, then pay for the business out of its tax-exempt profits. Or, it may purchase the business with a very small down payment, then lease the business back to the original owners and pay for it out of current profits, immune to income tax because of church ownership. Yet again, the church may assume title to the business on almost any terms, then hire the former owners back as managers. The profits go to the church which promptly rebates them to the managers who pay themselves for their business. The amount thus paid is subject only to the capital gains tax and escapes the higher levy on ordinary income. At the end of 10 or 20 years, the church owns the business and the managers have retained a large corpus for further investment.

Certainly the legislators did not intend that there be such a gaping hole in the tax law. Someone has estimated that if the churches really put their back into the thing, they could own the whole country in 60 years! The study by Dr. Larson and myself contains many pages describing the fortunes which churches are currently amassing under the tax shelter offered them in the present laws.

REFORM IS NEEDED

The entire exemption at Section 511 for churches or associations or conventions of churches should be removed. We note that the bill passed by the House has done this and we urge the Senate to keep the provision in the bill. We question the wisdom of Section 121(c)(16), however, which gives the unrelated businesses of churches continuance of their exemption for five years. This continuance simply maintains the unfair competition which these operators have posed to tax-paying operators. We urge that the same taxes be promptly imposed upon both.

Further reform is needed. Either the Code or the Regulations should draw a clear and proper distinction between related and unrelated business of churches. An absurb situation was created a decade ago when the De LaSalle Institute (corporate name of the Christian Brothers, makers and purveyors of brandies and wines) filed a lawsuit to recover income taxes on the ground that they were a church and therefore exempt. The Christian Brothers were a religious order. They argued that their brandies and wines were exempt because they were produced by an organization which technically qualified as a church or association of churches. In the case of *De LaSalle Institute v. United States*, Civil Action 7499, U.S. District Court for the Northern District of California, Northern Division, Judge Sherrill Halbert held against the order on the narrow ground that the Christian Brothers were not "sacerdotal" as defined in the Regulations. However, the judge went on to attack the Regulations themselves. He observed that "it would be impractical to accord an exemption to every corporation which asserted itself to be a church. Obviously, Congress did not intend to do this. . . . If the doctrine of the Catholic Church were such, work in a winery might be a church function. . . . This, however, could not transform an incorporated winery into an exempt church. . . ." Unfortunately, this decision was not appealed to the Supreme Court.

SACERDOTAL TEST INADEQUATE

The years since have demonstrated the inadequacy of the so-called "sacerdotal" test. As a matter of fact, even this test has not been vigorously applied by the Internal Revenue Service. The Christian Brothers were required to pay taxes on their liquor business and have been paying them since the suit. But other religious orders, technically sacerdotal, continue to operate unrelated businesses without tax. The Jesuit order is an example. Indeed, we are not aware of any effort to impose tax, even on the nonsacerdotal religious orders operating unrelated businesses. In the awesome deference that the government continues to show to religious bodies, it has been known to tax even those groups which have, in fact, been held to be taxable. The burgeoning of the commercial business of church organizations is the logical outcome of this reluctance.

What is needed in the light of the existing problem is a proper definition of a church. If the state is to exempt a church from tax, then certainly the state

has the responsibility of defining a church. Otherwise, how would one know what is to be exempt? The definition must not deal merely with clergy ordination, but with actual functions. There must be a specific identity of purpose between the church and the trade or business it carries on. The definition of the church must focus on the basic spiritual ministries of the church and should include, specifically, the functions of worship, evangelism, education and missions. All income derived from such activities might continue to be tax-exempt, but all income not so related should be subject to tax. The fact that this income is devoted to "good causes" should carry no weight in the determination.

OTHER IMMUNITIES

We would also recommend the elimination of Section 107 of the Code concerning the exclusions covered under the "rental value of parsonages." Also, the exemption at Section 119 which excludes from gross income of an employee the value of any meals or lodging furnished him by his employer under certain circumstances. This exclusion of living costs, but only if they are paid for by the employer and prepared by the employees, is tailor-made for Roman Catholic clerics and members of religious orders. Since the garb they wear and the cars they drive are necessary for their professional activity, these also are tax-exempt. Scarcely anything that comes to mind would be reportable as tax income for these members of the clergy. It is thus conceivable that they can enjoy the living standard of a millionaire without any tax obligation at all. There is neither reason nor excuse for such immunities in a country where church and state are constitutionally separated.

There are further exemptions for the personnel of religion that should be removed. It is true that some of these are matters established by Regulations which are not in the Code itself. If members of religious orders are under a vow of poverty, they have no money, work for their order, and receive mere maintenance in return. According to the existing Regulations, personnel under such a vow of poverty are not subject to withholding tax if they draw a salary from secular sources. Their check is simply transferred to the church without withholding. Thus, a member of the Jesuit order could theoretically serve as a bank president at a salary of $100,000 and not be required to make any report, much less pay any income or social security taxes. He could receive unlimited income from stocks, bonds, et cetera, held by him for the order without ever filling out a tax report. Nuns teaching in the public schools or serving as post-office employees, and priests serving as chaplains in the armed forces or as employees of the government's welfare service—provided they, too, are under the vow of poverty—are in the same category. They pay no taxes and simply turn their checks over intact to their orders.

The injustice of this is patent. Persons with family obligations are taxed heavily while those without such obligations pay no tax whatever. We recommend that clergymen be treated exactly the same as others by the tax collector.

LIMITATIONS ON EXEMPTS

Attention is invited to the definition of exempt organizations in the Regulations, particularly at Section 501 (c) (3). Here the limitations imposed on exempt groups are so comprehensive as virtually to destroy basic civil liberties. What is an even more serious matter, the strictures imposed here are of such a vague, though sweeping, nature that their enforcement had led to grossly discriminatory actions by the Service. The use of the word "substantial" in the Regulations is a good example. It is said that an organization cannot be exempt if a "substantial" part of its income and activities are devoted to legislative or political action. This means that a large organization could engage in considerable activity of this kind with impunity, whereas a small organization could engage in none of it at all. If these prohibitions are to remain in the Regulations they should at least be applied impartially to all exempt organizations.

TERMINATION OF SUBSIDIES

Another significant reform which we consider imperative, but which does not come under the purview of this committee, concerns the matter of government subsidy to church institutions. We urgently recommend the termination of all such subsidies as are derived under the Higher Education Act, the Economic Opportunity Act, and the Elementary and Secondary Education Act, et cetera, so

that the churches may resume their status as voluntary societies functionally and financially separated from the state.

REQUIRE DISCLOSURE

Finally, we recommend a substantial change at Section 6033(a)(1) which would remove the immunity to disclosure. We urge requirement of full disclosure of church income and assets on the same basis as (c)(4) organizations. Churches should have nothing to hide; it is in the public interest to require public reports of their finances, and it is to their own interest as well. Publicity is an excellent protection against many ills. We regard Section 6050(c) of the legislation in the House bill as inadequate. It continues to exempt church organizations from examination and audit of their finances except under rare circumstances at the request of a high-ranking official of the Service. We believe that churches should be subject to the same requirements of financial disclosure as other groups. groups.

At various other points the House bill continues the preferred treatment of churches for reasons that are obscure. For another example, at Section 514(b)(E) churches are given 15 years exemption from treatment as debt financed property for property designated for eventual related use, whereas other non-profit organizations are given only 10 years exemption. Also, churches are not subject to the "neighborhood test" as are other groups. We think all should be treated alike.

STATEMENT OF HON. O. K. ARMSTRONG, FORMER MEMBER OF THE HOUSE OF REPRESENTATIVES

Mr. Chairman, and members of the Committee: I am O. K. Armstrong, a former member of the U.S. House of Representatives, and a member of the Editorial Staff of *Reader's Digest*. I appear befor this committee as a churchman, a layman, concerned that this Congress include in its tax reform measure such provisions of the House bill, along with needed amendments, as will insure the taxing of churches and organizations of churches on incomes resulting from unrelated, competitive business enterprises.

During the last eight years I have made a careful study of the problem of the exemption of religious organizations on such incomes. My latest article on the subject, in the issue of *Reader's Digest* for March, 1969, which was made available to members of both bodies of Congress by inclusion in the *Congressional Record* of April 21, page E3143, entitled "Should Churches Be Allowed To Do Business Tax Free?" attracted the favorable attention of church leaders, of many faiths and kinds, all over the nation. Although no organization can speak officially for all churches and their agencies in this country, I can assure the members of this committee that numerous religious bodies have given official endorsement of the principle of taxing the incomes of churches on unrelated, competitive business enterprises.

Let me make it clear that in my opinion—a belief shared by the overwhelming majority of church leaders—that no level of government should have the power to tax the sanctuaries, the places of worship and all other facilities used for religious purposes, including places for publishing and distributing religious literature, for education and for propagating the fatih.

On the other hand, when churches and their agencies get over into business activities and enterprises unrelated to their religious purposes, in order to make untaxed profits, in all fairness and justice to their private competitors they should be taxed.

Surely members of this committee and of the Senate are aware that in the last few years the "lease-back" arrangement, whereby churches buy a comercial business, sell it back to the original owners, and receive profits from the business without paying the taxes which an ordinary business firm would have to pay, has become a disgrace. This practice should be stopped at once—and by an amendment to this House bill.

It is with satisfaction that concerned churchmen see in the revised reading of Section 511(a)(2)(A) the deletion of the provision that churches and associations of churches may receive unrelated business income without taxation. This is a great step forward. However, the bill includes also several provisions that all but nullify this good deletion. For example:

Section 121, subsection 16, gives churches and associations of churches a five-year moratorium, after May 27, 1969, during which those engaged in unrelated business enterprises before that date may continue to operate their competitive business without taxation or disclosure. Why give them five years more of tax free operation? Surely one year, or at most two years, would be ample time for chuches to divest themselves of businesses that are no concern of their religious functions.

Section 514 provides that income derived from debt-financed investments shall be taxable to churches in the same proportion that they are covered by such financing. As debt is reduced, so is taxable portion of income to the same extent. Churches will have a 15-year moratorium before this provision takes effect on their investment income. This 15-year moratorium was not in earlier versions of the House bill.

What churches, or organizations of churches, ask for these watering-down provisions? In all the voluminous hearings on the House bill in the Ways and Means Committee of that body, I fail to find any support for such modifications of what responsible churchmen hoped would be a direct, simple deletion of the provision that has exempted churches from paying income taxes on unrelated business.

Furthermore: This version of the bill provides that no church books shall be audited or examined; this is a just provision when applied to all matters pertaining to religious activities, finances, and so on, but should not apply to unrelated, competitive business dealings. The bill provides that no one below the status of a district director may make inquiries of a church as to its business operations; this is good with respect to religious activities of all kinds, but is not needed for unrelated business matters. And there is no specific requirement that churches shall disclose and report their incomes and profits from unrelated enterprises.

It is obvious that these provisions seriously weaken the case for eliminating the unfair and unjust competition of churches that engage in business for profit with ordinary taxpaying business firms who are hit hard on their profits.

I plead with the members of this committee to produce such amendments as will correct these unwise modifications of the principle that churches and their agencies should no longer have tax exemption on business profits. I can assure you of the support of responsible church leaders in major denominations and associations all over the United States.

Senator WILLIAMS. The next witness will be Mr. Glen McDaniel, chairman, executive committee, Litton Industries.

STATEMENT OF GLEN McDANIEL, CHAIRMAN, EXECUTIVE COMMITTEE, LITTON INDUSTRIES

Mr. McDANIEL. Mr. Chairman, we do not oppose that portion of section 421 of the House bill which relates to two classes of common stock but we do strenuously oppose that portion which relates to convertible preferred stocks and convertible bonds.

What that portion would do would be to levy an income tax on a stock dividend received by a common stockholder because a convertible preferred stock or a convertible bond was outstanding; and it rests upon the conclusive presumption that a convertible preferred or a convertible bond has already been converted, which is an assumption which flies in the face of the facts and is wholly untenable, in our opinion.

Now, I would like to make four points in the time available to me. The first is that the practical effect of these provisions about convertible preferreds and convertible bonds will merely be to force corporations to use rigid antidilution provisions in their stock or bond provisions. That is, they will be forced to use provisions which say that in the event of a stock dividend there will be a rigid mathematical adjustment of the conversion ratio of the convertible security to take account exactly for the amount of the stock dividend, no more, and no less.

It will raise no revenue whatsoever because no corporation in its right mind, apart from a mistake, would subject its stock dividends to its common stockholders to a tax when it is so easy to avoid it by merely using a complete antidilution clause.

On the other hand, the rigidity imposed by these provisions would, without any sensible reason that we can discover, eliminate many types of antidilution provisions which have been developed in American corporation finance since about the time of World War II.

I would like to give you five types that would be eliminated for no reason.

One is a very usual provision that there can be a 3-percent stock dividend without adjusting the conversion ratio. This is in the stock and bond provisions of many companies.

Second is a provision involving an increasing conversion price at periodic intervals, so that every 5 years or every 10 years the price which the bondholder has to pay to get common stock is increased.

Or, third, there are phaseout provisions whereby a certain proportion of the bond or preferred must be redeemed every 5 years or every 10 years so that ultimately the right of convertibility is lost.

And, fourth, there are conversion adjustment provisions which go both up and down. These occur in many cases of small companies, particularly in the portfolios of the small business investment companies, where the conversion ratio adjustment depends upon the earnings of the corporation. This also occurs in the Litton Industries series B convertible preferred stock, where the adjustment is based on the relationship between the value of the stock and the amount of the cash dividend paid on the convertible preferred.

Now, then, fifth, there are many other types of securities, particularly developed by smaller businesses, which have ingenious devices in their conversion provisions, like conversion dependent upon company earnings, which represent an attempt by these companies to make the best deal they can for their common stockholders.

Now, convertible debentures and preferred stock are an important method of financing in American industry.

About 40 percent of the financing done by small companies we are told is of convertible securities, because they can sometimes sell neither straight equity nor straight debt. In order to raise money they have to give the preferred stockholder of the bondholder not only a preferred position as compared to the common stock but an opportunity to share in growth through the conversion privilege.

There also is a great need for convertible securities by companies that are not in the best financial condition or whose earnings are not holding up the way they should, and also companies which have a great need for funds at a time when interest rates are high. This applies even, let us say, to A.T. & T. which announced the other day that it was going to convertibles. It raised $10 billion through convertibles in the years immediately after World War II because of the particular conditions existing in the capital market at that time, and the need for funds.

So that all of these companies, small—primarily small—but also large and medium sized, who need to raise money by the use of convertible securities are needlessly hurt by this bill, because they are deprived of the flexibility of negotiating types of antidilution provisions

in their convertible securities which will give a better break to the stockholders they represent, which are the common stockholders.

Now, this will happen needlessly, which is my second point, and the second point is that there is no valid revenue reason to deprive companies of this needed flexibility in negotiating the terms of convertible securities.

The asserted concern is that there will be a trend toward stock dividends in American industry, and there might be a trend toward the holding of stock dividend paying stocks by tax exemptable and wealthy taxpayers, whereas the cash dividend paying stocks would be held by low-bracket taxpayers and thus theoretically a loss of revenue could occur.

The facts show that this concern, which was expressed first shortly after the time of the 1954 act, is totally without merit. The trend is actually in the other direction as indicated both by the figures of the Treasury Department itself and by statistics from the Department of Commerce.

In the period, according to Treasury figures, from 1953 to 1965 cash dividends went up 124 percent. Stock dividends went up only 100 percent. But that doesn't tell the whole story, because what actually happened, stock dividends declined, because while they increased in value from $1.1 billion to $2.2 billion, that value is measured by the Dow-Jones industrial average and the Dow-Jones industrial average almost quadrupled during those years. Therefore, if the same companies that were declaring stock dividends in 1953 were still declaring them in 1965, the value would be nearer $4.4 billion than it would $2.2 billion. It is obvious from these Treasury figures that fewer companies are declaring stock dividends today than were declaring them in 1953.

Now, going over to figures from the Department of Commerce, they show that cash dividends, as a percent of corporate profits, were higher in 1968 than in 1954. They were higher in the last 5 years of that 15-year period than they were in the first 5 years of the 15-year period. Also, cash dividends as a percentage of total personal income was higher in 1968 than in 1954, and higher in the last five years of that 15-year period than in the first 5 years of the 15-year period.

Now, as to the second part of that expressed concern that the high-bracket taxpayers might not buy cash dividend paying stocks, Treasury figures show the opposite to be the case.

I have here a table prepared from the Treasury Department figures on the taxable returns. It shows that as between 1954 and 1967 the percent of total dividends received by high-bracket taxpayers increased, and it increased in all high-bracket categories beginning with the category from $20,000 to $50,000, where it increased from 24 to 28 percent. From $50,000 to $100,000 it increased 15 percent to 16⅓ percent.

From $100,000 to $200,000 of income it increased from 9⅓ to 10⅔ percent.

From $200,000 to $500,000 of income it increased from 5.62 to 7.60 percent.

And the same is true of those few people who had incomes of from $500,000 to $1 million, and $1 million and more. So, the facts show conclusively that there is no trend away from cash dividends and

toward stock dividends on the part of high-bracket taxpayers. The opposite is the fact.

It seems to me a strange and bizarre thing that legislative action is now proposed to correct something which the past 15 years have shown to have no foundation whatsoever.

Now, my third point is that these provisions are unfair to common stockholders. Of course, as I have pointed out, the provisions will benefit lenders and penalize common stockholders for no valid revenue reason. I do not think that is what the House intended, and it certainly is not to be assumed that that is what the Senate would intend. But the bill is unfair to common stockholders in another major respect, and that is that these provisions regarding convertible preferreds and bonds will tax individuals for something that they never received. That is unfair, and it can happen in three ways.

Now, in the first place, when the conversion of a convertible security occurs, the proportionate interest of the common stockholder in the corporation goes down. It does not go up. He can only have a dilution of his proportionate interest, and yet he is being taxed in this bill on an increase in his proportionate increase. He never receives an increase in his proportionate interest; he receives a decrease in his proportionate interest.

What is really supposed to be taxed is a diminution in the potential dilution of the common stockholder's interest, and that, I submit, is an entirely inadequate basis to levy an income tax on an individual.

Now, second, it is unfair because if the convertible security is never converted the common shareholder will have been taxed on something that he has never received. And, as I have said, a convertible security is treated in these proposals conclusively as if it has been converted and that is unfair, unreasonable, and contrary to the facts.

Hundreds of millions of dollars of convertible preferred stocks and bonds are never converted. They are redeemed, and never converted. To assume that they are converted is to fly in the face of the fact.

Senator WILLIAMS. Mr. McDaniel, your entire statement will be put in the record. We are not trying to cut you short but we are trying to complete this as soon as we can.

Mr. McDANIEL. Well, I will eliminate my third point and then give the next aspect in which this is unfair to common stockholders. There are many cases in which the conversion ratio can go both up and down. This means that when the common stockholder is taxed on a downward adjustment of the conversion ratio, and the ratio is later increased to the same point under the normal workings of the antidilution provision, which is the kind of provision we have in the Litton Industries B convertible preferred stock, the common stockholder is taxed on something he never received, even though conversion occurs. I do not think under any stretch of the imagination that anyone could call that fair treatment.

Mr. Chairman, I would like to offer for the record the table entitled "Comparison of Taxable Dividends by Income Classes," to which I referred earlier. It is not in the printed material and not in my statement.

Senator WILLIAMS. It will be printed in the record.

Mr. McDANIEL. I will hand that to the reporter. Thank you.

(The table referred to follows:)

COMPARISON OF TAXABLE DIVIDENDS BY INCOME CLASSES

Adjusted gross income class	Percent of total dividends in 1954	Percent of total dividends in 1967	Adjusted gross income class	Percent of total dividends in 1954	Percent of total dividends in 1967
Under $1,000	0.12	0.03	$9,000 to $10,000	2.16	1.90
$1,000 to $2,000	.78	.55	$10,000 to $15,000	10.60	9.63
$2,000 to $3,000	1.58	1.06	$15,000 to $20,000	7.80	8.00
$3,000 to $4,000	3.28	1.09	$20,000 to $50,000	24.76	26.02
$4,000 to $5,000	3.26	2.06	$50,000 to $100,000	15.09	16.34
$5,000 to $6,000	2.62	2.14	$100,000 to $200,000	9.33	10.66
$6,000 to $7,000	2.73	2.04	$200,000 to $500,000	5.62	7.60
$7,000 to $8,000	3.61	2.42	$500,000 to $1,000,000	2.13	2.81
$8,000 to $9,000	2.53	2.63	$1,000,000 or more	3.03	3.40

Source: Statistics of Income, Individual Income Tax Returns, Department of the Treasury (taxable returns).

Senator BENNETT. Mr. Chairman, I had two questions to ask Mr. McDaniel. In view of the time situation I will give them to him and ask him to reply to them in writing to go in the record.

Senator ANDERSON. Go ahead and ask them.

Senator BENNETT. Very well, first, it seems to me that the 305 proposal assumes that all preferred stock which is convertible into common stock is actually to be considered common stock. Isn't there any convertible preferred stock which can be clearly distinguished from common stock?

Mr. McDANIEL. Yes, of course. The preferred stocks have a first call on earnings and assets, and I can give you a good example from Litton's own experience currently of why it is a violent and unrealistic assumption to assume that a preferred will be converted. Our series B preferred sells at $42 and pays a $2 cash dividend. If it is converted into common, the value of the common stock received is $28 and it pays no dividends. Now, no person in his right mind would convert that stock, and any statute which assumes that every convertible preferred is going to be converted is making an assumption which is absolutely untenable. Hundreds of millions of dollars of convertibles are never converted.

Senator BENNETT. Well, is my understanding correct that this bill would give the Treasury Department the authority to write regulations which could impute taxable dividends to a common shareholder even though the common shareholder received no dividends.

Mr. McDANIEL. Absolutely. I have given examples of this in my statement.

Senator BENNETT. Fine, I will look them up.

Mr. McDANIEL. Of course, there are others that can be cited, but I think those in my statment are very persuasive. This is one of the great evils of these provisions, that it taxes a man on a benefit which he never receives.

Senator BENNETT. And that is just about as bad, Mr. Chairman, as giving a man a profit on charitable contributions. It is the other side of the story.

Mr. McDANIEL. That is correct.

Senator BENNETT. No further questions.

Senator ANDERSON. Thank you very much, and we appreciate hearing you.

(Mr. Glen McDaniel's prepared statement follows:)

STATEMENT OF GLEN McDANIEL, CHAIRMAN OF THE EXECUTIVE COMMITTEE, OF LITTON INDUSTRIES, INC.

I. A PRELIMINARY STATEMENT

A. *The Present Law.*—Prior to enactment of the 1954 Code, common stockholders were taxed on stock dividends only if such stock dividends increased their proportional interest in their company. This rule was developed through various Supreme Court decisions holding that a constitutional tax could be levied only if the stock dividend resulted in a change in proportional interest. (*Eisner* v. *Macomber*, 252 U.S. 189 (1920); *Koshland* v. *Helvering*, 298 U.S. 441 (1936); *Helvering* v. *Griffiths*, 318 U.S. 317 (1943); *Helvering* v. *Sprouse*, 318 U.S. 604 (1943); *Strassburger* v. *Commissioner of Internal Revenue*, 318 U.S. 604 (1943).)

The pre-1954 proportional interest rule was complex and productive of much litigation. See, e.g., *Wiegand* v. *Commissioner*, 194 F. 3d 479 (3d Cir. 1952), and *Tourtelot* v. *Commissioner*, 189 F. 2d 167 (7th Cir. 1951). As a result of such complications, when the 1954 Code was enacted, Congress adopted in § 305 the present rule exempting from tax all stock dividends received by common shareholders except thase received as a result of an election by the stockholder to take a stock dividend rather than a cash dividend. The present rule thus eliminated the proportional interest concept as a test of taxability. As shown later in this statement, the revenue from the taxation of dividends has not seemed to suffer from the adoption of the present rule. On the other hand, the simplification resulting from the adoption of the present rule has been a significant improvement over the pre-1954 law.

B. *The Proposed Law.*—Section 421 of H.R. 13270 would return us, to a considerable extent, to the pre-1954 complexities, both constitutional and otherwise, by taxing a common shareholder on an increase in his proportional interest (actual or assumed) if a related cash dividend is paid to other shareholders. In fact, the proposed new rules introduce serious new complexities, mainly arising from the treatment of convertible preferred stock and convertible indebtedness as common stock.

II. CONSIDERATION OF THE NEED FOR ANY CHANGE

The Report of the Ways and Means Committee states that the purpose of § 421 of H.R. 13270 is to prevent a loss of revenue which could result if publicly-held corporations adopted "a capital structure with two classes of common stock so that their stock could be sold both to investors desiring appreciation and to investors desiring a current income". This same concern was expressed by the Subchapter C Advisory Group to the Ways and Means Committee in 1959 and is identified with the feeling that high-bracket taxpayers would acquire and hold the common stock affording increased ownership of the corporation and low-bracket taxpayers, or exempt organizations, would hold the common stock paying a cash dividend.

This concern will not be relieved by the proposed amendments. A choice between stocks paying cash dividends and stocks offering equity growth will continue to be available to investors. An investor desiring income would buy the stock of a company paying cash dividends, whereas an investor desiring appreciation would invest in a company which retains its earnings for expansion and growth. The same choice frequently exists (and would still be acceptable under H.R. 13270) even within the same company, through a common stock paying no cash dividends and a preferred stock (even a convertible preferred stock if the conversion privilege is fully protected against dilution) which does pay cash dividends. The retention by public corporations of earnings certainly serves a proper and legitimate purpose of internal financing, and it would be an unsound tax policy which forces the payment of cash dividends, thereby increasing the borrowings required to serve corporate business needs.

A study of the dividend-paying habits of corporations since the adoption by Congress of the present rules raises a serious question as to the reality of the concern expressed in the Ways and Means Committee report. Attached hereto

is Schedule A showing the cash dividend and stock dividend paying practices of corporations from 1953 through 1965 as available in the Statistics of Income prepared each year by the Internal Revenue Service. These data show that the dollar amount of cash dividends has arisen each year and more than doubled during this period (from 11.6 billions to 26 billions), while the value of stock dividends paid demonstrates an absence of a growth pattern in the use of stock dividends. When one considers the fact that the value of stock dividends paid in 1953 was 1.1 billions and was 2.2 billions in 1965, during which period the Dow Jones Industrial Average almost quadrupled (250–280 in 1953 to 840–960 in 1965), it is clear that the use of stock dividends has not increased and has almost certainly decreased.

The attached Schedule B, taken from U.S. Department of Commerce data, demonstrates that the dividend paying practices of corporations have not changed as a percentage of corporate profits (although fluctuations have occurred) and, most significantly, that individuals received the same approximate percentage of their aggregate income in cash dividends in 1968 as they did in 1954 (3.4 vs. 3.2%). The 5-year averages for this period show that for 1954–1958, 1959–1963, and 1964–1968 cash dividends as a percentage of personal income were, respectively, 3.3%, 3.4% and 3.5%, while the percentage of corporate profits distributed in these periods approximated the 15-year average of 46%. These data strongly demonstrate that investors and companies have not moved to "tax-free" stock dividends. The feared impact on the revenue suggested in the House Report simply has not developed in the 15 years since the proportionate interest test was eliminated. There is no reason to think that the future will differ from the past in this request.

There can be no question but that the changes proposed in the taxation of stock dividends is a severe retrogression insofar as simplification is concerned. The alleged danger to the revenue is too questionable to justify the reintroduction into our tax system of the complexities inherent in the concepts of § 421.

III. TREATMENT OF CONVERTIBLE PREFERRED STOCK AND CONVERTIBLE SECURITIES AS COMMON STOCK

Although a strong case can be made against the reinstatement of the proportional interest test, it is argued by some that such reinstatement is justified as an effort to extend the exception in exising law which taxes a common shareholder on his stock dividend if he has an election between cash and stock. Section 421 would accomplish this by inhibiting the creation of two classes of common stock, one paying cash and the other stock but both participating alike in equity growth and equity decreases.

Even if it is assumed that such an extension of the present law is desirable, § 421 is a gross example of "overkill" in treating convertible preferred stock and indebtedness as common stock. A preferred stock, or a bond, or a debenture even if convertible into common stock, is *not* common stock and may never become common stock.

The lack of equivalence between common stock and a convertible preferred stock or security is plainly evident in a declining stock market such as today's: for example, a high-grade convertible bond with a face value of $100 and an interest rate of 5%, where the common stock into which it is convertible is worth $40, will sell in the market place as a debt and not as a common stock; the price it will command will be mainly the function of the yield and maturity and not its convertibility. Yet § 421 treats such convertible bond as common stock.

Even where the market price of the convertible preferred stock or security reflects the market price of the common stock into which it is convertible, it is incorrect and unsound to treat such convertible stock or security as common stock on the assumption that at some time conversion will occur. Whether conversion will occur is a product of investment desires and judgment which will vary from investor to investor.

We submit that the policy reflected in § 421 is unsound for the following reasons.

A. *The Inequity to the Common Shareholder.*—The proportional interest of a common shareholder can only be *decreased* through the issuance of a convertible preferred stock or bond. If conversion occurs and common stock is issued to the former holder of the convertible, the old common shareholder's proportionate interest is necessarily decreased. If conversion does not occur, his proportional interest does not change.

Section 421 would tax the common shareholder on the theory that he has a "gain" if the conversion right in the convertible stock or security is decreased. This "gain," in fact, is but a diminution in the potential dilution of the common shareholder's interest. This is a totally inadequate justification for a tax.

The theory implicit in § 421 that a convertible preferred stock or bond is common stock, or its equivalent, rests on the tenuous presumption that conversion will some day occur. Section 421 indeed makes the presumption conclusive, not even admitting of the possibility that conversion may not occur. Yet whether or not conversion will occur will depend on the judgment of the investor exercised in the light of economic facts. When, as is frequently the case, the market value of the convertible preferred stock or bond exceeds the market value of the common stock into which it is convertible, conversion is highly improbable.

If conversion does *not* occur, the common shareholder will have been taxed on the value of an "increase" in his proportional interest he did not receive. This can hardly be called fair taxation. To the contrary, when coupled with the facts that the common shareholder cannot control the preferred shareholder and has no right himself to convert into preferred stock, such a result is incredibly unjust.

B. *Interference with Corporate Financing.*—Convertible stock and securities have for many years played an important and respectable part in the financing by many corporations of their businesses. In the case of some companies, particularly new businesses, the use of convertible stock and securities is a "must" because lenders and investors are reluctant to risk their money unless growth equity options are also made available. In the case of practically all companies, under economic conditions such as today when interest rates are extraordinarily high, convertible stock and securities afford an essential alternative means of financing.

Section 421 unwisely interferes with this type of financing by sharply limiting the flexibility of the issuer in negotiating as favorable terms as possible. If the corporation could otherwise negotiate an exception which would permit it to pay stock dividends to its common shareholders without adjusting the conversion rate of the preferred stock or security, § 421 as a practical matter makes the company forego this advantage since it would tax the stock dividend. If the conversion rate is adjusted for the stock dividend, the stock dividend is not taxable, so the corporation is "locked" into giving complete anti-dilution protection to the holder of the convertible stock or security. This hurts common shareholders and benefits lenders.

Or if the corporation could otherwise negotiate a "phase-out" of the conversion right by diminishing that right periodically, so that the potential dilution of the common shareholder's interest is minimized, the corporation would as a practical matter have to forego this significant advantage because § 421 contemplates that the Treasury will *impute* a taxable dividend to the common shareholder by reason of the reduction in the conversion rate. The common stockholder, in this situation, is taxed even though he does not receive any more stock.

Or if the corporation could protect its common shareholders by periodically increasing the price at which a bond or debenture can be converted into common stock—a very common situation—, it would, in so doing, create an imaginary but taxable dividend to its common shareholders.

These adverse and unnecessary impediments to corporate financing result from the treatment of convertible stock and securities as common stock.

C. *The Vast Complications of § 421.*—One of the major reasons why Congress enacted the present rule in 1954 was to eliminate the complexities resulting from the then change-in-proportional-interest test of taxability of stock dividends. Section 421 will reintroduce into our system those same complexities and will further create additional complexities, arising mainly from the taxation of common shareholders because of the issuance of convertible stock and securities.

Examples of the complexities, which we respectfully submit that Congress should deal with in the statute and which § 421 totally ignores, are indicated by the following questions:

1. What precisely is meant by the term "proportionate interests" as used in the proposed § 305(b)(2)?

2. Since an increase in proportional interest of some stockholders would be taxed only if it is related to a cash dividend paid to other stockholders, when and to what extent will "relatedness" be considered to exist? Will the stock dividend be taxed only to the extent of the cash paid to other shareholders?

3. How will the "gain" taxed to common shareholders as a result of stock dividends *imputed* to them be measured? How can this be done in the case of a shareholder owning 100 shares of total outstanding shares of 35,000,000? Is the imputed "gain" likely to be realizable by the shareholder?

4. Where the conversion rate fluctuates with the market value of the common stock, and thus can go either up or down, will a common shareholder be allowed a loss where he has to "return" that portion of a conversion right which which he "received," and was taxed on, in a prior year? If he is to be allowed a loss, how is the amount to be determined and what will be its character?

5. If conversion never occurs, will the common shareholder who has been taxed on the assumption that conversion will occur be allowed a loss? And what if he has sold his stock in the interim?

6. Is it intended that the law apply to situations where the amount of the stock dividend is less than the corporation's related cost in advising its shareholders?

7. Will anti-dilution provisions in convertible stock and securities give rise to a taxable gain to their holders where expressed in terms of value rather than shares?

8. Does Congress intend that corporations must give complete anti-dilution protection to holders of convertible stock and securities, or else subject their common shareholders to tax on stock dividends received by them?

9. What is Congress' intention with respect to the application of the proposed rules in light of the constitutional doctrine developed in *Eisner* v. *Macomber*, 252 U.S. 189, and later cases?

These are but a few of the problems created by §421. They suffice, however, to raise the question whether these and other complications are justified by the unfounded concern over a speculative revenue loss.

D. *Revival of Constitutional Problems.*—The record of §421 of H.R. 13270 thus far is silent on the point, but it is plain that the amendments relating to convertible stock and securities raise serious constitutional questions.

The constitutional rules relating to the taxation of stock dividends are developed in *Eisner* v. *Macomber*, 252 U.C. 189, and the other cases cited on the first page of this memorandum. That rule is that a stock dividend cannot validly be taxed unless it results in a change in the stockholder's proportional interest. For example:

1. A distribution of common stock on common stock, there being no other stock outstanding, cannot validly be taxed. (*Eisner* v. *Macomber*, 252 U.S. 189)

2. A distribution of preferred stock on common stock, there being no other class of stock outstanding prior to such distribution, cannot validly be taxed. (*Strassburger* v. *Commissioner*, 318 U.S. 604)

3. A distribution of common stock on common stock, there also being nonconvertible preferred stock outstanding, cannot validly be taxed. (See Treasury Department's Tax Reform Proposals of April 22, 1969, Example (2), p. 223)

Section 421, of course, deals with common stock dividends paid (or considered as paid) to common shareholders where that stock dividend is related to cash dividends paid on convertible preferred stock or interest paid on convertible bonds or debentures. Section 421 thus raises these two constitutional questions:

1. Can a distribution of common stock on common stock validly be taxed where there is also outstanding a convertible preferred stock?

2. Can a distribution of common stock on common stock validly be taxed where there is no other stock outstanding but there is convertible indebtedness outstanding?

Both of these questions should be answered in the negative if the Supreme Court's decisions are to be respected. The decision of the Court of Appeals for the Second Circuit in *Choate* v. *Commissioner*, 129 F.2d 684 (1942), supports this conclusion. There, rights to acquire preferred stock, convertible into common stock at specified ratios varying from time to time, were issued to common shareholders, there also being outstanding preferred stock. The Court tested the constitutional point as though the convertible preferred stock was itself distributed and ruled that the distribution could validly be taxed. The court stated in this connection (p. 688, fn. 12):

"We regard as immaterial the fact that the preferred stock here is convertible, at the election of the holder, into common stock."

If the Court had treated the convertible preferred stock as common stock (contrary to the Government's position[1]), the distribution could not have been con-

[1] The Commissioner of Internal Revenue argued in his brief that "The distribution to holders of common stock of rights to purchase shares of the Crane Company's convertible preferred stock was essentially analogous to the distribution of a stock dividend in preferred stock on common stock."

stitutionally taxed. The Court recognized this in distinguishing *Miles* v. *Safe Deposit & Trust Co.*, 259 U.S. 247, where it was held that a distribution to common stockholders of rights to subscribe to common stock could not validly be taxed under *Eisner* v. *Macomber*.

A further serious constitutional question is raised by the proposed §305(b)(3) which would tax a distribution of convertible preferred stock unless advance clearance of the Secretary or his delegate is obtained. If such a distribution were made at a time when only common stock was outstanding, it seems clear that the *Strassburger* decision would make a tax on the distribution unconstitutional.

Whatever would be the final result of litigation testing the constitutionality of taxing common shareholders on common stock dividends received by them. Congress should be aware that enactment of the provisions of §421 concerning convertible preferred stock and debt raises constitutional questions and makes litigation on the point inevitable.

IV. UNCERTAINTY ARISING FROM BROAD DELEGATION

Section 421 gives the Treasury Department the broadest authority possible to make the substantive rules for determining whether the provisions of convertible preferred stock and debt will trigger a tax on common shareholders. The only guideline in §421 is that the stock distribution (actual or imputed) must result in an increase in proportionate interest and be related to or identified or somehow connected with cash payments to other shareholders.

If the provisions concerning convertible stock and securities are to be retained, Congress should provide the rules. Corporations raising capital must resort to stock and securities which are responsive to economic conditions existing at the time and should be able to determine the tax consequences from the statute.

V. APPLICABILITY TO LITTON INDUSTRIES, INC.

At its inception in 1953, Litton formulated a policy of retaining its earnings to finance its growth. In ten years since 1959, Litton has paid a 2½% stock dividend to its common shareholders, but the Company has not paid any cash dividends to the common shareholders. The Company has consistently followed its early announced policy of retaining earnings.

Of course, Litton (as other companies) has needed additional funds. It has on several occasions found it either necessary or desirable to use convertible stock or convertible securities in securing funds and continuing its growth. At an early juncture of the Company's history, the issuance of convertible debentures was the only mode by which the Company could obtain badly needed funds. This would be true of many businesses today in comparable stages of development.

When it has had to employ convertible stock or securities, Litton, of course, has always tried to negotiate as favorable terms as possible to the advantage of the corporation and its common shareholders. A prime objective of Litton in such negotiations is to minimize the dilution of the interests of its common shareholders should conversion occur. It has done this, when possible, by trying to obtain the right to pay annual stock dividends to the common shareholders without having to adjust the rate of conversion in the convertible stock or security or by periodically increasing the conversion price. These efforts to minimize dilution of the interests of common stockholders have had no tax implications whatsoever.

During the last two years Litton has issued its Series B Convertible Preferred Stock in connection with mergers of Litton and several other companies. In the first merger in which this stock was issued, the shareholders of the other company desired cash dividends and Litton's common stock pays no cash dividends. They also wanted, however, both the chance to participate in the growth of Litton and protection against possible sharp declines in the value of the common stock.

In the course of negotiations the parties agreed that the preferred shareholders should not have the right to both the cash dividend paid on the preferred and (through the conversion right) the stock dividend paid on the common. It was accordingly agreed that Litton should have the right to continue with its annual stock dividend without adjusting the conversion rate of the preferred stock. This exemption from the anti-dilution provision was limited, however, to

stock dividends up to a value of $2.00, the amount of the cash dividend paid on the preferred stock. The value of stock dividends in excess of $2.00 brings the anti-dilution provision into play, and the conversion rate is increased to reflect this excess. Similarly, in order to maintain the proportion between the common and preferred, it was agreed that the conversion rate of the preferred should decrease if the value of the stock dividend is less than $2.00.

Litton's Series B Convertible Preferred Stock was not created for any tax reasons. In fact, the stock increased tax revenue. It is a fair stock to both the common shareholder and the preferred shareholder. No good reason occurs to Litton why its contniued used should, in effect, be prohibited.

Litton's Series B Convertible Preferred Stock points up another of the deficiencies in §421. Since the conversion rate can either go up or down, dependent upon the market value of the common stock, the common shareholder could be taxed when the conversion rate goes down but gets no loss when the conversion rate goes up. In fact, during its existence the conversion rate of the Series B Stock has gone both up and down. It is entirely possible that conversion, should it occur, will be at the initial conversion rate although in the meantime the common shareholder would have been taxed on decreases in the conversion rate. This is a bizarre result.

CONCLUSION

The immediate reason why § 421 equates convertible preferred stock and bonds with common stock is apparent. Only by regarding convertible preferred stock and securities as common stock can even a theoretical increase in the real common shareholder's proportional interest as a result of a stock dividend be developed. If the preferred stock or debt is treated for what it is—a preferred stock or debt which remains such unless and until it is converted into common stock—, then the common shareholders who receive a stock dividend own the same proportional interest thereafter as before, viz., all of the company over and above the liquidating value of the preferred stock or the face amount of the debt.

It is, however, not so apparent why the authors of § 421 believe it necessary or desirable to tax a common shareholder on a stock dividend just because a convertible preferred shareholder or bondholder could not dilute the common stock, if he converts, to the same extent after the stock dividends as before.

It is evident that the characteristics of a preferred stock or a debt, even if convertible into common stock, are significantly different from those of common stock. Unlike the two-classes-of-common situation where the only difference in the two stocks is the nature of the dividend, both classes sharing alike in "ups" and "downs," no corporation would penalize its common stockholders by creating a convertible senior stock or security *solely* to provide investors with a choice between stock dividends and cash dividends. The common stockholder has to share his prosperity with the convertible holder but cannot count on the latter to share his losses; he cannot become a preferred shareholder or a creditor, either to get cash dividends or interest or to put a floor under the depreciation in the value of his common stock. Even from the point of view of the convertible holder, it cannot be said that he has a free "election" where the value of his preferred stock or debt is considerably in excess of the value of the common stock into which he can convert.

Any amendments relating to stock dividends paid to common shareholders should be confined to increases in proportionate interests received by holders of common stock because of the receipt of cash or its equivalent by other holders of common stock. No amendment should be made which would tax common stock dividends to holders of common stock because of the existence of convertible preferred stock or convertible indebtedness.

However, it is apparent that a stock can be labeled "preferred" notwithstanding that it is in reality common stock. Accordingly, tests such as those proposed on pages 10–11 of the memorandum accompanying this document might be adopted to distinguish bona fide preferred stock from sham preferred stocks.

It is also recognized that what is essentially an equity interest can be labeled "indebtedness." Any such interest could be evaluated under standards similar to those suggested in case of a preferred stock.

SCHEDULE A.—CASH DIVIDENDS AND STOCK DIVIDENDS, 1953-65, INCLUSIVE

[Billions of dollars]

Year	Cash on property dividends	Stock dividends	Year	Cash on property dividends	Stock dividends
1953	11.6	1.1	1960	17.2	2.0
1954	11.8	1.3	1961	18.0	2.2
1955	13.6	2.0	1962	19.6	2.1
1956	14.5	2.7	1963	21.1	2.1
1957	15.0	1.8	1964	23.3	3.1
1958	15.0	1.6	1965	26.0	2.2
1959	16.2	2.2			

Source of data: Statistics of income, corporation income tax returns, Department of the Treasury.

SCHEDULE B.—CORPORATE FINANCIAL STATISTICS, 1954-68

[Dollar amounts in billions]

	Personal income	Cash dividends	Cash dividends as a percent of personal income	Aftertax corporate profits	Cash dividends as a percent of corporate profits
1954	$290.1	$9.3	3.2	$20.6	45.1
1955	310.9	10.5	3.4	27.0	38.9
1956	333.0	11.3	3.4	27.2	41.5
1957	351.1	11.7	3.3	26.0	45.0
1958	361.2	11.6	3.2	22.3	52.0
1959	383.5	12.6	3.3	28.5	44.2
1960	401.0	13.4	3.3	26.7	50.2
1961	416.8	13.8	3.3	27.2	50.7
1962	442.6	15.2	3.4	31.2	48.7
1963	465.5	16.5	3.5	33.1	49.8
1964	497.5	17.8	3.6	38.4	46.4
1965	538.9	19.8	3.7	45.2	43.8
1966	587.2	20.8	3.5	49.9	41.7
1967	629.4	21.5	3.4	47.3	45.5
1968	687.9	23.1	3.4	49.8	46.4
5-YEAR AVERAGES					
1954 through 1958			3.3		44.5
1959 through 1963			3.4		48.7
1964 through 1968			3.5		44.8

Sources of data: U.S. Department of Commerce, Survey of Current Business (1967 biennial supplement; 1969 national income accounts issue).

MEMORANDUM

SECTION 305—POLICY CONSIDERATIONS RELATING TO CONVERTIBLE PREFERRED STOCK AND SECURITIES

Section 421 of H.R. 18270 would amend Code §305 to provide that where a common shareholder receives a stock dividend which increases his proportionate ownership of a company, and that stock dividend is related to a cash dividend paid to other shareholders, the distribution of the stock dividend is a taxable event. Although we think that the present rules, which ignore shifts in proportionate interest as a basis for taxing stock dividends, have worked satisfactorily, we do not dispute that the conjunction of these two conditions can be considered an appropriate cause for imposing a tax. Thus, we would agree as follows with these results of H.R. 18270:

Example 1. If A and B each own 50 shares of the common stock of Company X and on January 1, 1970, Company X pays a stock dividend to A and a cash dividend to B, there is cause for a tax to A with respect to his stock dividend since A owns more of Company X than he did before.

Example 2. If A owns all the common stock of Company X and B owns all of the non-convertible preferred stock of Company X, and on January 1, 1970, Company X pays a dividend in common stock to A and a dividend in cash to B equivalent to the fair market value of A's common stock dividend, there is not ade-

quate cause for a tax to A since he owns no more of Company X after the stock dividend than he owned before. Both before and after the stock dividend A owned all of Company X over and above the liquidating value of B's preferred stock.

However, we disagree with the policy reflected in H.R. 13270 concerning preferred stock or debt which is convertible into common stock. Specifically we object to the conclusive presumption that a mere right to convert a preferred stock into common stock justifies treating the preferred stock as common stock for determining whether the common shareholder has realized a proportionate increase in his ownership of the company.

Unless, of course, the convertible preferred stock is treated as common stock, the common shareholder could not be said to have an increase in his proportionate interest by reason of his receipt of a stock dividend, since both before and after receiving his stock dividend he would own all of the company's assets in excess of the liquidating value of the preferred stock or the amount of the debt. To illustrate:

Example 3. A owns all of the common stock of Company X and B owns all of Company X's preferred stock which is convertible into common stock on a share-for-share basis. On January 1, 1970, Company X pays a cash dividend to B and a dividend in common stock to A equivalent to the value of B's cash dividend. B continues to hold his preferred stock which remains convertible on a share-for-share basis.

Under H.R. 13270, A would be taxed on his stock dividend because his proportionate interest has increased, invoking the conclusive presumption that B owns common stock and not preferred stock. In short, H.R. 13270 argues that Example 3 is the same as Example 1 which involves only common stockholders.

We say, also referring to Example 3, that there is no cause for a tax to A on his stock dividend because A's proportionate ownership has not increased. B's preferred stock remains preferred stock until he converts and until then B is not entitled to participate in Company X's assets over and above the liquidating value of his preferred stock. If conversion never occurs, as frequently is the case, B's preferred stock results is no more change in ownership than the nonconvertible preferred stock in Example 2 where the stock dividend to A is not taxable.

What represents the sounder tax policy? For the following reasons, we submit that the choice should be in favor of our point of view and against the policy suggested by H.R. 13270.

1. No matter what the circumstances, the proportionate interest of a common stockholder can only be decreased because of a convertible preferred stock. If conversion does not occur, his interest remains the same, and surely he should not be taxed because his proportionate interest might have been decreased by conversion but wasn't.[5] If conversion does occur, this proportionate interest necessarily decreases.

Example 4. A owns all the common stock of Company X and B owns all the preferred stock which is convertible into common stock on a share-for-share basis. Before conversion, A's proportionate interest in the assets over and above the liquidating value of the preferred stock of Company X is 100%. If B's preferred stock is redeemed and not converted, A never owns less than 100%. If, however, B converts his preferred stock into common, A's proportionate interest drops to 50%.

Referring to Example 4 above, H.R. 13270 holds that if B lets his conversion right go unexercised, in whole or in part, A's proportionate interest is increased as a result thereof. This is incorrect. The real thrust of H.R. 13270 is that, even though A's proportionate interest has not increased, he should be taxed if the possibility that B could decrease A's proportionate interest by converting is either reduced or terminated.

2. The conclusive presumption of H.R. 13270 that a right of conversion justifies treating a convertible preferred stock or a convertible bond as common

[4] All convertibles or rights to acquire common stock are treated as common stock under H.R. 13270. Thus, convertible bonds or debentures, warrants, and rights are classed arbitrarily as common stock. We generally speak of convertible stock, but such reference should be understood to include the other affected securities.

[5] If the conversion privilege expires without exercise, the consequences of taxing the common stockholder are so demonstrably absurd we presume an exception will be made. However, it is difficult to justify imposing a tax when the conversion right expires 20% a year for five years, but not imposing a tax when the entire conversion right lapses at the end of the fifth year.

stock has no factual basis. Indeed, the presumption of conversion is made even where conversion is improbable. Whether or not a preferred shareholder will convert into common stock depends on economic factors and investment judgments.

Example 5. On January 1, 1970, the common stock of Company X, which pays no cash dividend but pays a 3% annual stock dividend, sells for $40 a share. The preferred stock of Company X, which pays $2.00 a year and isconvertible into .7 shares of common, also sells for $40 a share. The equivalent value of the underlying common into which the preferred is convertible is $28.

Under the circumstances in Example 5, it is plain that the preferred shareholder will not convert even if the conversion right is to terminate the next day.

3. Tax laws should be explainable and a common stockholder, sophisticated or otherwise, would never understand why he should be taxed because a preferred shareholder failed to exercise his conversion privilege. He would understand (correctly) that if the preferred shareholder converts into common stock, his percentage ownership of the common stock, and thus of his company, would be less. The common shareholder would justifiably think anyone irrational who could find a profit in such a situation for him. Even if it could be said that a common shareholder theoretically owns more of a company merely because a preferred shareholder lets his conversion right go unexercised or to be reduced, if would be a rash assumption that the market place would necessarily place an increased value on his common stock.

4. The common stockholder has no control over the preferred shareholder and no right to elect between a stock dividend or a cash dividend.

5. If a tax is levied on the common stockholders on the theory that conversion has occurred and if conversion never occurs, the common stockholder has obviously been taxed on something he never got. For this reason alone, H.R. 13270 cannot be the right answer.

6. Treating a convertible preferred stock as common stock is not involved in the provisions that would tax a preferred shareholder if he becomes entitled to more shares of common stock on conversion (other than by adjustments designed to protect the conversion right against dilution). H.R. 13270 would apparently tax a preferred shareholder on any distribution to him of stock or right to stock, whether or not that distribution is related to a cash dividend. This would not be disturbed by the argument we are making.

7. H.R. 13270 will complicable legitimate corporate financing involving convertible stock and securities and in many instances will foreclose the use of such type of financing. Convertible stock and securities have been used for many years because they minimize the cost of financing and benefit existing shareholders. Our count shows that as of April 21, 1969, there were outstanding over 700 issues of convertible preferred stock and securities, involving almost as many issuers. It would be most unfortunate if Congress adopts a policy which impedes the use of convertible stock and securities, particularly today when interest rates are extraordinarily high.

Under the policy of H.R. 13270 that a convertible preferred stock or bond should be regarded as common stock, many convertible stocks and securities used today could create significant and unexpected consequences to the common stockholders. An example is the 5¼% convertible subordinated debentures issued in 1966 by a large American metals company which are convertible into the issuer's common stock at $85 a share and 5% of which must be retired each year beginning in 1977.

There are at least two aspects of these debentures, mentioned below, which could (and as we understand H.R. 13270 would) create a taxable situation for the common stockholders. This situation would exist nothwithstanding that the value of the debenture, if converted into common steok, is less than the value of the debenture as a debt, thus making conversion improbable.

(1) The debenture holder's conversion right is protected against dilution resulting from an increase in the number of common shares, except that such protection does not extend to stock dividends on the common stock which are 5% or less of the outstanding common stock. In other words, the issuer could pay common stock dividends to its common shareholders up to 5% before the conversion rate of the debentures is adjusted. Provisions of this kind are common. Viewing the debentures as common stock, as H.R. 13270 requires, the common shareholder will be charged with getting an increase in his proportionate ownership with each stock dividend he receives up to 5%. The common shareholder would accordingly be taxed if there is a related cash dividend, and ap-

parently the interest paid on the debentures would be regarded as a related "cash dividend".

(2) The annual retirement of 5% of the debentures reduces the potential for dilution of the common shareholder's proportionate interest. That is to say, a debenture which is paid no longer exists and cannot be converted. This provision for annual retirement, also a usual type provision, is a plan of periodic retirement, similar in effect to reduction of the conversion ratio of the entire issue, and under H.R. 13270 also would create a taxable situation for the common stockholders.

Another typical financing situation with which H.R. 13270 will improperly interfere is illustrated by the following example:

Example 6. M Company is a growing company in the motel business. Because of its decision to finance itself to the maximum extent through earnings, it pays no cash dividends and in lieu thereof pays an annual stock dividend of 3%. In order to raise $100,000,000 to build new motels, it negotiates with a group of banks for a loan. The banks agree to lend at a rate of 9½%. The interest requirements would severely hamper M Company so it enters into negotiations for a lower interest rate with the debt being convertible into its common stock. A tentative interest rate is set at 6.5%. However, M Company wants its annual 3% stock dividend to be excused from the provision protecting the creditor's conversion right from dilution because of an increase in the outstanding common shares. The banks agree but insist on a compensating increase in the interest rate to 7%.

In Example 6, the common shareholders of M Company have "paid" for their stock dividend through the higher interest rate but are able to preclude the further dilution of their ownership which would result from adjusting the conversion rate for the stock dividends. Under H.R. 13270, this would no longer be feasible since the stock dividends would be taxable. M Company would, as a practical matter, have to give its creditors 100% protection again dilution, thus increasing the common shareholder's exposure to dilution.

CONCLUSION AND RECOMMENDATIONS

In our judgment, the considerations stated above show that it would be unwise and unsound to tax a common shareholder with respect to stock dividends received by him (actually or constructively) because of the existence of a bona fide convertible preferred stock or security. We recommend that the contrary policy reflected in H.R. 13270 be abandoned.

It is stated on page 116 of the Report of the Committee on Ways and Means that the purpose of the proposed amendments to § 305 is to deter publicly-held corporations from adopting "a capital structure with two classes of common stock so that their stock could be sold both to investors desiring appreciation and to investors desiring a current income". The soundness of this objective is highly questionable. It is in the public interest for corporations to be allowed to finance themselves internally through retained earnings to the maximum extent possible.

Assuming that the concern expressed by the Committee deserves alleviating, the remedy should not go beyond that concern—that is, the remedy should apply only to situations involving two classes of common stock and should not extend to situations where the second class of stock is "true" preferred stock. This is true even if the investor can convert his preferred stock into common stock, because conversion will be entirely a product of investment judgment exercised in the light of numerous market factors. The decision whether to convert or not to convert will not depend on just whether the holder wants a cash dividend or a stock dividend.

We recognize that it is possible to characterize a stock as a preferred stock when, in essence, it is a common stock—e.g., a "preferred" stock whose only preference is a $1.00 liquidating value. Obviously, such a stock will be regarded in the market place as a common stock.

Accordingly, we recommend:

1. Section 421 of H.R. 13270 should be amended to exclude as a taxable distribution of stock to a common shareholder any stock distribution which is related to a cash dividend paid with respect to convertible preferred stock.

2. For purposes of *1* above, § 421 of H.R. 13270 should also be amended to provide that a preferred stock is a stock possessing the following characteristics:

(a) The stock cannot be redeemed until five years after issuance.

(b) A fixed cumulative cash dividend is payable at least annually in preference to cash dividends on the common stock.

(c) The stock has a preference in the event of liquidation, and such preference is established at an amount which is, as of the time when the preferred stock is initially issued, at least 110% of the book value of the common shares into which the preferred stock is convertible.

(d) The redemption value is established at an amount which is, as of the time when the preferred stock is initially issued, at least equal to the fair market value of the property exchanged therefor. If the redemption value equals the fair market value of the property exchanged therefor at any time within the 12 months preceding the exchange, this test will be deemed satisfied.

A stock which does not possess these characteristics, even though it is called preferred stock and is listed as a preferred stock, would be treated as a common stock for purposes of § 305. Appropriate standards can, of course, be provided for convertible bonds.

(There follows, communications received by the committee expressing an interest in the subject of stock dividends:)

ARTHUR ANDERSEN & CO.,
Chicago, Ill., September 12, 1969.

Re statement regarding H.R. 13270, Tax Reform Act of 1969—Stock dividends.

Committee on Finance,
New Senate Office Building,
Washington, D.C.

SUMMARY OF COMMENTS AND RECOMMENDATIONS

DEAR SIR: 1. The status of preferred stock issued in corporate reorganizations should be clarified.

2. The provisions should be limited in scope to avoid problems of noncompliance through failure to understand the intricate rules.

BASIS FOR COMMENTS

1) Clarification of status of preferred stock issued in corporate reorganization

The provisions of Section 421 of the House Bill are very complex and cover a number of areas of imputed income. Complexity of the provisions is emphasized by the fact that the Secretary of the Treasury, or his delegate, is empowered to prescribe regulations to cover areas in which, apparently, the House did not feel that Congress would adequately describe the rules itself.

While the new provisions are cross-referenced to the sections of the Code relating to corporate organizations and reorganizations, the section should be limited by the provisions in Section 351, et. seq. of the Code.

We are concerned that the proposed section, on the regulations to be issued, could be interpreted to render taxable a transaction which has long been recognized to be a nontaxable corporate reorganization supported by strong business reasons. We refer to the situations where the parents own a substantial part or a majority of the stock in an operating corporation whose management is being assumed by the children. In this situation the Commissioner has frequently ruled that a recapitalization of the corporation with preferred stock (usually with a cumulative cash dividend requirement but not convertible) exchanged for all of the stock of the parents is a nontaxable recapitalization because of the strong corporate business purpose of management being in the hands of the common stockholders.

2) Limit scope to avoid noncompliance

In its general explanation of the Bill the House Committee, on page 114, anticipates that the regulations may provide that if a corporation has common stock, on which it pays no dividends, and preferred stock, which receives regular cash dividends, with a decreasing convertible feature to adjust for the cash dividends then "the holders of the common will be treated as receiving stock in a disproportionate distribution under Section 305(b)(2)." This would result in ordinary income to them.

It is difficult to understand why a cash basis taxpayer has received taxable income from a decrease in the conversion ratio of another stock. It is doubtful

that stockholders generally or dividend reporting services will have sufficient information to determine whether or not there is income.

The present revenue effect of the provision is negligible; it is the future that the House fears. But their concern seems directed to a relatively simple situation (two classes of common with one paying stock dividends and one paying cash dividends). Where stock provisions are unduly complicated we doubt that there is understanding and acceptance by investors. Accordingly, we suggests that the section be simplified and limited.

SUMMARY

The foregoing comments are not intended to indicate an approval or disapproval of the remaining portions of the Act, but are only indications of technical areas which obviously need simplification. This statement is submitted as part of a series of letters, each dealing with a particular area of the proposed legislation.It is intended that the comments and suggestions contained herein be made part of the record of testimony relative to the legislative changes contemplated for stock dividends. We shall be pleased to discuss these matters further with you or the Committee, either in person or by telephone. Please call us collect at 312-346-6262 if necessary.

Very truly yours,

JOHN MENDENHALL,
Director of Taxes.

NATIONAL SMALL BUSINESS ASSOCIATION,
September 11, 1969.

Hon. RUSSELL B. LONG,
Chairman, Committee on Finance, U.S. Senate, New Senate Office Building, Washington, D.C.

Dear CHAIRMAN LONG: National Small Business Association supports the statement of Mr. George C. Williams, President of the National Association of Small Business Investment Companies, with respect to Section 421 of H.R. 13270.

The proposed Section 421 would complicate the financing of smaller corporations with respect to convertible stock and securities. In some respects it could preclude the use of such type of financing.

Incorporation of this letter into the record of hearings on H.R. 13270 will be appreciated.

Sincerely,

JOHN LEWIS, *Executive Vice President.*

CHRYSLER CORP.,
September 3, 1969.

Re H.R. 13270—The Tax Reform Act of 1969.

Subject: Section 421—Stock Dividends.

Hon. RUSSELL B. LONG,
Chairman, Committee on Finance,
U.S. Senate, New Senate Office Building, Washington, D.C.

GENTLEMEN: Chrysler Corporation ("Chrysler") welcomes the opportunity to submit a written statement presenting its views with respect to those provisions of H.R. 13270 dealing with Stock Dividends (Section 421).

The principal point of this statement is that Section 421 of the bill should be clarified by specifically excluding from the operation of proposed Section 305(b)(2) of the Code those systematic stock redemptions which enable individuals unrelated to the redeeming shareholder to become the owners of their own businesses.

Products of many businesses are distributed to the public through retail stores which require a substantial investment. In many cases it is very difficult or impossible to find individuals who are experienced in selling a particular product and who also have the requisite capital. Businesses have often resolved this problem by establishing experienced salesmen as managers of company-owned stores and giving such managers a second class of stock under an arrangement whereby the remaining outstanding stock held by the manufacturer must be redeemed with profits of the retail store (or acquired by the operator out of such funds as his salary, bonus, etc). Such systematic redemptions of the entire interest of a stockholder (the manufacturer) should not result in adverse tax consequences to the salesman-manager (the continuing shareholder).

Where a continuing shareholder's interest in a small business is increased solely because another shareholder's stock is redeemed by his corporation, as in the dealer situation described above, the continuing shareholder would merely own a greater percentage of a corporation whose asset value has declined proportionately. For example, a person who owns 50% of a corporation worth $100 should not be penalized because his interest has changed to that of a 100% owner of a corporation worth $50. In its present form, Section 421 of the bill would, in effect, improve dividend income to the individual-manager-shareholder, who would realize no current economic benefit from the redemption justifying such tax treatment. Such a result would be inequitable and should not be engrafted upon the stock dividend rules of Section 305 of the Code.

Yours very truly,

BRIAN T. O'KEEFE,
Assistant Comptroller.

Senator ANDERSON. Mr. Howard Lee.

STATEMENT OF HOWARD M. LEE, PRESIDENT, EMPLOYEE RELOCATION REAL ESTATE ADVISORY COUNCIL; ACCOMPANIED BY JAY GLASMANN, TAX COUNSEL; AND WILLIAM SATTERLEE, CHAIRMAN, BOARD OF DIRECTORS

Mr. GLASMANN. Mr. Chairman, I am tax counsel for Employee Relocation Real Estate Advisory Council.

I have with me today the president of ERREAC, Mr. Howard Lee, and the chairman of the board of ERREAC, Mr. William T. Satterlee.

Mr. Lee is manager of real estate and taxes for the Kraft Food Division, Kraftco Corp., and Mr. Satterlee is with Dow Chemical, director of personal services.

Mr. Lee.

Mr. LEE. Mr. Chairman, we appreciate this opportunity.

ERREAC—Employee Relocation Real Estate Advisory Council—strongly supports the enactment of legislation along the line of section 231 of the bill to keep our Government from unjustifiably inflicting tax hardship each year on an estimated half-million employment-related family moves, including military, civil servant, and private business.

ERREAC was formed by representatives of private industry in 1963 to facilitate and promote the exchange of information among those responsible for the relocation housing programs of their respective companies. At this time, ERREAC's membership consists of more than 250 U.S. corporations, including many of the Nation's major employers.

For the past 3 years, ERREAC has actively supported the efforts of a large bipartisan group of Congressmen and Senators to obtain urgently needed corrective legislation dealing with the tax treatment of moving expenses. The ERREAC membership is most appreciative of the efforts of the many Congressmen and Senators who have taken an active interest in the moving expense problem. Business-related family relocations for Government and industry employees have one thing in common. They entail a great deal of expense.

For many years private industry has recognized the importance of being able to move employees from one geographical location to another, and that to achieve such job mobility, it is necessary to reimburse their employees for all or most of their moving expenses.

In 1966, with the enactment of Public Law 89-516, amending the Administrative Expenses Act of 1946, the Federal Government was at long last authorized by Congress to adopt moving expense reimbursement practices similar to those prevailing in private industry.

Unfortunately, since at least 1964, the IRS, with support from the courts, have taken the harsh view that all reimbursed moving expenses give rise to taxable income to the employee except for the "bare bones" cost of getting the employee, his family, and household goods from the old to the new job location. The next result, however, is that the Federal tax collector under existing law is subjecting thousands of employees to serious financial loss. It is unrealistic and unfair that an employee should be taxed on reimbursed expenses which the employee would not otherwise have had except to accommodate his employer.

ERREAC strongly supports enactment of the provisions of section 231 of the bill which would expand the definition of deductible moving expenses for employees now set forth in section 217 of the code.

While applauding the proposed addition to the code of the new categories of deductible moving expenses, ERREAC takes exception to the following major deficiencies in the bill which it is hoped will be corrected at this time by your committee.

One. The overall limitations of $2,500 per move for all the new categories of deductible moving expenses is too low for the average transferred employee who owns a house. The $2,500 limitation barely covers selling commissions and closing costs on disposal of a $30,000 home; leaving very little for the house-hunting trip, temporary living expenses, and out-of-pocket expenses incident to the acquisition of a residence at the new job location. The inadequancy of the $2,500 allowance is clearly evidenced by the fact that for just one of the new moving expense categories—selling expenses on the old residence—the Federal Government reimburses its employees up to 10 percent of the sales price of the house or $5,000, whichever is the smaller amount.

With continuing inflation, the flat dollar ceiling in the bill which is already inadequate will become increasingly a source of irritation and frustration to transferred employees. Flexible limitation similar to those covering the reimbursement of relocated Government employees under the Administrative Expenses Act of 1946 should be substituted for the $2,500 limitation in the bill.

Two. 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 would increase the 20-mile test to 50 miles. The 20-mile test of existing law should be retained. The substitution of a 50-mile test assumes an unreasonably long commuting pattern for employees whose principal place of work is changed.

What it comes down to is what is a normal and reasonable commuting distance for the average employee given today's clogged highways and inadequate transportation facilities? Should a man living in the Washington area be expected to commute daily to Baltimore or Annapolis, regardless of the inconveniences, or would a reasonable man move his residence to reduce the time and distance of the commute? Based upon such standards, we believe the proposed 50-mile test is completely unreasonable.

Three. The new moving expense rules should apply beginning with calendar year 1969, rather than with 1970 as proposed in the bill (p. 164, line 22, and p. 165, line 2). The Treasury Department last April 22 recommended a 1969 effective date. There is no sound reason for continuing until next year the existing inequities which, since the early 1960's have plagued industry and Government employees whose job locations are changed.

Mr. Chairman, we thank you, and if there are any questions we would hope that we could come up with the answer.

Senator ANDERSON. I do appreciate it a whole lot. We have had this moving question many times.

Senator BENNETT. I just have one. You are supporting the House bill. You are not asking for any further liberalization of that part of the House bill which refers to——

Mr. GLASMANN. Senator Bennett, we would recommend three amendments to the House bill. One would be to have a more flexible dollar limitation. The present bill has a ceiling of $2,500. We are suggesting that the Finance Committee consider something along the lines of the limitations imposed when a Federal employee moves, as specified in regulations issued by the Bureau of the Budget under the Administrative Expenses Act of 1946. We are also suggesting that the existing 20-mile rule which determines whether you have a move which qualifies under section 217 of the Code be retained rather than having a shift to 50 miles. Under the 50-mile rule, for example, in your own State, a man living in Brigham City and working in Ogden if he were moved to the other side of Salt Lake City, say Tooele, would not be eligible for a moving expense deduction because he would not meet the bill's 50-mile test even though he would have to drive perhaps 70 miles to work.

Similar hardship situations have been called to our attention. For example, a man working in New York living on Long Island, might have his job location changed to some place in Connecticut, and that would only be perhaps 20 or 30 miles across Long Island Sound, but he would not qualify under the 50 mile because this test is applied as the crow flies rather than by the actual road distance. This sort of thing we think should be corrected. Other examples of this type have been brought to our attention where as man would have to pay expensive toll bridge costs. For example, in Delaware, anyone driving from, well, we will say Dover up to Wilmington working in Wilmington who might be transferred to Philadelphia, the other side of Philadelphia, would not be eligible under this 50-mile rule even though he would have that big toll to pay on the Delaware bridge and would have all the expenses that go with such a long commute.

Our final recommended change is with respect to the effective date. We think the bill should be effective for moves in 1969 rather than waiting until 1970.

Senator BENNETT. Fine.

(Howard M. Lee's prepared statement follows:)

STATEMENT OF HOWARD M. LEE, PRESIDENT, EMPLOYEE RELOCATION REAL ESTATE ADVISORY COUNCIL

ERREAC (Employee Relocation Real Estate Advisory Council) strongly supports the enactment of legislation along the lines of § 231 of the Bill to keep our Government from unjustifiably inflicting tax hardship each year on an estimated

half million employment related family moves (including military, civil servant and private business).

ERREAC was formed by representatives of private industry in 1963 to facilitate and promote the exchange of information among those responsible for the relocation housing programs of their respective companies. At this time, ERREAC's membership consists of more than 250 U.S. corporations, including many of the Nation's major employers. Over the past 5 years, the purpose of ERREAC has broadened to include the study and development of methods and procedures whereby the sale of homes by employees who are teransferred by their employers to different geographical locations may be accomplished with a minimum of economic loss to the employee and his employer. Membership in ERREAC is open to all companies who transfer employees from one job location to another and who are interested in furthering the study and solution of the problems encountered by relocated employees, with particular emphasis on the acquisition and disposition of their homes.

For the past 3 years, ERREAC has actively supported the efforts of a large bipartisan group of Congressmen and Senators to obtain urgently needed corrective legislation dealing with the tax treatment of moving expenses. The ERREAC membership is most appreciative of the efforts of the many Congressmen and Senators who have taken an active interest in the moving expense problem.

The problem which § 231 of the Bill would meet is very simple. Day in and day out, thousands of Americans are expected by private business or by the Government to pack up and move from one part of the country or world to another. These are not optional moves. For those who value their jobs and careers they are for the most part compulsory. They are dictated by the needs not of employees, but of employers.

Such moves may be the result of an opening of a new installation, a change in location of corporate headquarters, a transfer from one office or plant to another, or any one of a number of other valid and important business reasons. In general, employees who are transferred by private industry are not wealthy people; they are middle income, lower and middle echelon employees—salesmen, engineers, and the like—earning between $7,000 and $15,000 a year. In many cases—perhaps as many as two-thirds, according to ERREAC estimates—the moves are not connected with a promotion.

They may involve a sidewise or lateral job opportunity for the employee. This is particularly true in the case of a mass move brought about by the opening or closing of a plant or other major facility.

Also, according to a 1968 survey by Atlas Van Lines, most transferred employees of major corporations tend to be young—about 40 percent are between 25 and 35 and nearly two-thirds are under 45—and most must anticipate moving several times during their job careers.

Regardless of the reason for the transfer or the age or salary level of the transferred employee, business-related family relocations have one thing in common: They entail a great deal of expense.

Among the many costs involved are:

1. The expense of transporting family members and household goods to the new job location (including temporary storage).
2. The costs of selling a house or terminating a lease at the former location.
3. The cost of searching for a residence at the new location.
4. Meals and lodging for the employee and his family while awaiting arrival of their furniture or availability of their residence.
5. Expenses incident to the purchase of a residence at the new place of work, such as legal fees, title search, recording fees, and so forth.
6. Loss suffered by the transferred employee on the sale of his old residence for less than its fair value because of the necessity of selling his home and moving to the new location without delay.
7. Miscellaneous or incidental expenses resulting from the move, such as forfeited tuition fees, costs of disconnecting and reconnecting appliances, and the like.

For many years private industry has recognized the importance of being able to move employees from one geographical location to another, and that to achieve such job mobility, it is necessary to reimburse their employees for all or most of their moving expenses of the types previously mentioned.

In 1966, with the enactment of Public Law 89-516, the Federal Government was at long last authorized by Congress to adopt moving expense reimbursement practices similar to those prevailing in private industry, including reimbursement for one round trip to the new location for the employee and his spouse to search for a residence, living expenses for the employee and his family for a period of 30 days while occupying temporary quarters, real estate expenses resulting from the transferred employee's sale or purchase of a residence, or settlement of a lease on rented quarters, and a flat allowance to cover miscellaneous moving expenses. In effect, subject to certain limitations, the Federal Government's reimbursement practices were brought into line with those of private industry, with the single exception that the Government was not permitted to reimburse for "house losses" (item 6 above for private industry).

Unfortunately, the efforts on the part of responsible employers, both Government and private, to ease the financial hardship to the employee who is moved for the business convenience of the employer have been partially thwarted by the Internal Revenue Service and the courts.

Under the Internal Revenue Code, as interpreted (at the insistence of the Internal Revenue Service and the Justice Department) by the courts in recent cases such as *Bradley v. Commissioner*, 324 F. 2d 610 (4th Cir. 1963); *England v. United States*, 345 F. 2d 414 (7th Cir. 1965); *K[illegible]er v. United States*, 393 F. 2d 827 (Ct. Cls. 1968); and *Commissioner v. Starr*, 399 F. 2d 675 (10th Cir. 1968); it is now all too clear that reimbursement of moving expenses, other than actual transportation costs and subsistence while en route, results in taxable income to the employee.

The legal theory which permits this result is that the reimbursed employee has received a taxable benefit because he is better off financially than he would have been had he been forced to move without reimbursement. The net result, however, is that the Federal tax collector under existing law is subjecting thousands of employees to serious financial loss, even as their employers, including the U.S. Government, are doing their very best to prevent such hardship. This absurd and grotesque result must not be permitted to continue. It is unrealistic and unfair that an employee should be taxed on reimbursed expenses which the employee would not otherwise have had except to accommodate his employer.

Some prosperous companies, it is said, can ameliorate this problem by paying a transferred employee an allowance over and above his moving expenses to cover the tax imposed by the Internal Revenue Service on most of the reimbursed items of expense. This can and is being done in greater or lesser degree by many ERREAC members. But is it a sound procedure for the Government to force the cost of employee moves up by such a tax "gross up"?

This increased cost factor, aside from its inflationary features if passed on to the employer's customers, can only discourage labor mobility to some degree.

On the other hand, what about the employees of smaller or less prosperous companies which may not be able to afford the employee's tax bill (including the tax on a tax)? And what about the employees of the Federal Government which is barred by law from reimbursing them for income taxes incident to reimbursed relocation costs? For all such employees, the taxation of reimbursed moving expenses seriously dilutes the benefit of the reimbursement, and job mobility necessarily suffers. Moreover, the present situation would appear to discriminate unfairly against them as compared to the employees of large, financially strong corporate employers.

For the above reasons and others, and because the inequities of the present harsh Internal Revenue Service position are so readily apparent, there has been a ground swell of support in Congress for liberalizing the moving expense tax rules.

ERREAC, in accordance with the unanimous vote of its board of directors last December, strongly supports the provisions of § 231 of the Bill which expand the definition of deductible moving expenses for employees now set forth in section 217(b) of the Internal Revenue Code to include:

(a) A pre-move house hunting trip or trips by the employee and members of his household;

(b) Temporary living expenses at the new employment location for not more than 30 days while awaiting occupancy of permanent quarters;

(c) Selling commissions and other expenses incident to the sale of the employee's old residence or to the settlement of an unexpired lease on the employee's old residence;

(d) Out-of-pocket costs incident to the purchase or rental of a residence at the new job location.

Addition of the above categories to the already excludable or deductible "bare bones" transportation costs of present section 217 will be a substantial forward step in assuring fair tax treatment for relocated employees. Moreover, as the bill covers all transferred employees, whether reimbursed or not, on an equal footing, a past Treasury objection against having the bill cover only reimbursed employees has been eliminated.

While applauding the proposed addition to the Code of the new categories of deductible moving expenses, ERREAC takes exception to four deficiencies in the Bill which it is hoped will be corrected by your Committee.

1. The overall limitations of $2,500 per move on the new deductions is too low for the average transferred employee who owns a house. Thus, this $2,500 limitation on the deductible expenses in the new categories for the home owner barely covers selling commissions and closing costs on disposal of a $30,000 home, leaving very little for the house hunting trip, temporary living expenses and out-of-pocket expenses incident to the acquisition of a residence at the new job location. The very modest nature of the $2,500 allowance is also evidenced by the fact that for selling expenses on the old residence alone, civilian Government employees may be reimbursed (under the amendments made by Congress in 1966 to the Administrative Expenses Act of 1946) up to 10 percent of the sales price of the house or $5,000, whichever is the smaller amount.

With continuing inflation, the flat dollar ceiling in the Bill which is already inadequate will become increasingly a source of irritation and frustration to transferred employees. ERREAC recommends, therefore, that flexible limitations similar to those provided for reimbursement of relocated Government employees under the Administrative Expenses Act of 1946, as amended in 1966, be substituted for the overall dollar limitation of the Bill. See appendix A for ERREAC's specific suggestions on appropriate limitations.

2. 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 would increase the 20 miles test to 50 miles.

Many members of ERREAC are very much concerned about this proposed increase in the mileage test for qualifying for deduction of moving expenses. For any major company with many individual business locations scattered throughout the country, the effect of this change is most undesirable. The net effect is that unlucky employees who may already be commuting a considerable distance to work are exempted to increase the commute up to 50 miles each way every working day if their place of work is changed, rather than move closer to the new job location.

We believe this is completely unrealistic. By way of example, under the proposed legislation, an employee living in Brigham City, Utah and working in Ogden (about 22 miles apart) would be denied a moving expense deduction if he moved to the Salt Lake City area (35 miles from Ogden and about 53 miles from Brigham) because of a transfer of his principal place of work to Salt Lake. And a man living any place between Dover and Wilmington, Delaware and working in Wilmington would get no deduction for moving expenses if required to move to the far side of Philadelphia because of a job connected transfer.

What it comes down to is what is a normal and reasonable commuting distance for the average employee given today's clogged highways and inadequate transportation facilities? Should a man living in the Washington area be expected to commute daily to Baltimore or Annapolis, regardless of the inconveniences, or would a reasonable man move his residence to reduce the time and distance of the commute? Based upon such standards, we believe the proposed 50 mile test is completely unreasonable. While there is no particular magic to the present 20 miles test (determined incidentally by the IRS on a straight line basis, irrespective of obstacles such as bays, rivers, lack of roads, etc.), at least it permits the deduction of moving expenses on a basis which the average man and the Treasury Department feel to be within the bounds of reason. Moreover, to the extent mobility of labor is regarded as desirable, the proposed 50 miles rule would obviously have a negative effect on those employees who are being asked to move to new job locations between 20 and 50 miles farther from the old residence than were their old job locations.

3. The new proposals (both those ERREAC which supports and those we find objectional) apply with respect to moving expenses or incurred in taxable years beginning after December 31, 1959. ERREAC strongly recommends that the liberalizing changes apply to moves made in 1969, as recommended by the Treasury

Department last April when it first presented its tax reform proposals to the Ways and Means Committee.

From a procedural standpoint, one thing that apparently delayed action on moving expense legislation during 1966, 1967 and 1968 was the absence of a formal Treasury Department report on the many pending bills. This deficiency was taken care of early this year. Under such circumstances, ERREAC strongly recommends that the obvious inequities in the taxation of moving expenses not be permitted to continue beyond the date proposed by the Treasury Department last April. In fact, in all fairness to Federal Government employees and to those in industry not fully reimbursed for the expenses of their jobs connected moves, a good case can be made for applying the change retroactively to 1966.

4. With the three modifications outlined above, ERREAC supports the enactment of § 231 of the Bill. However, it should be pointed out that the Bill fails to cover two categories of moving expenses which are frequently the subject of reimbursement in the case of employer directed moves in industry. These are "miscellaneous moving expenses" and "house losses."

One of the amendments made by Congress in 1966 to the Administrative Expenses Act of 1946 authorized the reimbursement of so called miscellaneous moving expenses for civilian Government employees through an allowance related to the employee's salary and family status. P.L. 89–516. ERREAC believes that the regulatory and statutory conditions, requirements and limitations on the payment of the miscellaneous moving expense allowance to be transferred employee of the Federal Government can appropriately be adopted in providing a deductible "miscellaneous moving expense category" for all relocated employees. Thus, a miscellaneous expense category could be added to the Bill providing for a maximum deduction equal to one or two weeks' pay depending upon family status, with the overall deduction being limited by the maximum pay scale for Grade GS–13.

ERREAC also suggests that at an appropriate time the committee should consider adding a house loss category to the list of moving expense categories receiving favorable tax treatment. To avoid possible abuse, it may be necessary to limit the availability of the house loss deduction to those cases where the loss is reimbursed by the employer and there is, hence, a built in, self policing device. This provision would be similar to that approved by the Senate in 1964, but eliminated in conference, in connection with the consideration of the Revenue Act of 1964.

Finally, we would point out that confusion has been created by the unqualified statement at page 77 of the Ways and Means Committee Report on the Bill that moving expense reimbursements are wages subject to the withholding provisions of section 3401(a) of the Code. As we understand it, section 3401(a)(15) specifically excludes from any withholding requirement those reimbursed moving expenses which it is reasonable for the employer to believe are deductible by the employee under section 217. We believe it would be helpful if the Senate Report could include an appropriate reference to section 3401(a)(15) at the point the tax treatment of reimbursements is discussed.

Appendix A: Proposed Substitution of More Flexible Limitations by Category of Moving Expenses for Overall Limitation of $2,500 Provided in Bill

ERREAC recommends that the Bill's overall limit of $2,500 on the deductibility of the new categories of moving expenses (with expenses related to house hunting trips and temporary living expenses being limited to $1,000 of the $2,500) be modified to apply separate limitations on a category by category basis rather than on an overall basis and to provide more flexible limitations with respect to expenses incurred on the sale and purchase of a residence. The new limitations would be similar to the limitations provided for these items under the Administrative Expenses Act of 1946, as amended in 1966, by P. L. 89–516, when the Federal Government reimburses moving expenses of its transferred employees.

Specifically, ERREAC recommends the following limitations on the new categories of moving expenses.

1. *Residence sale.*—For reasonable expenses incident to the sale or exchange of the employee's former residence (p. 159, lines 14–20 of H.R. 13270), the limitation would be the smaller of 10 percent of the actual sales price of the residence or $5,000. This limitation is the same as provided at p. 26 of Bureau of the Budget Circular No. A–56, Revised October 12, 1966 for reimbursement of Federal civilian employees moving at the request of the Government.

2. *Residence purchase.*—For reasonable expenses incident to the purchase of a new residence in the general location of the new principal place of work (p. 159, lines 21–25) the limitation would be the smaller of 5 percent of the purchase price, or $2,500. See Budget Bureau Circular No. A–56, p. 26.

3. *Residence lease.*—The Bureau of the Budget regulations under Civil Service reimbursement law (P. L. 89–516) do not set forth specific dollar limitations for expenses incident to the settlement of an unexpired lease on the employee's former residence, or for the acquisition of a lease on a new residence in the general location of the new principal place of work (p. 160, lines 6–13). A reasonable dollar limitation in these areas would be $1,500 for settlement of an unexpired lease and $750 for the acquisition of a lease on a new residence.

4. *House hunting trips and temporary living expenses.*—For the combination of house hunting trip expenses and temporary living expenses up to 30 days at the new job location (p. 158, beginning with line 24 through p. 159, line 7, of H. R. 13270), the limitation of $1,00 now set forth in the bill (p. 160, line 15–20) appears reasonable at this time. The regulations under the Administrative Expenses Act of 1946 do not specify overall dollar amounts for these items, but instead apply per diem allowances, and specify the maximum duration of the house hunting trips. Budget Bureau Circular No. A–56, pp. 17 and 20. Limitations of this type, while representing a reasonable approach, might be difficult for the IRS and for employers to administer and are not recommended by ERREAC for this reason.

(There follow, communications received by the committee expressing an interest in the subject of moving expenses:)

STATEMENT OF THE BUSINESS EQUIPMENT MANUFACTURERS ASSOCIATION, NEW YORK, N.Y., SUBMITTED BY C. MATHEWS DICK, JR., PRESIDENT

The Business Equipment Manufacturers Association is comprised of 65 firms operating throughout the nation and specializing in the manufacture and sale of data processing equipment, office machines and office furniture equipment. This Association's membership represents approximately 85% of the total sales of this 12.5 billion dollar industry.

We wish to comment with respect to Section 231 of the Tax Reform Bill (H.R. 13270) passed by the U.S. House of Representatives which relates to job relocation expenses incurred by employees.

We submit that the public interest is better served by tax reform provisions which tend to increase, rather than decrease, the mobility of labor and thus to help achieve a dynamic and efficient economy. Although the proposed bill is intended to liberalize the tax treatment of some job relocation expenses incurred by an employee, we submit that the bill is, in some respects, counterproductive.

First, the bill sets a maximum deduction of $2,500 for those new categories of relocation expense it recognizes. Any additional reimbursed cost is subject to income tax, effectively reducing the net amount of reimbursement to an employee in meeting the cost of relocation. Such limitation on the amount which a presently employed person can deduct for these new categories of relocation expense appears patently inconsistent with the stated Congressional policy of maximizing employee mobility.

Second, we question the necessity for imposing severely restrictive mileage conditions to deductibility of moving expenses incurred by an employee who is required by his employer to move to a new job location. The implication of Section 231 is that an employee who is relocated should be prepared to *increase* his commutation distance by as much as 49 miles in metropolitan areas where a 20–25 mile commutation distance is already typical. In our opinion, this is both injust and unreasonable. For companies with numerous offices and plant locations throughout the country, this restriction would prevent substantial numbers of employees, who must as a matter of necessity move their residence when their job location is changed, from taking advantage of the new deductions, or even of utilizing those deductions presently permitted.

If the intent of the tax relief provisions of this legislation is to bring the tax implications of relocation expenses into line with a realistic view of individual necessity, we believe increasing the distance from 20 miles to 50 miles in order to qualify for tax deductions is a clear step in the opposite direction.

Accordingly, consistent with the liberalizing effect that the proposed moving expense provision is specifically designed to achieve, we recommend:

1. That the limitation of the proposed deductible amount of $2,500 for these new categories of relocation expense be eliminated where a presently employed person is reimbursed by his employer for expenses incurred in connection with relocating his residence so as to maintain his employment relationship at a new location with his present employer or with an affiliate of such employer, and

2. That if the present 20 mile test to determine eligibility for the relocation expense deduction cannot be reduced, at the very least that it not be increased by a new and additional 50 miles.

STATEMENT OF JOHN C. MASON, PRESIDENT, NATIONAL ASSOCIATED BUSINESSMEN, INC.

Mr. Chairman and Members of the Committee, I am John C. Mason, a member of the law firm of Mason, Knudsen, Berkheimer & Endacott, of Lincoln, Nebraska, and President of National Associated Businessmen, Inc., a business league of approximately 2,000 business corporations and businessmen.

National Associated Businessmen is wholeheartedly in favor of legislation to liberalize the present rules governing the tax treatment of moving expenses. We presented oral testimony on this subject before the Committee on Ways and Means last March. The members of our association, as employers, find the present moving expense rules unsatisfactory for several reasons: (1) they impede the most efficient use of available labor, (2) they put a strain on employer-employee relationships, and (3) they breed litigation and widespread confusion.

Our members believe that the provisions of H.R. 13270 (Sec. 231) represent a substantial improvement but that to be realistic they should be made somewhat more liberal.

BACKGROUND

Employers frequently find it necessary to transfer employees from one job location to another. Current estimates are that approximately a half million employees, including government, military and civilian, are requested by their employers to move to new job locations each year. Some employees are moved to new job locations as part of a training or sales program. Others are moved because their special skills are needed at a particular place at a particular time. Some transfers are made because the employer is opening new offices and others because the employer is closing old offices.

Recently, some employers have found it necessary to transfer sizable numbers of employees to different locations because of changes in the structure of the organization brought on by automation. One corporation, for example, transferred 2,329 employees in 1967 at a total cost to it of $5.4 million. Most of these moves were due to the installation of a computerized record-keeping system which required the centralization of the company's bookkeeping and accounting personnel. Whatever the reason for the move may be, however, employers know that they can operate their businesses more efficiently if they can transfer employees freely to new locations as the need arises. This is good for business and good for the economy.

THE PROBLEM

One factor which impedes the employer's ability to freely transfer employees is the heavy financial burden that must be borne by the transferred employee. Employees who are required to move incur substantial expenses in connection with the move. These include the cost of transportation to a new location, food and lodging enroute, transportation and storage of household goods and personal effects, house hunting trips, the cost of temporary quarters before a new residence can be obtained, expenses in connection with sale of the old home and purchase of a new one, and other miscellaneous expenses which are too numerous to enumerate. The heavier the financial burden, the more reluctance there is on the part of the employee to move to a new location.

In order to minimize the financial hardship on the employee, most employers reimburse their employees for part of the moving expenses incurred. Employers recognize that the cost of the move are incurred primarily for the benefit of the employer's business and, as such, they should properly be treated as overhead expenses of the employer. In short, it does not make sense to require the employee to pay for a move that is made for the benefit of the employer. We know of no employer, however, who has a completely make-whole reimbursement policy, and it is a rare case indeed where a transferred employee suffers no financial loss as

a result of a move even though he is reimbursed. The tax bite taken out of a large part of the reimbursement makes the situation worse.

Efforts made by employers to soften the economic blow on transferred employees have been frustrated by the present tax treatment of moving expenses. The Internal Revenue takes the position that an employee who is transferred by his employer to a new location must pay tax on part of the reimbursement received from the employer. The Service allows the employee to exclude from income that part of the reimbursement which covers the "bare-bone" expenses of the move; that is, the cost of transferring himself, his family and his household goods to the new job location. However, the Service requires that the remainder of the reimbursement be included in the employee's income, even though it covers other reasonable expenses associated with the move, such as the cost of house-hunting trips, expenses of selling the old and buying a new house, and temporary living expenses at the new location while awaiting permanent quarters. Some lower courts have disagreed with the Service although two Courts of Appeal and the Court of Claims have upheld the Service position.

In 1965, the Internal Revenue Service ruled that reimbursements covering the non-bare-bone expenses of a move constitute wages subject to withholding. Prior to that time, most employers were not withholding taxes and most employees were probably not including the reimbursements in income. Since 1965, most large employers have been withholding on moving expense reimbursements. It is difficult for the average employee to understand, however, why part of the reimbursement is taxable while another part is not.

In order to help solve the problem, some employers are now reimbursing employees additional amounts to enable the employee to pay the tax on the reimbursed moving expenses. Since the additional reimbursement is also subject to tax, some employers also reimburse employees for the tax on the tax. This progression could go on indefinitely, of course, but very few employers carry it past the second tax. Tax rules that encourage employers to pay their employees' tax and engender bewilderment on the part of employees do not produce a satisfactory system. Legislation is clearly needed.

Legislation to liberalize the moving expense rules would also end the expensive and protracted litigation that has been going on in this area; litigation which is particularly unfair to employees of small means. The present Internal Revenue Service position on the taxability of moving expense reimbursements stems from a 1954 Revenue Ruling. The ruling furnishes no reason—nor is one readily ascertainable—to explain why, on the one hand, reimbursements received for bare-bone expenses are *not* taxable while, on the other hand, reimbursements received for other reasonable expenses of the move *are* taxable. The difficulty of justifying the rule-of-thumb approach taken by the Service in its 1954 ruling has bred litigation and widespread confusion.

Sound legal arguments exist for excluding reimbursements for all the reasonable expenses incurred incident to an employer-directed move. Employees who have litigated the question have met with some success in the trial courts although not in the appellate courts. Because of the sympathetic approach taken by the lower courts, however, and because so many people are affected by the Service's position, litigation can be expected to continue until the Supreme Court decides the question—an action which, so far, the Court has refused to undertake.

The legal argument to support the non-taxability of moving expense reimbursements involves the proper application of the longstanding "convenience of the employer" rule. This rule deals with the crucial distinction between personal expenses of the employee and expenses which should be treated as overhead expenses of the employer's business. The rule recognizes that every benefit provided by an employer to an employee does not necessarily constitute income or compensation.

For example, an employer may provide his employees with desks or tools or a clean, well-lighted place to work. Yet no one would presume to argue that the value of those benefits should be taxed to the employees. The dynamic nature of the concept underlying the convenience of the employer rule is best expressed in the following comment by former Secretary of Labor and Supreme Court Justice, Arthur Goldberg:

"The line between (compensation and conditions of employment) is perhaps, not susceptible of precise definition. * * * it depends very much on what our current conception of the relative responsibilities of employer and employee happen to be. The question is whether the benefit in question is one which we regard as a proper responsibility which employers should supply for employees as a condition of employment wholly apart from the compensation for their work. And

the answers to that question vary from time to time. To the extent that benefits are usually or normally provided by employers, even though they may involve a saving to an employee over alternative methods of providing this facility by himself, then, to that extent the provision of such benefits should not be considered as compensation to the employee but as the provision of improved conditions of work * * *."

The expenses of moving an employee to a new job location fall within that category of expenses that are properly viewed as overhead expenses of the employer rather than compensation to the employee. The Service recognizes this when it permits the bare-bone expenses of a move to be converted, in a sense, into a business expense of the employer. The Service is arbitrary, however, in limiting application of the rule to the bare-bone expenses and in failing to recognize that other expenses incurred in the move should be treated the same way.

The cost of relocating employees is regarded today as a proper responsibility of the employer, and that responsibility does not end with the bare-bone expenses. Even the Government, under a recent amendment to the Administrative Expense Act, is authorized to reimburse a transferred employee for other than the bare-bone expenses. Public Law 89-516 passed by the Congress as H.R. 10607, authorizes reimbursement for the costs of a househunting trip, the cost of temporary quarters at the new post, expenses involved in selling the old house and buying a new one, and a flat amount to cover other miscellaneous expenses of the move.

In reporting out this amendment, the Senate Committee on Government Operations indicated a marked concern over the tax status of the reimbursements authorized by the bill, and, in the following language, expressly stated that reimbursements of this nature should not be taxed:

"The committee is of the view * * * that the general purpose and effect of H.R. 10607 would be seriously diluted if the benefits and allowances authorized thereunder are deemed taxable as income. In this regard the committee is in full accord with the following testimony given on this matter by John W. Macy, Chairman of the Civil Service Commission, before the House Committee:

"* * * the basic philosophy behind this legislation would indicate that this is not compensation, this is not additional income. This is reimbursement, and therefore, should not be taxable.

An amendment to exempt from taxation the reimbursements authorized by the bill was not adopted by the Senate Committee on Government Operations because of the jurisdictional problems that might have resulted, and because the Committee was aware that legislation similar to the proposed amendment was pending before the House Committee on Ways and Means, and the Senate Committee on Finance.

The fact that the Government itself, as an employer, does not view moving expense reimbursements as compensation for services highlights even further the untenable nature of the position currently being taken on the question by Internal Revenue. Expenses of moving employees are not "personal" expenses. They are part of the cost of doing business (and of operating a government) in a highly mobile society. As such they should be viewed as a condition of employment and not as compensation.

Legislative to liberalize the tax treatment of moving expenses is needed. The many employees involved in this controversy are people of limited means and the amounts involved are often small. Under these circumstances, they must either accept the arbitrary position currently being taken by Internal Revenue or undertake costly and time-consuming litigation. The situation is unfair, and should be remedied.

Moreover, the legislation would take up where the Congress left off in enacting H.R. 10607. The expression of Congressional concern over the taxability of the reimbursements authorized by H.R. 10607, when coupled with the obvious equities of a bill to bring relief to the moving expense area, clearly indicates that the time is ripe for passing this much needed legislation.

THE PRESENT LAW

As set forth in the Committee Report to accompany H.R. 18270:

"Present law allows, under specified conditions, a deduction from gross income for certain job-related moving expenses. The deductible expenses are those of transporting the taxpayer, members of his household and their belongings from the old residence to the new residence, including meals and lodging enroute.

The deduction is available to new employees and to unreimbursed transferred employees.

* * * * * * *

"Present law does not deal with reimbursed moving expenses other than to provide that no deduction is allowed for moving expenses for any item to the extent that the taxpayer receives reimbursement or other expense allowance for such item unless the amount of the reimbursement or other expense allowance is included in the taxpayer's gross income. Thus, if an employee has claimed a deduction for moving expenses and subsequently receives a reimbursement for these expenses which he does not include in his gross income, then he must file an amended return for the taxable year in which the deduction was claimed. Generally, the courts have held that reimbursements for those moving expenses which are presently deductible are not includible in gross income and that reimbursements for other moving expenses are includible in gross income."

PROVISIONS OF H.R. 13270

The bill provides that a moving expense deduction is to be allowed for three additional categories of expenses. The first additional category is expenses for premove house-hunting trips. The second additional category is temporary living expenses at the new job location. Qualified residence sale, purchase, or lease expenses constitute the third additional category of moving expenses for which a deduction is to be allowed.

The deduction for these additional categories of moving expenses is subject to an overall limit of $2,500, and the additional expenses related to house-hunting trips and temporary living expenses at the new job location is limited to $1,000 of the $2,500.

RECOMMENDATIONS

We believe that the provisions of H.R. 13270 represent a substantial improvement but that to be realistic they should be made somewhat more liberal.

We recommend that the limitation of $1,000 for expenses related to house-hunting trips and temporary living expenses at the new job location be changed to $2,500.00.

We also recommend that no specific limitation be applied to the expenses of selling the old house and buying a new one. Expenses falling into this category, like the present "bare-bone" expenses now permitted, should be deductible so long as they are reasonable in amount.

Even with this more reasonable treatment, some employees will still realize an economic loss because of the multitude of miscellaneous expenses generally incurred in connection with the move. The effect on the revenue of these recommended modifications should be more than offset, however, by the benefits to the economy that will result from the more effective utilization of the work force. In addition, and of paramount importance, the recommended legislation will help alleviate the economy hardships employees must now face when forced to move for the convenience of their employers.

STATEMENT OF AMERICAN TELEPHONE & TELEGRAPH CO., SUBMITTED BY W. C. MERCER, VICE PRESIDENT

American Telephone and Telegraph Company, for itself and its associated companies in the Bell System, submits this statement on the subject of Moving Expenses, section 231 of the bill. The Bell System companies support the provisions in that section of H.R. 13270 which expand the definition of deductible moving expenses. However, we urge that consideration be given to three modifications of the House bill.

1. RETENTION OF THE 20-MILE RULE

Under present law, the deduction for job-related moving expenses is conditioned upon the taxpayer's new principal place of work being located at least 20 miles farther from his former residence than was his former principal place of work. The House bill increases the distance from 20 miles to 50 miles.

On April 22, 1969, when the Treasury Department presented its tax reform proposals to the House Committee on Ways and Means, there was no suggestion that the 20-mile test was unsatisfactory. In fact, the Treasury Department recom-

mended that "the so-called 20-mile test contained in present law would not be changed." (House Ways and Means Committee Print, April 22, 1969, p. 253.) Moreover, when the House Ways and Means Committee reported H.R. 13270 out of Committee on August 2, 1969, there were 35 bills pending in that Committee on the subject of deduction of moving expenses and *none* of these bills provided for a change in the 20-mile test. There are 2 bills pending before the Senate Finance Committee on this subject, and neither of these bills provides for any change in the 20-mile test.

During hearings before the House Committee on Ways and Means on March 3, 1969, there was no testimony as to the need for any change in the 20-mile test and no evidence that this condition has been abused by any taxpayer.

Lastly, there is nothing in the House Report as to the reason for the substitution of a 50-mile test or, for that matter, the reason for using 50 miles, as distinguished from 20 miles, as the criterion. In the absence of any evidence that the 20-mile test is unreasonable or that it has been the subject of some abuse by taxpayers, we urge the Committee to adopt the Treasury Department recommendations of September 4, 1969, to restore the 20-mile test.

Our primary concern is that if the moving expense provisions of H.R. 13270 are approved in their present form, many employees of organizations having multiple work locations in large metropolitan areas will be denied tax benefits which they might otherwise be entitled to under the 20-mile test. The purpose of limiting the deduction to moves of a certain distance would appear to be one of reasonableness. Certainly an employee whose new job location is 20 miles or more from his former residence than was his old job location cannot be considered as moving for mere convenience. In fact, such a commute could impose considerable hardship on the employee, not to mention a safety hazard. But under the House version such an employee would no longer be entitled to any deduction for the expenses he incurred in moving his residence. We are hopeful that the Committee will restore the 20-mile test and not impose a hardship on such employees.

2. WITHHOLDING ON DEDUCTIBLE MOVING EXPENSES

A clarification by the Committee as to the withholding status of amounts paid to employees as reimbursement for moving expenses would be a great aid to the business community. In the past this technical issue was clearly defined under Revenue Code section 3401(a)(15) which specifically excludes from any withholding requirement moving expense reimbursements which the employer considers deductible under section 217 of the Code. Under Section 231 of H.R. 13270, however, a reasonable doubt remains as to the withholding treatment to be accorded moving expense reimbursements. Page 77 of the Ways and Means Committee Report No. 91–413 (Part I), accompanying the House-approved measure, states that amounts reimbursed to employees for moving expenses are "wages" subject to the withholding provisions of section 3401(a) of the Code. No mention is made of the exception in subparagraph (15) of section 3401(a).

Certainly there was no intention by the Treasury Department to change the existing practice. In their proposal to the House Ways and Means Committee, the Treasury Department stated:

"Under present law remuneration for services of an employee is subject to withholding of income and social security taxes. Moving expense reimbursements, in the case of employees, are subject to this general withholding rule. However, present law provides an exception to the withholding requirements to the extent that at the time of the reimbursement or payment it is reasonable to believe that a moving expense deduction will be allowable to the employee under section 217 of the Code with respect to the expenses being reimbursed. *This rule of present law would be continued.* Thus, withholding would be required on moving expense reimbursements or payments made to employees only to the extent that no deduction with respect thereto is provided in section 217, as amended by the bill. Reimbursements to transferred employees which are excludable from gross income under present law and which would become includible under the bill are deductible under section 217, and, thus, they would not be subject to withholding." (House Committee on Ways and Means Committee Print, April 22, 1969, p. 249.) (Italics added.)

We do not believe it was intended that withholding be required with respect to moving expenses deductible under the proposed law since any such withholding must be made from the employee's regular wages. We respectfully urge that this matter be clarified in the Committee report.

3. LIMITATIONS ON DEDUCTIBLE AMOUNTS

The $2,500 limitation in the House bill follows the Treasury Department's recommendation of April 22, 1969 but, we believe, should be modified to reflect the rather serious impact that inflation has had, and likely will have, upon our economy. At one time, the $2,500 would have been quite adequate. For example, in our statement filed with the House Committee on Ways and Means (Tax Reform, 1969, Part 5 of 15, pp. 1931–33) we stated that the average cost incurred by a Bell System employee relocated *in 1965* was about $3,500. Moreover, we stated that about $900 was not subjected to taxation (i.e., the "direct" expenses of transporting the taxpayer, members of his household, and their belongings from the old to the new residence) leaving $2,400 subject to taxation to the employee.

Under H.R. 13270, the $2,500 limitation would have been adequate for the average Bell System employee *in 1965*. However, the unusual inflation experienced since 1965 will result in considerable larger reimbursements for the average move. With the $2,500 ceiling under the House bill, the employee will have to pay tax on the excess. We believe some relief is needed to offset this effect of inflation.

One of the more significant factors in moving expenses is the real estate commission where an employee sells his old residence through a real estate broker. Generally this amounts to approximately 6% of the gross sales price. For a $25,000 house, the real estate commission would be about $1,500, leaving only $900 remaining for deduction under H.R. 13270. Where the employee's house sells for $40,000,[1] the $2,400 real estate commission would consume almost the entire $2,500 allowance.

The $2,500 limitation has two obvious purposes. First, it permits Treasury to measure more accurately the Federal revenue impact of such deductions. Secondly, it is intended to prevent an abuse of the tax deduction. Both are worthwhile objectives which we support. However, we believe some modification in the House version is warranted which will recognize the impact of inflation and, at the same time, achieve these objectives. As the real estate commission on the sale of a residence (or the cost of settling an unexpired lease) is likely to be the principal cost incurred in moving, and also the item which tends to be most affected by inflation, this could be treated in the same manner as the "direct" expense of transporting the employee and his family to the new residence.

Removing the real estate commission from the purview of the $2,500 limitation will afford a more realistic deduction of the other so-called "indirect" expenses and, at the same time, provide protection against taxpayer abuse. Like the direct costs of transporting the employee and his belongings, a real estate commission is something over which the employee has little or no control and, therefore, no opportunity for abuse exists.

Accordingly, we recommend that the $2,500 limitation be modified by classifying any real estate commission incurred in connection with the sale of an employee's residence or the settlement of an unexpired lease as "direct" expense.

INTERNATIONAL BUSINESS MACHINES CORP.,
Armonk, N.Y., September 24, 1969.

Hon. RUSSELL B. LONG,
U.S. Senate, Washington, D.C.

DEAR SENATOR LONG: On behalf of International Business Machines Corporation, I wish to express support for the statement made before the Senate Finance Committee on September 18 by Mr. Howard M. Lee, President of the Employee Relocation Real Estate Advisory Council, with respect to the moving expense provisions (sec. 231) of H.R. 13270.

We are particularly concerned with that portion of the bill which would increase the so-called "20 mile test" for deductibility of job-related moving expenses to 50 miles. In other words, a transferred employee would be denied a moving expense deduction unless his new work location is 50 miles *farther* from his former residence than was his former work location. This is a completely unrealistic requirement.

[1] The Median price of new homes sold in Montgomery County, Maryland, during the first 8 months of 1969, was $40,733. See article on page B–1, *Washington Post*, Thursday, August 28, 1969.

IBM, like many other corporations, requires substantial numbers of its employees to change jobs in any year, often within a large metropolitan area such as the District of Columbia or New York City and environs. Many of these changes realistically require the employee to relocate his residence. The bill's provisions contemplate that an employee should be prepared to commute up to an *additional* 49 miles, whereas a 20–25 mile commutation distance is already commonplace. This is unrealistic, and effectively denies the moving expense deduction to many employees incurring substantial moving expenses in connection with employment-related moves, including some who would be entitled to it under present law. This is contrary to the expressed intent of the bill to liberalize the tax treatment of relocation expenses in the interests of greater employee mobility.

We urge the Senate Finance Committee to restore the 20 mile test in order to make section 231 a meaningful improvement of the moving expense deduction.

Very truly yours,

W. J. PEDICORD,
Vice President, Personnel.

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GENERAL ELECTRIC COMPANY,
New York, N.Y., September 30, 1969.

Hon. RUSSELL B. LONG,
Chairman, Committee on Finance, 2227 New Senate Office Building, Washington, D.C.

DEAR MR. CHAIRMAN: The General Electric Company appreciates the opportunity to submit to the Committee on Finance of the Senate its comments on Section 231 of H.R. 13070, which broadens the deduction for employee moving expenses.

We respectfully request that this letter be included in the printed record of the current hearings under Moving Expenses.

In order to fill openings in professional and managerial positions with the best available manpower from within the Company, we find it necessary to relocate more than 3000 employees a year and to reimburse these employees for all identifiable expenses which are attributable to the moves. As you are aware, it is a trying experience for an employee and his family to have to pull up stakes and move to a new location. It is especially trying if they have to make a financial sacrifice in order to accomplish the move—and that has been the result of the strict interpretation which Internal Revenue Service and the courts have placed on the status of "indirect" moving expense reimbursements under existing law. Every transferred employee has a strong, emotional conviction that such reimbursements are not income at all, because they merely cover expenses he incurred for the Company. Legislative relief would, therefore, greatly increase employees' confidence in the fairness of the tax laws.

From the standpoint of equity among taxpayers, we are in general agreement with the deduction approach to solving the problem. We do, however, have several specific suggestions with regard to the provisions of the bill passed by the House, and these can be summarized briefly as follows:

1. In view of the proposed limitation on *types* of deductible moving expenses, we suggest that additional limitations on *dollar amounts* are unnecessary and inequitable.
2. While 30 days may be a reasonable limitation with regard to temporay living expenses for the employee's family, a 90-day period would be more reasonable for the employee himself.
3. Deductible categories should include expenses reasonably incurred in traveling between the new and the old locations to close out personal affairs.
4. The distance requirement for allowance of the deduction should remain at 20 miles, instead of being increased to 50 miles.
5. A suggestion is made regarding the requirements for accounting for deductible expenses.
6. Inasmuch as the deduction is being broadened to correct an inequity of long standing, the amendments should be made applicable to the current year as well as to future years.

These points are developed more fully hereinafter.

HOUSEHUNTING AND TEMPORARY LIVING EXPENSES

Under the House bill the deduction for these expenses is limited to $1,000. In addition, the following limitations apply to the types of expenses which are deductible: (1) while the employee is working at the new location prior to moving his family, only meals and lodging may be deducted, with no allowance being made for transportation costs which the employee may reasonably incur in traveling between the new and old locations to close out his personal affairs, and (2) the deduction for temporary living expenses is limited to expenses for any selected period of 30 consecutive days after obtaining employment.

We recognize the need for limiting the *types* of expenses to be deductible, but once this is done we do not see the need for imposing dollar limitations or severe time restrictions on the expenses.

Under the statute, the expenses will be required to meet the test of reasonableness, and this should be a sufficient control over their amount. Dollar limitations can lead to serious inequities; for example, between an employee whose househunting trip must span the country and one who is moving a short distance, or between employees transferred to high and low cost geographical areas. In addition, dollar limitations become more and more restrictive and unrealistic as cost levels increase and living standards rise. We recommend, therefore, that this limitation be eliminated.

As for time restrictions, the 30-day allowance for temporary living expenses would usually be adequate for members of the employee's family, but it would generally be far from adequate to cover his own expenses between the time he starts work at the new location and the time his family moves into their new home. We suggest that in lieu of the limits included in the House bill, the employee be allowed up to 90 days' temporary living expenses at the new location and members of his family up to 30 day's expenses.

In addition, we suggest that the categories of deductible expenses be expanded to include trips for the employee between the new and old location for the purpose of closing out his personal affairs.

REAL ESTATE COSTS

The House bill allows a deduction for the expenses of selling the employee's residence at the old location (or settling an unexpired lease) and purchasing a residence at the new location (or acquiring a lease), but the aggregate deduction for expenses in these categories plus deductible househunting and temporary living expenses is limited to $2,500. Assuming full utilization of the maximum proposed allowable deduction for househunting and temporary living, the deduction for real estate costs is limited to $1,500.

What the House bill provides, in effect, is that if a transferred employee lives in a house worth approximately $20,000 or less, he will be allowed a full deduction for his real estate costs; but if he lives in a house worth more than that, he will be allowed only a partial deduction. In many areas today—certainly here in the Northeast, very few houses still sell for as little as $20,000. Therefore, this

limitation would create inequities not only between employees transferring to or from high and low cost geographical areas but also between employees in high and how level positions, because their standards of living are customarily related to their earning capacity. Not only would a substantial part of the deduction be denied to the higher level employee, but his loss through denial of the deduction would be calculated at high bracket tax rates. Such a limitation would impede the mobility of the country's most valuable manpower, and we strongly urge that it be eliminated. We do not believe that the over-all effect on the revenue of such elimination would be substantial in relation to that contemplated, but retention of the limitation would result in undue financial hardship and resentment in many individual cases, and would be clearly discriminatory against some of the more productive individuals in our economy.

DISTANCE REQUIREMENT FOR ALLOWANCE OF DEDUCTION

The House bill provides that no moving expense deduction will be allowed unless the change in job location would increase the employee's commuting distance to work by at least 50 miles if he did not move. Under present law this distance requirement is only 20 miles. In our view this change would impose an unreasonable burden on those employees who would be affected by it. If an employee's present residence was 20 miles from his present place of work, for example, the House bill would allow him no deduction for moving expenses unless his new place of work was at least 70 miles from this residence. We strongly recommend that the present 20-mile requirement not be increased.

SUBSTANTIATION OF EXPENSES

The House bill requires inclusion in income of all reimbursements of expenses made by an employer, although no withholding is required from reimbursements of deductible expenses. We recommend very strongly that the treatment applicable to reimbursed travel and entertainment expenses by applied to deductible moving expenses; i.e., where the employee has accounted to his employer for the expenses and has been reimbursed for them, he will not be required to account for the reimbursements and expenses in his tax return. To provide otherwise would unduly complicate the preparation of the employee's return and would serve no useful purpose.

EFFECTIVE DATE OF AMENDMENTS

The House bill provides that the amendments made by Section 231 will apply to taxable years beginning after December 31, 1969. In view of the urgency of enacting legislation in this area to correct an inequity which has existed for several years, we strongly recommend that the amendments be made applicable to taxable years beginning after December 31, 1968. This should present no problem from an administrative standpoint because tax returns for 1969 will not yet have been filed.

We are very pleased, of course, that urgently needed legislation on moving expenses appears to be nearing enactment, and we cannot emphasize too strongly the necessity for prompt action to relieve the present inequity. We are concerned, however, as outlined herein, regarding some of the specific details of the House bill, and especially urge that the dollar limitations be removed completely. They are unnecessary in view of the category limitations and the over-all test of reasonableness, they are highly discriminatory, and their elimination would not seriously alter the revenue effects.

Very truly yours,

GEORGE H. KITENDAUGH,
Manager, Tax Accounting Service.

STATEMENT OF OWENS-ILLINOIS, INC.

This statement is with respect to the provision of moving expenses, Section 231 of the Tax Reform Bill of 1969, H.R. 13270, now under consideration by The Committee on Finance of The United States Senate.

Mr. Richard L. Berry, Vice President-Personnel, Owens-Illinois, Inc., presented oral testimony on the subject of moving expenses before the Committee on Ways and Means of the United States House of Representatives on March 3, 1969, which is a matter of public record in the House Committee print.

Owens-Illinois restates its position with respect to the additional categories of nontaxable moving expenses by submitting up-dated statistical data for the Committee's consideration which indicates the effects of inflation on such costs.

For the sake of brevity, we are not submitting up-dated data respecting individual costs of fifty illustrative relocations similar to the schedule submitted to the Committee on Ways and Means. Such up-dated data is available if desired. It would confirm the schedule previously submitted.

Based on Owens-Illinois' actual experience, which we believe is representative of most employers, and based on our revised estimate of the average cost per typical move (see Schedule 2 attached) the aggregate deductible dollar limit in the House Bill is exceeded in nearly every move of an employee regardless of his earnings level as shown in Schedule 1 attached.

1. Employees relocated are not in the highly compensated salary brackets. For the years 1966 and 1967 (Schedule 1 attached) the statistical data shows that 94% of the relocated employees received less than $20,000 and 81.5% received less than $15,000. The up-dated data for 1968 indicates that 92.2% received less than $20,000 and 79.2% received less than $15,000.

2. The up-dated typical cost of an employee move (Schedule 2 attached), which is substantiated by actual costs, shows that if one considers only the temporary costs of maintaining a family of five in a motel at the new job location for a period of 30 days and the real estate commission of 6% to 7% on a $20,000 to $25,000 home, the costs quickly exceed the proposed aggregate deductible dollar limit of $2,500. While the House Bill is a step in the right direction, it does not go far enough to provide the complete relief which should be given, at least for expenses reimbursed by an employer under a uniform, consistently applied reimbursement plan or program.

3. The nontaxable reimbursements under existing tax law and those nontaxable reimbursements (subject to the aggregate limitation) as proposed ought not to be included in gross income (as compensation for services) and correspondingly should be excluded from the withholding provisions in order to prevent an over-withholding of tax for which the individual cannot get a refund until the following tax year and to eliminate unnecessary accounting detail and administrative overhead burdens by the employer, the employee and the government tax auditors. We strongly suggest that the Federal tax system already has an alternative method of accounting for reimbursed expenses which is generally accepted and which works well, namely the present statutes, regulations and procedures in the area of travel and entertainment expenses, which method easily can be applied to reimbursed moving expenses.

4. We urge that the 20-mile test in current tax law be restored as one of the conditions for the allowance of moving expense deductions.

A 50-mile test is unrealistic and would severly penalize employees who are required to relocate within large congested metropolitan areas.

OWENS-ILLINOIS, INC.

WAGE AND SALARY BRACKETS OF EMPLOYEES RELOCATED

Data Submitted to House Ways and Means Committee on Mar. 3, 1969, for Years 1966 and 1967

Wage bracket	Number of employees	Wage bracket	Number of employees
0 to $5,999	23	$0 to $5,999	22
$6,000 to $7,999	296	$6,000 to $7,999	34
$8,000 to $9,999	246	$8,000 to $9,999	248
$10,000 to $11,999	219	$10,000 to $11,999	146
$12,000 to $14,999	191	$12,000 to $14,999	155
$15,000 to $19,999	150	$15,000 to $19,999	99
$20,000 to $24,999	48	$20,000 to $24,999	43
$25,000 to $29,999	13	$25,000 to $29,999	7
$30,000 to $33,999	1	$30,000 to $33,999	4
$34,000 to $35,999	3	$34,000 to $35,999	
$36,000 to $36,999	1	$36,000 to $36,999	1
$37,000 to $37,999	3	$37,000 to $37,999	1
Over $38,000	3	Over $38,000	4
Total	1,197	Total	764

PERCENTAGES

Wage bracket	Number of employees	Percent
0 to $9,999	565	47.2
0 to $11,999	784	65.5
0 to $14,999	975	81.5
0 to $19,999	1,125	94.0
Over $20,000	72	6.0
Total	1,197	100.0

Note: Included above were 186 hourly employees, 15.5 percent of the total.

PERCENTAGES

Wage bracket	Number of employees	Percent
0 to $9,999	304	39.7
0 to $11,000	450	58.9
0 to $14,999	605	79.2
0 to $19,999	704	92.2
Over $20,000	60	7.8
Total	764	100.0

Note: Included above were 110 hourly employees, 14.3 percent of the total.

OWENS-ILLINOIS, INC.
TYPICAL COST OF AN EMPLOYEE MOVE

	Average estimated cost	
	Data submitted to House Ways and Means Committee on Mar. 3, 1969	Estimated Cost as of Aug. 28, 1969
Travel:		
House hunting*	$327	$347
Bring family to new location	213	233
Move household and personal possessions	904	959
Living expenses at new location (30 days)* (for a family of 5)	2,490	2,684
Average relocation allowance (married couple plus 3 children)	1,400	1,400
Costs at former location:		
Duplicate house expenses (excluding mortgage principal)	936	700
Maintenance (heat, yard work, etc.)	288	308
Broker's commission*	1,500	1,560
Prepayment penalty*	150	150
Attorney fees*	100	200
Appraisal fees*	250	350
Miscellaneous	113	119
Deficiency of sales price (house guarantee)	500	200
Costs at new location:		
Attorney fees*	100	125
Installing and adjusting appliances	119	128
Loan costs (loan application, mortgage origination, etc.)*	500	600
Miscellaneous	57	60
Total costs	$9,947	$10,113

Note: The House tax reform bill gives some recognition to the items marked with an asterisk (*), but the proposed aggregate deductible dollar limit of $2,500 is exceeded as shown by Owens-Illinois' experience of the cost of a typical employee move. The comparative data above shows also the effects of inflation on such costs.

ARTHUR ANDERSEN & CO.,
Chicago, Ill., September 12, 1969.

Re statement regarding H.R. 13720, Tax Reform Act of 1969—Moving Expenses.
Committee on Finance,
2227 New Senate Office, Washington, D.C.

SUMMARY OF COMMENTS AND RECOMMENDATIONS

DEAR SIR: The House has made considerable progress in its attempt to remedy previous inequity and hardship with respect to employee moving expenses and reimbursements. However, we believe that further broadening of the provisions of Section 231 of the Bill is in order if it is to be a reasonable alleviation of hardship. The following additions and changes should be made in Section 231:

1. Specific exemption should be made from the withholding provisions for reimbursement of expenses reimbursed to employees, since each reportable amount of gross income will be offset with a corresponding deduction on each employee tax return. Withholding will only create financial hardship for employees.
2. The overall limitation of $2,500 is unrealistic in today's housing market.
3. Provision should be made for separate additional annual limitations in the case of second moves during a taxable year because of involuntary termination or retransfer.

BASIS FOR COMMENTS

1) Exemption of reimbursements from withholding

Present proposed changes provide for the inclusion of all moving expense reimbursements in the gross income of the employee. Such reimbursement is to constitute wages subject to withholding tax. As a result, the taxpayer-employee's net cash reimbursement will be substantially reduced (by approximately twenty percent), and he will have to wait until after his return is filed in the following year to receive complete reimbursement. In the event of a move early in the year, the employee could be forced to wait as long as 15 months for his complete reimbursement. It is well established that employees are rarely completely reimbursed for the cost of a move: the fitting of drapes and carpets, new accessories, changes in clothing due to climate, minor moving damage, and a myriad of other items cause a financial loss and immediate cash drain in any case. To further reduce his cash because of unnecessary withholding would be inequitable and unjustifiably harsh. Revenue effect to the government would be solely a matter of timing, and negligible in any case.

2) Increase in overall limitation

The average employee move, especially one involving a low-to-middle-grade executive, will probably involve costs in excess of the $2,500 presently provided for. It is fair to assume that most houses involved will be in the $25,000–$35,000 range, at least. The expense of selling the old house will normally be 6% for commissions, plus a varying percentage of one to five for other fees. Therefore, it is safe to say that the cost of selling the old residence will average over $2,000. In purchasing a house, fees of one to five percent are quite common, or an average of at least $1,000. If an employee and his family are forced into temporary quarters for two weeks during the move, these costs will average $50 to $75 per day, or $700 to $1,000. One house-hunting trip will easily cost $500, if airline travel is required. In the aggregate, most moves will average from at least $3,500 to $5,000 in qualifying expenses under Section 231, yet the Bill presently allows only $2,500, which will not be adequate in most cases. The limitation was apparently to prevent abuses and unreasonable allowances particularly in the case of employees owning unusually costly homes. We agree that some reasonable limitation is in order. Perhaps as with the limitation on salary expense it would be desirable only to require that the expense be "reasonable." However, we see no point in establishing a limitation that from the outset is inadequate and unreasonable. If the sole reason for the limitation is budgetary, perhaps your Committee Report could indicate a desire to raise the limit at a later date.

3) Provision for additional annual limitations in the case of additional moves

Section 231 modifies Section 217(d) to provide relief from Section 217(c)(2) (which requires 39 weeks of employment in the new location in the first 12 months after relocation), in the case of involuntary termination or retransfer. This relief only applies to allowance of a single deduction, however. Of course, if an employee is required to move more than once, his expenses will be substantially increased. In some cases, both moves will fall within one taxable year; under present provision the overall $2,500 limitation (or higher, if revised, as we urge in item 2) certainly would not be adequate to cover expenses and reimbursements for two moves. It is especially harsh for a low-echelon employee who might fall well within the limitation on the first move, but greatly exceed the limit when the combined reimbursement for two moves is considered. There should be provision for multiple limitations based on the number of moves in one year, which are due to involuntary separation or retransfer.

SUMMARY

The foregoing comments are not intended to indicate an approval or disapproval of the remaining portions of the Act, but are only indications of technical areas which obviously need simplification. This statement is submitted as part of a series of letters, each dealing with a particular area of the proposed legislation. It is intended that the comments and suggestions contained herein be made part of the record of testimony relative to the legislative changes contemplated for moving expenses. We shall be pleased to discuss these matters further with you or the Committee, either in person or by telephone. Please call us collect at 312-346-6262 if necessary.

Very truly yours,

JOHN MENDENHALL,
Director of Taxes.

Senator WILLIAMS. Mr. Chairman, the next witness was advised that we will not reach him until this afternoon and therefore he has a conference downtown and it is not his fault that he is not here so I suggest that we recess until 2:45 if that is all right.

Senator ANDERSON. We will be in recess until 2:45.

Thank you very much for being here.

(Whereupon, at 1:45 p.m. the committee recessed to reconvene at 2:45 p.m. of the same day.)

AFTERNOON SESSION

The CHAIRMAN. Mr. Cohen, we are pleased to have you here.

STATEMENT OF WILBUR J. COHEN, DEAN, SCHOOL OF EDUCATION, UNIVERSITY OF MICHIGAN

Mr. COHEN. How do you do, Senator.

The CHAIRMAN. I believe you have a prepared statement and you are going to summarize that for us.

Mr. COHEN. Yes, sir.

The CHAIRMAN. We are delighted to see you before our committee again. It seems like old times.

Mr. COHEN. It is really a pleasure for me to be here especially as a private citizen when I don't have to look around to see if anybody else will give me the wrong statistical answer to Senator Williams' question.

The CHAIRMAN. You mean that for one time you can actually answer for yourself without having to worry about somebody insisting that you go back and correct it?

Mr. COHEN. That is right.

The CHAIRMAN. Right. Well, that is fine now.

Senator WILLIAMS. I join the chairman in welcoming you back to the committee. I was just beginning to think maybe we had been overlooking some of your talent. During the period you were here when we tried to write the tax bill we should have had you in here before.

The CHAIRMAN. Mr. Cohen helped us write some tax bills. We wrote some bills on social security taxes with his help.

Will you proceed, sir?

Mr. COHEN. Yes, I would be glad to summarize.

The CHAIRMAN. I like to call you Wilbur because I feel I know you that well.

Go ahead.

Mr. COHEN. I would like to summarize my testimony, Senator. It can be briefed into about 20 separate points.

First, I believe that the tax yield under the tax reform bill should be increased substantially.

Second, more Federal funds are needed for education, to increase economic growth and to eliminate poverty.

Third, in my prepared statement I show that U.S. taxes are not as high as taxes are in many other countries, that is Federal, State and local taxes combined, but that the major problem is that we need a major redistribution of the tax burden.

Four, I believe that some additional taxes should be derived from the elimination of accelerated depreciation for high-income and luxury housing, tightening farm losses, capital gains, withholding of dividends and decrease of the depletion allowances but I strongly believe that corporation taxes should not be reduced to the extent that the administration has recommended.

Five, I recommend that dependents' deductions should be modified in the light of family planning policy that is incorporated in the 1967 amendments. I think that the present policy of giving the same amount for every child up to the 15th or 20th child is not sound. I had one man in my department who had 13 children. What you have done under the present tax policy is to give financial subsidies to everybody to have more children and in my paper I suggest a graded policy. Give a higher amount, $800 or $900 for the first one or two children and then go down in decreasing amounts so that tax policy is not viewed as an incentive for people to have large numbers of children. As you know, a large number of families that have five, six, seven children are on the welfare rolls.

Senator CURTIS. May I ask a question right there?

Mr. COHEN. Yes, sir.

Senator CURTIS. Will any of your friends among welfare workers support your contention that the desire for additional dependency allowances is the cause of large families?

Mr. COHEN. I don't think it is an immediate cause in the sense that an individual says, "I am going to have that one additional child because I get $600 more or less," but I think, Senator, it creates what I

call the psychological climate of opinion in this country, which says if you have more children, you get a bigger tax deduction.

Senator CURTIS. Shouldn't you?

Mr. COHEN. Well, in a social policy sense I say yes, but I think the way to do that is to take care of that through Mr. Nixon's new family assistance program.

Senator WILLIAMS. I know that you suggest, as I understand it, in reading your statement, the first child would get $700, the next one $600, the next one $500, $400, $300, $200, $100.

Mr. COHEN. Yes.

Senator WILLIAMS. And a man with seven children would get 2,800 exemption, whereas under existing law he would get $4,200.

Mr. COHEN. Yes.

Senator WILLIAMS. Now you mentioned the fellow with 13 children. After the seventh would you give a hundred dollars on out or would you just stop entirely?

Mr. COHEN. Well, my own preference would be to stop.

Senator WILLIAMS. Well, that would mean——

Senator CURTIS. I am interested in that point. I am the youngest of eight.

Mr. COHEN. I would go to nine, then, Senator.

Senator WILLIAMS. I was No. 9 in a family of 11.

Mr. COHEN. When I worked for Celebreeze he was No. 11, and he always kept telling me when I would suggest things like that, "Well, you at least ought to go up to that number."

But what I am trying to say, simply, Senator, you can change these amounts, and you can do it differently, but under present tax policy you really are saying to every person, "It is fine, go ahead and have more children. We will give you an additional deduction no matter what your income"——

Senator WILLIAMS. Just a question. But take, for instance, just this individual who has got 13 children. You would reduce his exemption to $4,600 whereas under existing law he get $9,000.

Mr. COHEN. Yes, sir.

Senator WILLIAMS. Now, I understand you would make up the difference in the welfare, is that correct, because if that man is making $9,000——

Mr. COHEN. In that case, no, he wouldn't get welfare either with that income.

Senator WILLIAMS. Well, you just would raise his taxes on that man because he had that many children. You would tax him because he had the children. It would have that effect, would it not?

Mr. COHEN. That would be the effect, yes, sir.

Senator WILLIAMS. That is a rather radical proposal.

Mr. COHEN. Yes, sir.

Senator WILLIAMS. For a man who has been advocating an expansion of welfare, is it not?

Mr. COHEN. But, I think we have come to the point when this committee in 1967 voted to put $30 million, your committee did it, in title V of the Social Security Act, $30 million for family planning, you took the country on a new tack in which you said that because of welfare, because of national needs, that we ought to have a national

policy that did not put so many people in poverty or on welfare because of the large family.

Senator WILLIAMS. But suppose this plan can't support, because it is costing a man $600 to support a child, more, and you cut his exemption down to $4,800, what would you do, starve some of these children or starve the mother so she couldn't have children?

Mr. COHEN. No. But you said he had $9,000 worth of income.

Senator WILLIAMS. He has $9,000 exemption.

Senator BENNETT. Exemption.

Mr. COHEN. I mean if he didn't have $9,000 of income it wouldn't really apply.

What I am saying is not so much that my proposal would have an economic disincentive to have additional children but that Congress—I am perfectly willing to change the figures so that it really——

Senator WILLIAMS. I am using your figure.

Mr. COHEN. Yes, but I am saying they are illustrative to the committee. There is no sanctity to the particular figures.

Senator BENNETT. Would you apply this same principle to aid to dependent children?

Mr. COHEN. No.

Senator BENNETT. That would discourage large families, really.

Mr. COHEN. Yes, in some cases.

Senator BENNETT. Because if these unmarried mothers didn't realize that they are going to get an equivalent amount for each new child they would not be producing.

Mr. COHEN. But it is in effect in the States right now. That policy is in effect in the States and hasn't had too much success. That is because there is a maximum family payment Senator, in many States. In other words, they say *x* dollars per child but not more than *y* dollars per family so it really has that effect. But I am not arguing so much that this would have a discouragement in an individual case, because I don't think people plan that——

Senator BENNETT. I don't think they plan to take advantage of $600 tax exemptions either?

Mr. COHEN. I don't think so either. What I am saying is, though, that I think the recognition of a policy in the tax law, just like you put in deductions for pension plans, to encourage pension plans, and just like you have tax policy on stock options encourages stock options. It creates the climate of opinion in which our economy and our society operates. Of the 25 million people who are in poverty today under the social security definition which is roughly $3,500 for a family of four, adjusted for size of family, if all of those who were in poverty with more than three children had only limited themselves to three children there would be about 3 million less persons in poverty in the United States.

Senator WILLIAMS. When you were the Administrator you didn't make too much progress in cutting back families.

Mr. COHEN. If you want to start on that line, I have a good case, Senator, because poverty decreased in the 8 years that I was in the administration, from 40 million to 25 million persons.

The CHAIRMAN. Let the man answer the question. Go ahead, Mr. Cohen.

Mr. COHEN. Senator, in 1960 there were 40 million people in poverty in this country by that standard that I just indicated, and this year there are only 25 million in poverty.

The CHAIRMAN. Let me ask you——

Mr. COHEN. That is a reduction of 15 million.

The CHAIRMAN. Let me ask you this. By the standard you have in mind now, Mr. Cohen, does that include an increase in the cost of living factor?

Mr. COHEN. Yes, sir.

The CHAIRMAN. Are you talking in terms of constant dollar?

Mr. COHEN. Yes. I adjusted the figure, it is about $3,500 today but it was adjusted for 1960.

The CHAIRMAN. Back at that time it was $3,000 I guess or something like that?

Mr. COHEN. Yes, sir.

The CHAIRMAN. In other words, you are saying that compared to 1960, let us say that we are talking in terms of 1960 dollars and 1968 dollars, it doesn't make any difference.

Mr. COHEN. 1968.

The CHAIRMAN. So in terms of 1968 dollars by 1968 standards, that in 1960 there were how many families?

Mr. COHEN. 40 million individuals below the poverty level.

The CHAIRMAN. 40 million below. How many are there now?

Mr. COHEN. 25 million.

The CHAIRMAN. 25 million. So you are saying that there were 15 million families moved up above that poverty line during that 8-year period?

Mr. COHEN. Yes, sir.

The CHAIRMAN. Pretty good record.

Mr. COHEN. I would say the House Ways and Means Committee and the Senate Finance Committee, which primarily dealt with the economic, tax and fiscal policies of this country during those 8 years, did a darned good job.

Senator WILLIAMS. And your idea is if we cut back some of the tax credit and allowances for these extra children they would do a better job.

Mr. COHEN. Well, I am not going to be overenthusiastic about what could be achieved. But here is my point: The Finance Committee has responsibility for taxes, welfare, social security, and family planning. You happen to be the committee that has all of those things in your jurisdiction. All I am saying to you today is think about their interrelationship, think about their interrelationship because you are the gentlemen who are to raise the money, for the welfare program. The programs under your jurisdiction, including veterans' benefits, social security, welfare, unemployment insurance, are the basic programs that deal with poverty in this country.

The CHAIRMAN. I think you have got a good point there.

Let me ask you this. You know you and I tried to work together some, Mr. Cohen, to put some of these people to work and I think you will agree with me that it is much better to have somebody working for a living than it is just to put them on the dole, and that they are better citizens. It keeps them out of harm's way, it keeps them out of mischief it gives them a sense of pride. I have driven through some of those

ghetto areas, and I must say it distresses me to find most of those people living off the government on welfare and yet you can't get anybody to go pick up the trash. Now, that is something you and I have in common. I was one of the chief trash pickeruppers in my neighborhood and you were one of the chief trash pickeruppers in your neighborhood.

Mr. COHEN. I still do that, I pick up these beer cans every Sunday on the highway along my property.

The CHAIRMAN. For your benefit, over the recess I visited my sister out in Boulder, Colo. They have a beautiful road behind her home that goes up to Flagstaff Mountain, right behind Boulder. So I decided to walk up. I looked at all those beer cans and I got busy picking up Coca-Cola cans, beer cans, junk, and I couldn't help but think, well, the place would be better because I was there, because some of those places where people could park and look at the beautiful view and young folks might even do a little courting from time to time but those beautiful places were all messed up by people who threw junk out of automobiles, and several of them were fairly neat by the time I went there and I think it sort of appeals to you there.

Mr. COHEN. Yes, sir.

Mr. CHAIRMAN. In your spare time you might as well go pick up some of the trash around your place. Why can't we get some of those people who are living off government money in the so-called ghetto to clean up the joint?

Mr. COHEN. Since you developed your idea into the 1967 social security amendment, I have developed another idea of how to carry that out which I am recommending or when you come to the welfare bill to make a practical suggestion on that. It may involve actually eventually an amendment to the tax laws. Let me put it this way:

If private employers would take people who had recently been on the welfare rolls off the welfare rolls and give them a job, and if we could work out some way to make a determination that since those people did not at that point have the economic competence, let us say, to earn $2 an hour, then I think it would be sound to probably continue to pay welfare, and maybe even give the employer a slight tax advantage or incentive for a year, to employ that person, recognizing that it wasn't economically worth his while to pay $2 an hour for the first year or two.

Senator WILLIAMS. How has that worked in your present capacity as an employer, as a dean of the University of Michigan? Have you been able to implement that program very much?

Mr. COHEN. No, but I will give you an illustration. That is what brought it to my mind. I hired a disadvantaged 19-year-old girl about a month ago. She was a high school graduate but when she came in to the office and worked the other girls in my office said that she just was not competent to do her job. She just did not know how to work in an office. The telephone calls got bungled up, the mail routing became confused, she sent the wrong things to the wrong people, and it was just a mess and they said, "You are just too good hearted, Mr. Cohen, you are trying to help this nice girl and she can't really do the work."

The CHAIRMAN. What you mean is you would have been better off without her at all?

Mr. COHEN. Yes, sir, and it ended up my wife came in to the office and worked for a week.

The CHAIRMAN. I see your wife here, by the way, and we are pleased to have her.

Mr. COHEN. Now, from a standpoint of an employer, if he is going to hire people who are not really worth their full salary and try to give people a job it may well be that we should subsidize an employer who gives jobs to disadvantaged persons.

What I finally did is I put the girl in the mimeograph machine operation where I felt she couldn't do too much damage. But I think she needs a job. I think in about a year of work in my office, she would learn how to be a pretty competent person. She is neat, she is clean, she is responsible but she is not worth $2 an hour now.

Now, my question is maybe somebody ought to subsidize her in some way. If she were a relief person or a welfare person maybe if we gave those people a job and somebody contributed 50 cents or a dollar an hour to the employer maybe the country would be better off in the long run.

When you come to the welfare program in the hearings and I would like to come back and give you a specific suggestion as to how I think that might work.

Senator WILLIAMS. We always welcome you to hearings.

I notice, Mr. Cohen, in your statement you start out on page 2 saying you support the general outline of proposals by Senators Ribicoff, Hart, and Kennedy, and then I notice you take a vigorous stand against college tuition——

Mr. COHEN. Yes, sir.

Senator WILLIAMS (continuing). Credit. I notice on page 16 you state that and I quote:

> I must make it clear that I do not support the proposal pending before your Committee for a tax credit for tuition fees for higher education.

Mr. COHEN. Yes.

Senator WILLIAMS (continues reading):

> While there is substantial support for this from higher income earners it is wrong in principle and in practice and would not be helpful to higher education.

It so happens that Senators Ribicoff and Hart are the authors of that bill and I am wondering how you can reconcile your support for their position and then take such strong exception to S. 835, the bill which they and others have before the committee recommending tax credit?

Mr. COHEN. Yes. Well, what I really mean to say is I support Senator Ribicoff's, all the provisions of his bill except that one.

Senator WILLIAMS. This is the only bill, that is his bill.

Mr. COHEN. No, he has got another bill.

Senator WILLIAMS. He has got several bills but that college tuition that is before the committee is Senator Ribicoff's bill.

Mr. COHEN. Yes; well, I am opposed to that.

Senator WILLIAMS. You are opposed to that but you just support Senator Ribicoff personally?

Mr. COHEN. Well, he is a former Secretary of Health, Education, and Welfare and I have got to stick together with him on his major proposals.

The CHAIRMAN. He is your former boss, you have to be careful.

Senator WILLIAMS. I appreciate that but I just wanted to get the record straight.

Mr. COHEN. Yes, sir.

Senator WILLIAMS. Because you refer specifically to the proposal before this committee to allow a tax credit for college tuition. The only proposal we have is their proposal.

Mr. COHEN. I see.

Senator WILLIAMS. I thought we should clarify that.

Mr. COHEN. I should make it doubly clear I support his general proposals but not that specific one.

Senator WILLIAMS. You do oppose that one?

Mr. COHEN. Yes, sir, I think that would be very, very destructive of the financing of higher education in this country, and it is no secret, I have told Senator Ribicoff that a number of times both when I worked for him——

Senator WILLIAMS. Yes.

Mr. COHEN. And when I worked for him I signed the bills, the reports to this committee saying I was opposed to them.

Senator WILLIAMS. I was just trying to clarify the position because we may be considering that later and I notice that also you state, following where you say you support Senators Ribicoff, Hart, and Kennedy and others, that you particularly urge us to eliminate accelerated depreciation for high income and luxury housing.

Mr. COHEN. Yes.

Senator WILLIAMS. And the bill, the only bill we have before the committee to provide for additional depreciation scales, more liberal depreciation scales and tax credits even for public housing, including this same luxury, is a bill introduced of which Senator Ribicoff and those are cosponsors and I take it you oppose that, too, is that correct?

Mr. COHEN. If that is——

Senator WILLIAMS. That is S. 15 I am speaking of.

Mr. COHEN. I see.

Senator WILLIAMS. We held hearings here sometime back on it, and the bill would have reduced the depreciation period for the housing, all types, and it also gave a tax credit.

Mr. COHEN. That is right. I would oppose those for this reason.

Senator WILLIAMS. And I know Senator Robert Kennedy and others had one when he was here along the same lines.

Mr. COHEN. I feel very strongly, as I said in my statement, that this committee, with its future obligations that it is going to have to finance President Nixon's welfare program, with the need for spending more money on education since you are only appropriating about half of the authorization for education today, I think it would be tragic if you reported out a bill that had more tax reduction in it than tax increases. You ought to be neutral, at least. But I would recommend, and I make suggestions in here in which I hope you would raise some additional income, and I would be glad to continue with my suggestion on it. But I think that you are not in the next 2 or 3 years going to get out of the present situation of having to appropriate a lot more money than is in the budget for this year. I am not talking about new programs. I am talking about the built-in appropriations that are in the present authorization. Therefore, it seems to me we ought to look for some places to add some additional revenue.

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Senator WILLIAMS. Now, you are making my speech for me, you are back supporting me.

Mr. COHEN. You and I have made the same speech several times. For instance, I have another suggestion. I would repeal the double exemption of $600 on people 65 and over.

Senator ANDERSON. What have we done? [Laughter.]

Mr. COHEN. Maybe I am speaking to the wrong group right now. [Laughter.] But let me just explain this to you, gentlemen. With the changes that have come over from the House on the low-income individuals, you will have taken off a big tax burden on the lowest income people, and I heartily support that.

Now, the reason in 1948 the double deduction was put into the law in the House is because you didn't have that kind of special exemption for low-income aged people. But if you are going to make the exemption for the low-income people generally then you don't need the double exemption of the aged. That would not only save money but it would largely come from higher income people. I want to urge you, as I urged the House, the most complicated thing in the income tax today is the tax credit form for people over 65. I begged the House committee to simplify it. There are millions of aged people, in my opinion, who don't take their full tax credit because they can't understand the forms. You just take a look at that supplementary form for people 65 and over, and if any member of this committee can make that form out correctly by himself, I will buy you a good meal. You just can't do it.

Senator WILLIAMS. I notice you suggest that we should raise additional taxes through change in the capital gains structure. How would you change the capital gains?

Mr. COHEN. Well, I certainly believe that the capital gains requirement ought to be a minimum of a year instead of the 6 months. I think that is in the House bill. I would certainly favor at least providing that the tax rate for capital gains, would at least be 40, maybe 45 percent. Maybe the top of 50 percent at the present time is too high. But I wouldn't lower it substantially. I think people who——

Senator WILLIAMS. When you say 40, 45 percent, do you mean—you see under existing law, one-half of the capital gains are taxable not to exceed 50 percent.

Mr. COHEN. That is correct.

Senator WILLIAMS. Do I understand your proposal to lower that 50 to half or are you recommending 40 on all?

Mr. COHEN. I would say 40 on all.

Senator WILLIAMS. On all.

Mr. COHEN. Yes.

Senator WILLIAMS. On all, in other words, tax them on regular income rates?

Mr. COHEN. Well, pretty close to that. What is your marginal top rate in the bill now?

Senator WILLIAMS. Sixty-five.

Mr. COHEN. For ordinary income?

Senator WILLIAMS. Sixty-five.

Mr. COHEN. Sixty-five.

Senator WILLIAMS. When it gets fully implemented it would be 65. Yours under the present law would be 70, plus the surcharge would

be 77. But under the House bill, capital gains would be taxed without this ceiling which means they could go all the way to 32½ when the law becomes fully implemented.

Mr. COHEN. I would say that is too low. I would say that 15 to 20 points less than the maximum rates for ordinary income would still be fair for capital gains. What you want to do with capital gains is you want to give people an incentive to be enterprising and to go out and develop new products and new companies and to make money, and that helps the country as a whole. But I would say that if it were about 15 or 20 points less than the top rate for ordinary income that would be satisfactory.

Senator WILLIAMS. Under existing law, they could be taxed not to exceed 50 percent on one-half of it.

Mr. COHEN. Yes, that is 25 percent.

Senator WILLIAMS. Under the House bill they could be taxed at 65 percent on one-half of it which is 32½ when actually implemented.

Mr. COHEN. I would go at least 40, 45 percent.

Senator WILLIAMS. Forty, forty-five percent.

Mr. COHEN. Yes. I think what you are trying to do is trying to balance income to the Federal Government with not having a disincentive to invest in the future of the economy.

Senator WILLIAMS. There has been a suggestion made before the committee that where an individual dies and there is an appreciation, and under the existing law they pay the inheritance tax on the appraised value——

Mr. COHEN. Yes.

Senator WILLIAMS. There has been a suggestion made by some before this committee that that should be taxed at capital gains rates as though it had been sold the day before the man died and then pay inheritance tax also. What is your opinion on that?

Mr. COHEN. Well, I am not enough of an expert to say but it seems to me to tax it only at its appraised value is too low. Maybe it should be half way between the appraised value and the market value.

Senator WILLIAMS. I mean are you recommending capital gains in that instance?

Mr. COHEN. Well, I don't know that I would go all the way but I would use the concept to say if there was an appreciable appreciation part of that should be taxable, maybe not all but part of it.

Senator WILLIAMS. Well, of course, in capital gains half of it would be taxes.

Mr. COHEN. Well, maybe that general principle, half of the appreciated value.

Senator WILLIAMS. How would you work on gifts? A man makes a gift to a church, a foundation or something, and he has $10,000 cost in stock. It is worth a hundred thousand dollars. Would you tax him on that appreciated value?

Mr. COHEN. Well, my colleagues in the universities and the charitable organizations, as some have testified before you here, say that if you did that that would be a discouragement for them.

Senator WILLIAMS. I noticed one of your colleagues testified the other day that he was in favor of taxing the appreciated value of any assets given to charity unless they were given to universities. That was the testimony. But, of course, our tax law as you know relates to

everybody. How would you deal with gifts, well, to get specific, to universities. Do you think that if a man has appreciated property which cost him $10,000 and it is worth a million and he gets the charitable deduction for the full million, do you think any tax should be paid on that? That is one of the biggest questions we are having before us today.

Mr. COHEN. Well, I think my opinion is, yes, he should pay a tax on some part of that, Senator. I am very sympathetic with my colleagues in the universities who say that they, of course, want to get as much income because of their financial plight, but on the other hand, it seems to me that a taxpayer who is going to give a lot of money to a university should not do it simply because it is a nice way to get a tax deduction but he should do it because he wants to do it for the university or for whatever intellectual or other particular purpose, and paying some part, some tax on the appreciated value would seem to me to be desirable.

Senator WILLIAMS. On capital gains rates which would be on half of the value, the appreciated value?

Mr. COHEN. Well, that might be a little bit too much in that case but I would say at least on part of it. I am not in a position to say whether that should be 10 percent or 20 percent but it seems to me that our universiies and our foundations, while they need more money and should get more money, the donor should not do it simply because it is a nice way to avoid his responsibilities as a citizen for the upkeep of the Federal Government.

Senator WILLIAMS. What would you do about capital gains on livestock, racehorses and cattle breeding and so forth? I notice you say that we should plug the farm losses, and——

Mr. COHEN. I think the general approach as I understand it that is in the House bill is in the right direction. I would be just a little tighter on the general——

Senator WILLIAMS. How would you tighten it?

Mr. COHEN. Well, I think I would, I forget what the threshold provision is in the House bill on the extent to which farm losses are not deductible, I just don't recall it right off the bat.

Senator WILLIAMS. But they do need tightening?

Mr. COHEN. I think they need tightening. We are in a position where we have to find more income.

Senator WILLIAMS. How does the House bill change from the existing law, and how would you change it?

Mr. COHEN. I am just not enough of an expert on that to tell you off the top of my head.

Senator WILLIAMS. Well, you underestimate your talents. I noticed——

Senator BENNETT. The top of his head is like the top of yours and mine. [Laughter.]

Senator WILLIAMS. I notice in your testimony that you specifically—

Mr. COHEN Yes.

Senator WILLIAMS (continuing). Recommended that we should do something about tightening up on the farm losses.

Mr. COHEN. Yes.

Senator WILLIAMS. So you must have something in mind.

Mr. COHEN. Well, I went through the House bill about 3 or 4 weeks ago, and various suggestions——

Senator WILLIAMS. It is still the same bill.

Mr. COHEN. Yes, and as I say I just don't recall it right off the bat. But I came to the conclusion from looking at the Treasury income figures that the House bill could yield some additional income in that area. I would not have gasoline taxes deductible either. I think those could be looked upon as as user taxes. I see no reason why since the individual who is driving the automobile gets the user satisfaction out of the gasoline and the road, why we should give a tax deduction there. You would pick up some additional funds.

Senator WILLIAMS. But you are not sure whether you would eliminate the capital gains provision in the existing law for race horses or livestock?

Mr. COHEN. I really am not that much of an expert. I never had a race horse and I never really am that expert to know.

Senator WILLIAMS. Well, I don't either but we are going to have to deal with this problem.

Mr. COHEN. Yes.

Senator WILLIAMS. And I was just wondering what your opinion was.

Mr. COHEN. If you forced me to state——

Senator WILLIAMS. I wasn't forcing you, I was just trying to get the benefit of your thinking.

Mr. COHEN. I would say yes to that. I would apply that and the other rules you are going to apply in capital gains and see if you can get more income.

Senator WILLIAMS. You would be surprised on how much you and I agree. I opposed that when it went into the law 20 years ago.

Mr. COHEN. I think we are in the position now, Senator, where while the American public wants very substantial tax reform we have got to find ways that the American people accept where we can close some avenues of tax reduction whether it is justified as others are.

Senator WILLIAMS. But you would recommend that some form of tax, capital gains or in that direction be placed on the appreciated value of the assets at the time they are given away or at death, is that correct?

Mr. COHEN. Yes, sir, as a general principle I completely endorse that.

Senator WILLIAMS. Even when they are given to universities or foundations?

Mr. COHEN. Yes, sir.

Senator WILLIAMS. What is your recommendation about taxing foundations?

Mr. COHEN. My recommendations are:

First, I do not favor the 7½ percent tax on investment income of the foundations. I favor instead a filing fee. I did not hear in detail what either Secretary Kennedy or Assistant Secretary Cohen said but, in general, I would favor a filing fee, in effect, on foundations, plus full disclosure.

I make this recommendation, that instead of giving that responsibility to the Treasury Department that you give it to the Department of HEW, not the collection of the filing fee, which would be a Treasury

responsibility, but the full disclosure provisions on foundations you should give to the Secretary of HEW, and you should require him each year to make a complete report on how this money of the foundations is helping the universities, education, charity, welfare, health, which the money is directed to be used for.

In other words, the reason you are giving a tax deduction for those purposes is because you assume it effectuates some national benefit, educates more people, helps the health of the people, accomplishes other important results.

Now, you and I do not know whether that is true because there is not a full disclosure of what all of the foundations do. I think that what you need and what you do not have at the present time is a unit that is appraising these expenditures. I must say I am strongly opposed to what I call the punitive provisions in the bill of the 100-percent tax on the foundation and the 50-percent tax on the officers who have made what is called an improper expenditure.

If the committee, if the Congress is going to adopt that principle, and then apply it to all American business as well on any expenditure that is made that is not proper under the tax law, you have taken on a pretty big problem.

Senator BENNETT. Shouldn't we also apply it to officials in the executive department?

Mr. COHEN. I would say if you are going to apply it to foundations you are going to eventually apply it to everybody. But I am opposed to it in principle.

Senator WILLIAMS. You are opposed to it.

There is a provision in the bill that deals with the right of, about hiring Government employees on the payroll of a foundation. What is your, what would be your, opinion on that as a matter of public policy?

Mr. COHEN. Yes, as a matter of public policy, I think that grants should not be made to any individual while and during the period he is an employee. But I do not think previous employees of Government or a Senator should be barred from getting a foundation grant.

Senator WILLIAMS. You mean while they are on their Government payroll?

Mr. COHEN. No, sir. I meant to say——

Senator WILLIAMS. While they are on Government payroll they should not get aything from the foundations.

Mr. COHEN. That is correct, sir. I am very strong for a principle of what I would call the application of sabbaticals in Government like in universities.

I think Government would be a lot more efficient if more people in Government were to take off a year or two and go into business or go into universities and be able to come back 2 or 3 years later with new information, new insights, and I do not think you should bar people during periods which they are not drawing a Government salary, either before or after they are a Government employee.

Senator WILLIAMS. But you do think it would be wrong for any official in Government, either the legislative, judiciary, executive, whatever it may be——

Mr. COHEN. Yes, sir.

Senator WILLIAMS (continuing). To accept any——

Mr. COHEN. Yes, sir.

Senator WILLIAMS (continuing). Anything at all from a foundation.

Mr. COHEN. I think there could be a conflict of interest there.

Senator WILLIAMS. Yes.

Under existing law it is possible for foundations to make what they call awards to public officials. Is there any difference in that, and should that be permitted, and if so, should that be taxable income or nontaxable?

Mr. COHEN. Well, you are asking me an embarrassing question because I happened——

Senator WILLIAMS. I did not mean to.

Mr. COHEN. Because I happened to receive one of those awards, so I suppose that my answer to that question would be a little bit difficult.

I not only received one but, of course, as you know, it was deemed by the Internal Revenue to be nontaxable.

Senator WILLIAMS. Perhaps now you can answer the question real well.

Mr. COHEN. But I do not believe in barring those kinds of episodic awards, which are once in a lifetime, and way out in the public domain, and you do not know whether you are ever going to get it. I did not know I was ever going to get one. I did not even know I was being considered for one until a few days before they told me I received it. So that no conduct of mine was related to it, although, I suppose, one could argue the anticipation might have had some impact on me.

But I believe that the Rockefeller public awards should not be barred from Government employees, and they should be considered as nontaxable.

Senator WILLIAMS. Well, there was nothing personal in the question because it was my amendment we are trying to deal with. I think we are both familiar with the circumstances in recent months, the publicity of why this was brought so sharply to our attention about Government officials being on the payroll either in the disguise of expense accounts or otherwise.

But I personally do question the propriety of it or the advisability of it from a practical standpoint, because it could raise questions.

For example, we are dealing with the question now, will we or will we not tax these foundations, and our committee will be voting on that.

Government officials, will be making recommendations for or against these measures which are of vital importance to them, and if one of use, as members of Congress or as members of the executive, was the recipient of one of these awards there could be a question raised in the minds of some American citizens, perhaps properly or improperly as to the propriety of it. And I just ask you, don't you think—do you think it is a good matter of public policy that a Government official, while he is on the payroll of the Government, can receive compensation in the form of travel expenses, awards or salaries for whatnot from these foundations with whom we are going to making such vital decisions?

Mr. COHEN. As a general proposition, I think your position is correct, that a public official should not be subjected to any kind of a possibility of being influenced by any monetary award or travel or anything else.

I would except unusual things that related to the Presidential Award of Merit or a Rockefeller award that was so out in the public domain that, you know, it was sui generis in terms of its nature. But, generally speaking, I would say your position is one that I would heartily endorse.

Senator WILLIAMS. Of course, in the particular case that was brought to our attention which brought this into sharp focus to our committee, the man explained it in almost the same manner, and yet there was a difference, but I just wonder where we can stop.

I understand Rockefeller awards are made by Princeton University from funds supplied by Rockefellers individuals, and that may be rather than a foundation, I do not know.

Mr. COHEN. Yes.

Senator WILLIAMS. I do not know which way it would be, but we were in agreement that as a matter of public policy it may be advisable tol imit them.

Mr. COHEN. I think you are generally correct, yes.

I had two other points which I would like to make and, perhaps, Senators would like to question me on them.

I want to make two points with regard to medical care that I thought you would be interested in.

Senator WILLIAMS. Yes.

Mr. COHEN. I think I share with the members of the committee and, particularly, with you, Senator Williams, the concern about the rising costs of medicaid, and I have two suggestions in connection with the tax laws that I would like you to consider.

One of our big problems, why, among other things, medicaid costs are going up is that there are at least 50 million people in this country who have no Blue Cross, no Blue Shield, no major medical coverage whatsoever, not a nickel or dime of it.

Now, the passage of the medicaid law presents a particular problem because for those very low income people there is no incentive to take out Blue Cross, Blue Shield from now on because if you live in a State that said, let us say, if it were Iowa, and they said, "We are going to take care of your medical bills if your income is less than $2,000," if you have less than $2,000 there is no point in your taking out Blue Cross because you could get it from medicaid, and if it is New York, the medicaid coverage is set at $5,000, there is no point in taking out voluntary medical insurance if your income is below that figure.

I believe you ought to do two things in the tax law. First, you ought to change the present deduction.

As you know, the present deduction provision that Mr. Byrnes recommended some years ago was to allow a deduction of one-half of any health insurance premiums up to $150, that is one-half of $300.

I suggest that you modify that by giving individuals a 100-percent deduction, let us say, up to $100 or $200, to encourage lower income people to get a comprehensive Blue Cross, Blue Shield policy that

will be completely tax deductible if they had income that made it taxable, and then deduct something like 50 or 25 percent above that, let us say, up to $600, so that a person would be encouraged to buy a comprehensive policy.

That is one suggestion to put in the tax an effort to encourage the lower income, noninsured people to purchase health insurance.

The other suggestion is this: I think you ought to make as a condition of any corporation, employer, or trust, or any taxable unit in this country that does use the tax laws to get a tax deduction because it has a pension plan or a stock option plan, to require them to at least insure their employees for Blue Cross, Blue Shield, and major medical.

I do not see why you should give employers this tax advantage to take care of their employees for old age if they omit including a protection against health, which, if they do not have it, merely means that you are going to finance it later on through medicaid.

Senator WILLIAMS. I understand your proposal is that all of the employees be covered under a medical policy whose scope is at least as broad as medicaid, and that the employer would pay at least one-half of the cost of the employee coverage, is that what you are suggesting?

Mr. COHEN. That would be my objective.

Senator WILLIAMS. At the University of Michigan, for which you are one of the principal officers, do you have that program fully implemented?

Mr. COHEN. Yes, sir, and better than that.

Senator WILLIAMS. Better than that?

Mr. COHEN. Better than that; yes, sir.

Senator WILLIAMS. As a result of your job?

Mr. COHEN. Yes. Actually, you see, it is the same general policy as the Federal Government has for the Federal employee, too. Under your Federal employee health insurance system you have a master contract covering all employees, although there are some options and the Federal Government pays a certain percentage of the cost.

All I am saying, you can vary the details, but if you want to see that medicaid costs in this country are reduced in the next 10 years, you have got to do something about covering more people under voluntary health insurance.

Senator WILLIAMS. I agree with you. We have got to do something. I am not unmindful of the fact that we had this medicaid program put through, you remember, you were one of the principal witnesses, at an additional cost of $238 million above the then going program, which was around $400 million, and which was going to bring around $700 million total, and now it is close to the $5 billion figure, so that is the reason that I recognize you as an authority on these escalating costs of these medical programs.

Mr. COHEN. I would say, Senator, I thought you were going to ask me about that question.

Senator WILLIAMS. I am just relating history.

Mr. COHEN. I thought you would remember the $238 million. It is indelibly engraved in your mind and mine.

Senator WILLIAMS. It is indelibly engraved in the minds of every American taxpayer because we sold them a bill of goods, and they are paying much more than that.

Mr. COHEN. No one who sat in this room could have possibly—and I am sure it never passed your mind and it never passed my mind that the States, the physicians, the hospitals, the people of this country would have in any way, you know, used and abused medicaid to the extent that it has up until now.

Senator WILLIAMS. Of course, we all make mistakes. But the chairman of the committee at that time, the Senator from Virginia, was most emphatic that the costs were underestimated if it were going to be achieved, a small fraction of the results that were being held out.

Mr. COHEN. Yes, sir.

Senator WILLIAMS. And, you know, he was a vigorous opponent of the program on the basis that the costs were not realistic, and he had some support because I was one of those at the time.

Mr. COHEN. Yes, sir.

Senator WILLIAMS. I do not mean to say we saw $5 billion costs, but we did not think you could do all these things for $250 million, either.

Mr. COHEN. No.

I want to make one other specific suggestion to this committee in this bill, and that is that you authorize by law the publication of the incomes received by taxpayers in which they receive $50,000 a year or more from any payment, directly or indirectly received, from the Federal Government.

What I have in mind is, of course, the publication of the information that I submitted to this committee before I left office, which gave the numbers but not the names of those physicians and other practitioners who received this amount of income from medicare.

However, I did not reveal at that time the individual names because the law, in my opinion, did not authorize me to do so.

I understand the committee has those names. I think it would be good public policy if the committee would put in the law an authorization that there be a public access to the Members of Congress and for the public of any who received more than a certain amount, whatever amount the committee in its wisdom thinks fair to the public.

Senator ANDERSON. What benefit would it be?

Mr. COHEN. Pardon, sir?

Senator ANDERSON. How would it benefit the public?

Mr. COHEN. How would it benefit the public? Because then I think the matter would be out in the public.

If a man makes $100,000 or $200,000 of income from Federal payments under medicare and medicaid, I think that if he is doing it all by himself he is either running a lot more people through his office than he can give high-quality medical care or he is in some way submitting bills which I do not think are justified.

Senator WILLIAMS. Well, it could be; we are checking that now. I regret that you did not get interested in that until after you left office because, as one member of this committee, we were trying to find out some of that; and I noticed that you made your speech afterward.

Mr. COHEN. No, sir. I submitted that information, Mr. Williams, in my report to this committee before I left office.

Senator WILLIAMS. Yes; but just about the time you left office.

Mr. COHEN. Well, that is the first time I had the information.

Senator WILLIAMS. But we are getting the numbers.

One of the problems we had with getting that information was this confusion within HEW.

Mr. COHEN. Yes.

Senator WILLIAMS. Of using the so-called Swiss bank account numbers for the doctors where we found some doctors having four or five different numbers.

You might be interested to know that under the instructions of the committee, they are now using social security numbers for the payments; so that it will be a very simple matter on the computer now to find out what John Doe does.

Mr. COHEN. I concur with that decision wholeheartedly.

Senator WILLIAMS. I was amazed when I went down through the Department to see that that was the first time that they ever thought of the fact that they could ever use the social security number as identification.

Mr. COHEN. I did not know about that. I was not aware of that until the committee brought that to public attention.

Senator WILLIAMS. Well, I do not know, they said that they had never thought of it before; but it was a little surprising to find when we have a law that every taxpayer in America who makes a payment to another individual in the form of compensation must use their social security number, we found the only violator of that law was the agency itself which puts out the number.

Mr. COHEN. I think we deserved an appropriate reprimand for that.

Senator WILLIAMS. And we are having an embarrassing job convincing our constituents where the agency that put out the numbers under the law cannot follow its own laws.

Mr. COHEN. But I think you ought to go a step further now, Senator, and I think you ought to authorize by law, under whatever safeguards you want, or at least public access to certain of this information with regard to the tax returns of certain individuals, and I think it would be very healthy.

Senator WILLIAMS. Well, we were advised that, first, the Social Security Administration had taken the position that they could not turn this information, under the law, over either to the public, to the committee, or to the Treasury Department itself, which collects taxes.

But recently, as a result of reexamining the law, they found that they do have the authority. We are told we do not need a law now; that the Social Security Administration can, under the existing law as it is interpreted today, make available to the Treasury Department and other Government agencies the information which they have in their files.

Mr. COHEN. But I am recommending going a step further than that.

Senator WILLIAMS. And make them do it; is that what you want?

Mr. COHEN. No. On step further. I am saying making public the information. You have them now and that is fine, and I hope you go into them. I know of no specific statutory authority that permits you to publicly release it, certainly I know of none that permits the Department of HEW to release it, and what I am suggesting is public disclosure of that information under appropriate circumstances.

Senator WILLIAMS. I would be of the opinion that the Department could, if they wished—I do not know, but this has been suggested to the committee that we do this. It has also been suggested that under

this guise of the right of the people to know, that they also publish the list of the grants and the names and recipients of all the grants that are made by the various departments. For example, in HEW, they make millions of dollars in distribution of grants for various purposes. What would you think about publishing a monthly list of all of those grants and making it readily available?

Mr. COHEN. I think that is fine because, in my opinion, they are all publicly available now.

Senator WILLIAMS. They are if you go ask for them specifically; yes.

Mr. COHEN. Now, the Ways and Means Committee wrote into the bill in 1967, and you concurred in an amendment, which required me—I was then Under Secretary—to personally sign all of those; both Mr. Mills and Mr. Byrnes were very much concerned about it, and they wrote in the statute a requirement that the Secretary or Under Secretary had to personally authorize those particular grants.

I was not very happy about it, I might say, because it was a big ministerial function. But the amendment also provides that I send to the Ways and Means Committee and to the Senate Finance Committee each quarter a record of those grants made under the applicable titles of the Social Security Act.

Senator WILLIAMS. Would that cover also your public disclosure of grants that were, well, like your surplus property that was turned over to the agency and then later disposed of by the agency to somebody?

Mr. COHEN. No; that is under another statute, but I see no reason why it should not——

Senator WILLIAMS. It should not be made public as well.

Mr. COHEN. I am for full public disclosure, I believe that. I go a step farther. I think you ought to authorize by law either the publication or public access of every taxpayer who does not pay a tax, every taxpayer whose tax is less than 10 percent of his gross income, including the deductible items, and you ought to include every person who is getting a very substantial amount of money from medicare, medicaid, farm payments, or otherwise, because I think that would be the most healthy thing for our taxpayers to know, and I think it would have——

Senator WILLIAMS. Those files are readily available if somebody asked for the specific file on John Doe's case now, are they not?

Mr. COHEN. No, sir.

Senator WILLIAMS. Should they be?

Mr. COHEN. You can ask Mr. Woodworth, but my understanding is those are not publicly accessible now.

Senator WILLIAMS. Perhaps we are talking about something else. I am speaking of the grants to colleges.

Mr. COHEN. Oh, yes, sir.

Senator WILLIAMS. The grants that are made by HEW and other various agencies.

Mr. COHEN. No, sir. There is a modification there. The actual notification of the grant and the grantee is public information and is published by the Department, but such matters relating to the action of a particular council or the refusal to make a grant is not public.

Senator WILLIAMS. I am speaking of the grant itself.

Mr. COHEN. All of those are public information.

Senator WILLIAMS. Or of the transfer of surplus property, that is publicly available.

Mr. COHEN. It is all public information. If that is not available now for some reason or other——

Senator WILLIAMS. Of course, I know it is.

Mr. COHEN. As far as I know, when I was in the Department all of that kind of information that you are talking about was public information and was available.

Senator WILLIAMS. I notice in your statement you also make rather one revolutionary recommendation for taxing social security benefits.

Mr. COHEN. Yes, sir.

Well, let me discuss that for a moment. When social security was first started in 1935 the law in effect was silent about the taxability of social security benefits mainly because the benefits were so low, incomes were low, that I think the congressional committees as well as the sponsors could not quite conceive that anybody who received benefits would be taxable, and probably that was so.

Since the social security contribution of the individual was taxable as income, but the employer is not, no thought really was given to it in the original act.

Then, as you know, the Treasury Department, under a provision in the law that certainly was not specifically intended for that, where it said no attachment, assignment, garnishment, or anything else, shall apply to social security benefits, was interpreted to mean no tax should apply to it.

Now, I think after 35 years, Senator, social security benefits are substantial, they go to a lot of people and, as I tried to point out, older people have a double deduction.

Senator WILLIAMS. You are recommending that be repealed.

Mr. COHEN. I recommend that be taken away, and everybody at least has, I think $1,524, that is not taxable in any kind of pension benefit. You have got the private pension plans and the Keogh plans, and all that sort of thing. I think you have got to take another look at the taxability of pension benefits generally, and if you do not want to tax all of social security benefits for whatever good economic or political reason, at least you ought to start taxing them, let us say, about $100 a month or about $120 or $150, above a certain amount that you thought was a reasonable exemption for low-income people.

Senator WILLIAMS. To get back to the capital gains provision, under existing law a public official, a Member of Congress can leave and donate his papers to the university or some private library or something and get charitable deductions for those as a donation to charity. At the same time, they did not cost him anything.

Do you think that should be taxable income on the basis of its appraised value?

Mr. COHEN. Well, I have not transferred my papers yet.

Senator WILLIAMS. Neither have I, so we are both in the same category.

Mr. COHEN. Simply because I am very much upset about that provision, and I do not know what to do about it. I have some very valuable papers that are mixed up with public papers and my private papers. I have made a legal instrument to transfer them to my alma

mater, but I do not know in my mind what to do about transferring them with regard to the tax status because it is kind of mixed up with my public papers, and so on. I really do not know how to handle it.

Senator WILLIAMS. As we mentioned before, we want to get charity on the basis of wanting to give something rather than to receive something in return.

Mr. COHEN. Yes.

Senator WILLIAMS. And I am not too sure that this would act as a deterrent on a bona fide turning over. But anyway the bill does deal with that.

Mr. COHEN. Yes.

Senator WILLIAMS. I, too, will be affected. I am leaving after this next year.

Mr. COHEN. I really do not know how to do that because, you see, I am in a dilemma. I have items in my papers which, if I did not give them to the university, it is quite true I could probably sell to somebody else and get——

Senator WILLIAMS. But you would pay taxes on them.

Mr. COHEN. And I would have to pay taxes on them, that is the point.

I have some letters in there from John Williams. If I wanted to sell those letters, I think I could make a lot of money. [Laughter.]

Senator WILLIAMS. Yes, sir.

Mr. COHEN. And you sent me some pretty hot letters, and I have some from Senator Miller in my file, I am sure.

Senator WILLIAMS. We can exchange them and both make some money. [Laughter.]

Mr. COHEN. I really do not know what is the right answer to that question, I really do not.

Senator WILLIAMS. I really appreciate it because I know you would be affected, and so am I.

Mr. COHEN. Yes.

Senator WILLIAMS. I mean, there is nothing personal in this because I, too, as you know, am planning to leave. But it has always been a question in my mind, these Government papers that are accumulated, while we are drawing a Government salary, they are accumulated by Government secretaries on Government salaries as a result of our work.

Mr. COHEN. Yes.

Senator WILLIAMS. And to the extent that we get a tax deduction for them, say, we are in the 50-percent bracket and they are valued at $20,000, it is $10,000 cash.

Mr. COHEN. Yes.

Senator WILLIAMS. And the question is if they are going to be valued, should we pay at least a capital gains tax. The question comes sharply to both you and me at this time because we are recommending that capital gains in general be tightened up on everybody else in America on their appreciated assets, and so I think that before I can move in and effectively tell John Doe that I think his capital gains structure should be tightened and the tax raised in his field, either at death or otherwise, I should be able to say how I want to deal with

mine. That is where I am asking you to help me, how do you think they ought to deal with yours?

Mr. COHEN. I really do not know that I can.

Incidentally, in the last 6 months where I have had more time, I have visited a number of my friends, former Senators, Governors, Congressmen, and the thing that is amazing to me is how many of them did not save or give their papers to anyone. I am appalled.

Senator WILLIAMS. I know it.

Mr. COHEN. I am appalled at the fact that many people who I think were very influential people in Congress, left office and did not do a thing with them.

Senator WILLIAMS. A lot of them I know have given them to a historical society and never took any credit.

Mr. COHEN. I want to encourage public officials to give their papers to the universities. That is why I do not want to discourage some tax advantage in that area. That is the reason for the doubt in my mind.

Senator WILLIAMS. It is a little hard for me to talk about eliminating some of the tax advantages of John Doe when I say I do not want to eliminate mine. I am just wondering how you would feel about that, as an expert.

Mr. COHEN. Well, I think what it will end up with, and I do not want to make this a certainty, but I think what I am going to do is to give my public papers to the university and not take a tax advantage.

Senator WILLIAMS. I was not speaking personally about this. There is nothing personal——

Mr. COHEN. Yes.

Senator WILLIAMS. Because this happens to be one that I personally am going to be affected by, and every other Member of the Senate at some time will. It is also equally true with former Presidents or future Presidents.

It is a problem, something we have to deal with, and it is in the House bill so we are going to be confronted with the answer.

Mr. COHEN. I am not quite clear. Maybe I did not observe it carefully. What does the House bill provide on that?

Senator WILLIAMS. The House bill provides that you can donate them to the university and take a deduction as though they were a gift to charity, but it is offset by taxing them on that same basis as though it were income, so there is no tax advantage in giving them. You can give them or, you know, you can give them away or you can just give them and not take a deduction, either way, but it is not a case——

Mr. COHEN. Does it work out that way? If you give them and they give you a $5,000 evaluation of it, and you take that deduction, and then you must also——

Senator WILLIAMS. Add the $5,000 in on your income.

Mr. COHEN. So you come out neutral, then, is that it?

Senator WILLIAMS. That is right.

Mr. COHEN. You come out neutral.

Senator WILLIAMS. That is correct.

Mr. COHEN. Well, in general, I would say that is the right policy. But I think it is probably going to inhibit some people giving their papers to the universities.

Senator WILLIAMS. Or a simpler way around it, you could give them and just call their value zero in both instances, but it averages out to zero as far as the tax benefit is concerned.

Mr. COHEN. I think you ought to give them some tax credit though, Senator. I think the House provision is a little too tough. Let me say why I am really for a person to preserve their own papers. The wear and tear on my wife about the collection of——

Senator WILLIAMS. In other words, the tax law won't allow any depreciation on wives.

Mr. COHEN. If you are going to keep a depletion allowance, I think you ought to give a depletion allowance on wives, too.

Senator WILLIAMS. I think our wives think we are depreciating faster than they are.

Mr. COHEN. I would urge you not to go as far as the House bill, and see if a more intermediate measure could not be worked out.

In other words, I would give at least a $100 or $1,000 deduction, or some minimal amount in order for Congress to at least say, if you give your papers to a university, why, there is some tax advantage. It does not have to be much, but just a recognition that the person is making a contribution.

I think this is extremely important because I want the people of the future to know the history of their country as indicated by the biographies of their leading citizens and legislators.

Senator WILLIAMS. I agree with you, the importance of that, particularly the correspondence you and I have had, which is really important. [Laughter.]

Mr. COHEN. Yes.

I will tell you some of that correspondence on medicaid is going to be good reading later on.

But I really do think that we have not been historic minded enough in this country in preserving the papers of distinguished statesmen and people, and I know those kinds of people are not doing it primarily for the tax situation.

Senator WILLIAMS. I did not mean to infer that they were. I think they should be preserved.

Mr. COHEN. I did not think so either, but I think the recognition of the difficulty and the problems and the various costs that are involved, a minimal amount of tax exemption, a nominal kind, ought to be considered.

Senator WILLIAMS. One suggestion has been that the House bill, as I said, deals with it as income and as a deduction would be zero.

One suggestion was made that maybe it be taxed as capital gains and then allow the deduction, which would be about halfway between.

Mr. COHEN. I see, that would give—that would give them about a 12½ percent deduction or——

Senator WILLIAMS. It would vary according to their rights in the tax bracket they were in, give some advantage.

Mr. COHEN. But some minimal amount, yes. I would think that would be important. I have been doing a lot of things since I left office, and my wife and I went down to Florida, and we visited Mr. Forand. You remember Mr. Forand who first introduced medicare. I stopped in to see him and I said, "By the way, Aime, what did you do with your papers?"

He said, "I didn't do anything with them. I threw most of them away."

I think that is a great calamity that a man like Mr. Forand, who had been in Congress so long and had been connected with the Ways and Means Committee did not save his papers. I think anybody connected with the Ways and Means Committee and the Finance Committee ought to have his papers preserved, so I would like to encourage it.

Senator MILLER. It is good to see you, Mr. Cohen.

Mr. COHEN. It is good to see you, Senator.

Senator MILLER. I notice in your testimony that is printed that you make a statement relating to the exemptions for dependents, you say,

> A more sensible policy would be $700 for the first child, $600 for the second, $500 for the third, $400 for the fourth, $300 for the fifth, $200 for the sixth, and $100 for the seventh.

Then you refer to one man in one of the Government departments who had 13 children, and you say, why subsidize him by the tax system to have more children. I read correctly, do I not, from your statement?

Mr. COHEN. Pardon?

Senator MILLER. I read correctly from your statement, do I not?

You know when I read this, I thought back to the days when I was in the Iowa Legislature, and we had pending before us a proposal by one of my colleagues to cut back the allowance per child on a scale similar to this in the ADC program. It was defeated rather severely. I voted against it, but the argument was that you were adding penalties to the children.

Mr. COHEN. Yes.

Senator MILLER. And it would seem to me that this could result in more taxation which would deprive, especially large-family, low-income people of proper care for the children.

Now, I think I see a similarity there between the advocacy of cutting back on ADC, according to the number of children, and this proposal.

Mr. COHEN. No, I did not, Senator. That is the distinction I would like to make.

In AFDC the only people who are eligible as far as the program is concerned are people whose incomes are below some minimum standards that the State has determined to be a poverty or dependency level, and if you have children who are in need, who are faced with a situation that certainly the children should not be penalized.

But what I am saying is if you have a taxpayer who is making income that is normally thought of to be taxable income, in the range of taxable income, why, in effect, should I pay more income taxes? I have limited myself to three children because I want my children to get a good education and support them and so on, while another man who has 13 gets, let us say, for 10 more, he gets $6,000 more exemption.

I perfectly admit he needs it if he has got those 13 children. I understand that to be a real problem.

Senator MILLER. That is where I draw the comparison with the ADC because if you deprive him of the extra exemption he would get normally you are going to squeeze a low income family which might otherwise not be in a taxable situation.

Mr. COHEN. Well, I would not do it so hard that it would be a penalty.

Senator MILLER. Whatever you call it, if I am a low income family breadwinner and I am now going to be thrown into a tax position, whereas with the straight $600 exemption I am not——

Mr. COHEN. Let me ask you this, Senator, the $600 tax exemption for every dependent is an absolutely illogical provision.

Senator MILLER. We are not going to argue about whether it is realistic or all of that. But when you start to separate this out according to the number of children in a family, I must say I can see certainly in the low income areas, a situation not unlike that ADC question that I brought up.

Mr. COHEN. No, I think it is different.

All I am arguing for is this, in principle: I think you ought to have a higher amount for the first or second child. If you want to have $600 for a child, go ahead and do it, but then I think you ought to give $1,000 for the first and $750 for the second, and if you want to give $600 or $500 for every one more, that is fine, but I do not think it costs the same in the household for every child after the first.

I think you ought to recognize the economics of bringing up children. The cost is more for the first child. The others have a reduced cost because of the light, clothes, and heat, and so on. Also, you ought to in some way recognize Government population policy to encourage people to concentrate on the quality of life for two or three of them.

I do not want to penalize any child or any family, but I would like Government policy to recognize that we ought to put a lot more into bringing up the first two or three children.

Senator MILLER. Well, I can see a lot of merit to your policy, but I have very severe reservations about using the tax law as a means toward that end just as I had very severe reservations about coming down on the ADC allowance on a child, depending on the size of the family, as an inducement for poor people not to have any more children.

Mr. COHEN. I am not only saying poor people, I am saying rich people. I do not see why we gave Bobby Kennedy all of those tax deductions for 13 children. He could afford to pay more taxes.

Why should high-income people who have a lot of children get $600 per child? If he wanted to have more children, that is fine, but I do not see why I should pay more taxes to support people who have 13 children.

Senator MILLER. You have at least one member of this committee who is advocating increasing it to $1,000 or $1,200.

Mr. COHEN. Well, yes, and I would too for the first child.

Senator MILLER. I pointed out to him that this would to a high-income or a high-tax bracket taxpayer result in quite a difference in treatment compared to the low-income taxpayer.

Mr. COHEN. Let me say this, Senator. I was trying to argue here, not for increasing or decreasing the total revenues. That is another question. But if you do go to $1,000, and I think for the first child $1,000 would be proper, and $750 maybe for the second child, but then I sure would not go to $1,000 for every additional child. That is what I am saying, you see.

Senator MILLER. Well now, one other thing.

I presume you would have a grandfather clause in this proposal, and I do not mean for a grandfather——

Mr. COHEN. At least a father clause.

Senator MILLER. Those children are already in existence.

Mr. COHEN. Well, I thought a good deal about that, but I am not competent to really figure that.

Senator MILLER. You are not a grandfather. [Laughter.]

Mr. COHEN. I want to say this, I think where this very distinguished committee and the Ways and Means Committee has really overlooked the fact that you do not really consciously realize what an important part the tax laws of this country have on social policy.

You can say all you want, and I have read the books, where it says when we deal with tax policy we do not take social implications into account, but the fact is you do.

When you give a deduction for a pension plan, you are encouraging pension plans. When you give a tax advantage for stock options, you are encouraging stock options. When you give a deduction for medical care, you are encouraging health insurance.

When you give a deduction for $600 for a child you are saying by a law of the United States of America, we think it is nice for you to have all the children you want.

All I am saying is you ought to go through the tax laws of the United States, and the committee ought to decide what it wants to do. There is a recommendation pending before this committee, that John D. Rockefeller made to spend $120 million a year for family planning, and I support that, and it is going to come before your committee.

I am for it 100 percent.

All I am trying to say is, when you adopt that, think also about the tax laws in relation to them. I am not wedded to this particular proposal. I think you could very easily find flaws in it.

But if you change the child deduction in any way, then I think you ought to consider what its impact is on families in the future.

Senator WILLIAMS. Would the Senator yield? Just a brief observation on the line that the income tax deduction for children is not altogether the determining factor.

As I stated earlier, I am No. 9 in a family of 11, and the last one was born 3 years before the income tax law was initiated. [Laughter.]

Mr. COHEN. Senator, it is very difficult to make these kinds——

Senator WILLIAMS. And I am sure my mother would be delighted if she knew that there was no income tax law in existence. [Laughter.]

Mr. COHEN. But, you see, this problem is really much more serious. If we were discussing the population policy here, and I am not saying this is the answer, maybe it is the wrong answer, I am willing to admit, but I am deeply concerned about the fact that if, before the end of this decade our population is 300 million in this country, I am deeply concerned where we are going to get the oil, the copper, whether we are going to have clean water, clean air, whether the roads will be congested.

The CHAIRMAN. Might I just put in one more word, if the Senator will yield to me for a moment, and then I think I will be through.

Mr. Cohen, you have worked hard to try to find ways to make better use of human resources and to provide people with opportunities. I regret very much that my efforts and yours to put a lot of poor folks to

work were frustrated by people who did not seem to agree with that, who did not seem to think it is better to work than it is not to work and live along on welfare checks.

We are going to have another try in connection with this Nixon recommendation, I suppose. We will see how we make out. But we ought to also be trying to find ways to provide day care centers—good day care centers for these children of—these working mothers, many of them on welfare now.

While you were testifying here I was talking to Mr. Bob Ball, and he is thinking about setting up a day care center up at Baltimore where you have got 15,000 people working for the Social Security program.

Mr. COHEN. Yes.

The CHAIRMAN. And I know you have had some experience in trying to help people who have problems.

As I recall, you told us about the problem you had with these expectant mothers who did not have husbands. You organized them into one school to teach these young people to take care of themselves, and their children. You might come down and take a look and make a few suggestions and help encourage that kind of thing, because we need to have pilot plans to show how these day care centers could operate properly. If we had the right day care centers we would be able to get a lot of people to work that we cannot do now.

Mr. COHEN. Senator, there is another provision that will just take a moment. I do not think the House-passed bill changed the allowance or the deduction for the working mothers who have a caretaker for their children.

I think that ought to be looked into. I think when a woman goes into work and she has to have day care for her children, the allowable deduction in the tax law ought to be increased so that she has adequate care for her children. Many of these welfare mothers after they get off of welfare and go to work, and then having to pay for the day care even if she is earning from private enterprise, substantially enough, if she has got two children, it now costs may be $2,000 or maybe $2,500 a year to put those children in day care, so she has got to earn $5,000 or $6,000 in order to make it worthwhile.

I think you are discouraging many of those welfare mothers eventually getting a job, going to work, if they really have to take care of their children.

The CHAIRMAN. What you are going to have to do in the first place, Mr. Cohen, it seems to me, is to have somebody look at that mother's problem and find the answer to it. Then somebody is going to have to pay for it. We ought to be willing to pay for it.

Mr. COHEN. Right.

The CHAIRMAN. And your starting point has to be that you are not going to save any money on that one case when you take that person into your program. You are going to have to pay her more and you are going to have to take better care of those children than was happening before. Someone must provide guidance, and I think that is one of our problems. We are spreading our caseworkers too thin.

Mr. COHEN. Too thin.

The CHAIRMAN. I think we need to have some people, good solid citizens, in that particular area, that particular community—if it is a ghetto, somebody within a block of that person—who can help provide some supervision and help. Not a full-time worker but as a part-time worker, to look after eight or 10 people to see that those people's problems are properly supervised.

Then we need to put those people to work, and we will have to pay them more. You should not plan on saving money by doing that on the individual cases.

Mr. COHEN. Right.

The CHAIRMAN. But then you ought to say when you put these people to work and you provide for the children and you show them how to do it right, then you gradually reduce their payments as those people learn how to do something useful so they can proceed to earn something for themselves.

Mr. COHEN. Right, and give them an incentive to do it, give them a little bit more as they go into work. I completely agree with that principle.

The CHAIRMAN. One of these days I think we ought to stop this thing of every administration junking everything the other administration did. I know it is perhaps good politics to come in and take everything the other fellow did and throw it all out and make a completely new start.

What you really ought to do is, when a new administration comes in is, to have a good excuse to junk everything that did not work, what the other fellow did, and that is a good time to do it. But everything the other fellow did that makes sense and works, you ought to build on that rather than destroy it.

Mr. COHEN. I agree.

The CHAIRMAN. If I can give just one illustration of something I noticed just in my own State one time. Here was a man running for Governor, a good, highly motivated man, but, generally speaking, his attitude was that everything the administration he was running against did had to be crooked, it had to be corrupt, because he was charging it with dealing with those kinds of people.

So when he got in, the first thing he did was to cancel all their highway contracts.

Well then, about the time they got ready to get his own highway contracts going, before his contractors could mobilize and get on the job, a war came along, so then he could not get the materials.

By the time the war was over he was out of the governorship. The result was that he had to go down as a do-nothing Governor, he could not show a single yard of concrete he had poured, nothing. Well, I mean, he could show some, but very little had been achieved.

By contrast, the same man he replaced came back and became Governor again, and he did not cancel a single one of the other fellow's contracts. He got credit for doing a fine amount of great work in road building and improvements because everything the other fellow had underway, he kept it right ahead, moving, and he proceeded then to get his own contracts and tried to improve on that, but he kept the good works of the other man, kept that rolling rather than lose all that time.

One of these days I think we are going to find that time is also a precious asset.

Mr. COHEN. Yes.

Senator, could I make one more suggestion that I did not have in my statement? You have a provision in the House-passed bill that, if I recall, allows hospitals to be tax free or nonprofit institutions, something like that, simply on the basis of being a hospital, and I believe very strongly that that should be amended so that a hospital which denied receiving any individual by virtue of being a medicare or medicaid recipient or being paid for by Federal or State funds or being an emergency case on the highways, if a hospital automatically said, "We are not going to take those cases," I do not think they should get a tax deduction.

The CHAIRMAN. That is a good point.

Now, I have got to go and vote, Mr. Cohen, but Senator Miller very much wants to ask you some additional questions.

Mr. COHEN. I will be glad to stay.

The CHAIRMAN. If I do say, you are obviously one of the most appealing witnesses and one of the most articulate because you cannot seem to get away from the witness stand. But if you would be good enough to stay here for a few minutes until Senator Miller comes back so that he will have an opportunity to ask you some questions, please do so.

May I say it is a real pleasure to see you back here again, and I think your award that you got for your contribution to Government—what award was that by the way?

Mr. COHEN. It was a Rockefeller award. I told Mr. Rockefeller at the time I met him, if he and I put all his money and my money together, he could keep two-thirds of it. [Laughter.]

The CHAIRMAN. Well, you deserved it, and you are very much entitled to it. I think that is one of the many good works of the Rockefellers.

Mr. COHEN. Thank you.

The CHAIRMAN. Thank you, sir.

When Senator Miller has had a chance to ask you his questions, we will then quit for the day, and we will come back at 10 o'clock Monday in public hearing.

The committee meets at 10 o'clock tomorrow in executive session. Thank you. It is good to see you, Mr. Cohen.

Mr. COHEN. It is good to see you, Senator.

The CHAIRMAN. Glad you brought your wife along.

(Whereupon, there was a short recess.)

Senator MILLER. The committee will resume.

I only had a couple of additional questions, and I am sorry we had to detain the witness.

Mr. COHEN. That is all right, no problem.

Senator MILLER. Let me give you this problem that I have. It is one of windfalls under the social security system.

Take the situation of an individual who has paid maybe $4,000 of social security taxes or at least between him and his employer he has paid $4,000, or a self-employed person has paid $4,000, and the next thing you know he ends up with a $20,000 or $30,000 or $40,000 tax windfall or income windfall because as the years go on, having be-

come eligible for social security, his payments far, far exceed the amount of tax money that was paid into the Social Security Trust Fund.

Mr. COHEN. Yes, sir.

Senator MILLER. I have no problem with that if that income to him is necessary to keep him above the poverty level, because I recognize that society and government at some level or other have an obligation to try to keep our people above the poverty level.

But I must say I have a grievous concern over the individual who may be in a $50,000 income bracket who is receiving these windfalls, and especially when I realize that some wage earner who may be trying to support a wife and two or three children and is making $5,000 or $6,000 a year is paying tax money in that is being used to help pay for that windfall.

Now, my concern is such that I would like to do something about it. I am wondering if this might be a sound approach: to provide that these payments under social security would stop once the individual had received back in the payments the amount of his own tax money plus the amount that the employer had paid in in his behalf, plus any interest that would be accumulated thereon at a proper rate, and they would stop where he is above the poverty level of income.

If he needs them to stay above the poverty level they will continue. Now, I would like your comments.

Mr. COHEN. Well, I do not think I would be favorable to that, but let me say where I do agree with you in principle and then see if I can develop this.

I believe that, as I said in my statement, some portion of the social security benefit first should be taxable, that is the first thing, because as the present time, as you have said, many individuals received back very substantially more than they and their employer have paid in in contributions, plus interest, and I think on the whole, this is of interest to society by what we mean as to social security, you get a guaranteed benefit.

I, therefore, favor some method for this higher income person of making the social security benefit taxable above a certain level.

Senator MILLER. Yes. But if you do that you are only going to cut down on his windfall.

Mr. COHEN. That is right.

Senator MILLER. In other words——

Mr. COHEN. Yes, but you are proposing——

Senator MILLER (continuing). The example I gave you, he probably would have to pay maybe 30 percent on that, so he gets instead of $26,000 worth of windfall, he only gets $18,000 worth of windfall.

Mr. COHEN. Right.

But my point, let me develop why I think your approach to it is not the most desirable way to do it. I think the basic approach when you deal with retirement income, it is more important to an individual to get certainty or continued income than it is to get larger amounts.

In other words, I think when anyone retires the assurance that they are going to get a continuous income for the rest of their life is what enables them to plan their arrangements and take it into account the whole way that they want to live, the style that they want to live, and their other obligations.

So I do not favor any proposal that would automatically either increase or decrease a pension simply because I believe that it is more important, and I think that is what the words, "social security" mean, is to give a person a sense of—I used the word "guarantee," there is no such thing as guarantee in an absolute sense in our society—but a reasonable kind of guarantee that they are going to have continued income.

Now, even if you tell me that the person is above the poverty level or any other level, obviously they ought to have some continued income in order that they might be able to make their arrangements, to move where they want to move, their health conditions may be different from someone else's, so I could not be sympathetic with anything that would cut a person's income off after a certain point of income.

Senator MILLER. Even though he has not paid for it?

Mr. COHEN. Yes. That has nothing to do with it.

Senator MILLER. Even though he does not need it?

Mr. COHEN. But you say he does not need it, I mean, that is a rather arbitrary decision. You said——

Senator MILLER. Well, he certainly, the example I gave you, I just use that as one example, he does not need to have social security. Of course, he would have the assurance that if the day came when that $50,000 of annual income disappeared he would have the security.

Mr. COHEN. Yes.

But here is the point. It is not that simple. You used the $50,000 example. But here is a case of a person whose income is $3,600 or $3,800 or $4,200. That is not enough, while it is above the poverty level, to take care of that person should he have medical care bills that are not covered by medicare, have special problems of diet for his wife, special problems of care for his wife or himself if he went blind.

In other words, what I am trying to say is you cannot make that assumption in terms of that income so arbitrarily, and therefore I think you have to give people some assurance of continued income so they can take care of their special cases.

Now, I recommended in there that you take away the double $600 exemption, and that you tax some part of social security benefits. If you did those two things together you would, in someway—and I agree with you not completely, but you would—still give the aged person the security of a continuing income but not give people in the higher incomes the very beneficial effects that they have now of a combination of nontaxability of social security plus a double exemption. I do not think you should have both of those.

Senator MILLER. I think that you and I are somewhat in the same chain of thinking on this. The only thing I cannot quite understand is why you are happy about letting the high income person have a $18,000 windfall instead of a $24,000 or $25,000.

Mr. COHEN. I will tell you why, and this will start another conversation, and that is because I do not want to inject a welfare concept into the insurance system, and what you have done when you do that by putting that kind of a total income test of the individual in, you are saying that social security is basically a savings bank, noninsurance kind of welfare system.

First, you limit it to what the person has paid in, plus the interest, if he has income above a certain level. Well, that is no real insurance system. That is no real pension system. That is a glorified welfare system.

Senator MILLER. We have it.

Mr. COHEN. Well, but I don't want to go in that direction.

Senator MILLER. In those cases.

Mr. COHEN. But I do not want to go in that direction. That is what I am saying. You asked me why I do not favor it.

Senator MILLER. You do not want to go in that direction. We are in that direction whether you like it or not. Those windfalls are occurring everyday.

Mr. COHEN. Yes; but like you said, I think the windfalls should be reduced, but I do not think you should necessarily try to eliminate the total windfall.

Senator MILLER. All right.

Mr. COHEN. That is what I am saying.

Senator MILLER. But you only want to reduce them by the amount of the tax that would be placed upon them. And I gave you the example of where you can have a windfall of $26,000 but reduce it by that tax and you end up with $18,000 worth of windfall.

Mr. COHEN. Yes.

But, look, the whole beneficial value of social security during these last 35 years, the same thing in the private pension plan, the same thing in every plan, is to give the man who retired that sense of security that he is going to get that payment.

If you change that fundamental principle, in my idea, then you are weakening the whole element of security in the program, and I would say this, if you are going to do that for social security, do it for private pensions, too; only give the man back the value of his contribution.

If you are going to apply it to social security, and consider social security as an income-related system, then do not give the man in private industry a different break because his deductions coming out, the employer's deductions for private pension plan is coming out, of the general taxpayer because he is getting a tax deduction for it.

Senator MILLER. Yes, that is the difference. It is paid by the general taxpayer. It is coming out of the general fund of the Treasury which is largely funded by taxation according to relative ability to pay, and that is OK if we want to do that.

But this other one is coming out of a very regressive tax system.

Mr. COHEN. Well, you ought to make the tax system of social security less regressive and I have a number of specific suggestions on that.

Senator MILLER. If we do not do that, but we continue what we are doing, and I have not seen much indication from the other side of the Hill to change it, then I suggest to you two things: I suggest to you, one, that this is a windfall and, two, we are not changing the principle just because we are avoiding the abuses of windfalls; that does not mean you are changing the principle. Just because you say to a relatively few, although totally they amount to quite a bit of drain on the social security system, relatively few people, you are not going to have a windfall, I do not think it changes the fundamental thrust of the system.

Mr. Cohen. I would rather approach it from a completely different point of view. I would make the social security tax system much more progressive, by three measures: first, taxing a certain part of the benefits; second, giving a refund to people in the low-income groups of part of the social security tax, and third, for the employer paying on the payroll all the way up.

I think if you combine those three features you would have a much more progressive system in social security.

Senator Miller. If you do that, do you not then change the system from one of an insurance-type system to a welfare system?

Mr. Cohen. No, sir; I do not think so. If I thought it did I would not favor it, Senator Miller.

Senator Miller. It is my understanding that the reason why the Congress has continued to use the so-called regressive tax approach is to preserve the concept of a social insurance system.

Mr. Cohen. Yes; but I do not believe it has to be as regressive as it now is, is all I am saying. I think you can inject some progressive features into the present program.

Senator Miller. In other words, you would say that by making a few little changes, we are not really changing the basic thrust of it, and I say the same thing with respect to my hitting at a windfall.

Mr. Cohen. I guess then there is just a difference in the way in which we would approach the problem. I feel very strongly that having it a general income condition to benefits overall would be an extremely undesirable thing. I do not feel that requiring employers on the entire payroll or giving individuals a refund or taxing social security benefits violate the essential elements of a contributory wage-related system.

For instance, I will give you another suggestion. There would be nothing wrong, in my opinion, to keep the social security system and have earmarked, let us say, a 1-percent income tax to finance part of social security. I do not think that would make it less an insurance system.

Senator Miller. Well, to the extent that you pay these windfalls, I could go along with you. But when you pay these windfalls, not out of the general fund of the Treasury but out of the social security system, I think we are violating the best concepts, the best sensibilities, regarding regressiveness, and also regarding equity.

Mr. Cohen. You and I might be able to agree on an alternative way of financing the present benefits, but I certainly feel that psychologically for the bulk of American people an income conditioned benefit would be viewed by them as being substantially a welfare system.

Now, that may be right, that may be wrong, but that is my personal view about it.

Senator Miller. I do not know how many of the average people who receive this are particularly concerned whether it is called one thing or another. What counts to them is the check that comes in, but I must tell you that there are some individuals who, when they find out about these windfalls and realize that they are paying for them, especially when they are having a hard time making ends meet, are rather unhappy about it, and I would like to try to do something about it.

You suggested one approach to not eliminate them but to cut them down some.

Mr. COHEN. Yes, and it might well be, Senator, that if you are concerned about the impact of the payroll tax on the individual, there are several alternative ways of dealing with that. One could reduce that tax and, as I say, put an earmarked income tax in it. In my opinion, there is nothing sacrosanct about the present 50–50 financing in social security between the employee and the employer, because the employer's 50 percent is immediately deductible. Let us say he is a corporation, half of that comes off as a wage and salary expense before, whereas the employee has to pay, has to include that, as taxable income immediately, and if you look at it, he is, in effect, paying a tax on all of it. I think you might well look into that to see whether that is the right way to approach it.

Senator MILLER. I was just going to come to that.

Mr. COHEN. All right.

Senator MILLER. Take somebody who has received $2,000 of social security, and he has got $10,000 of income. If I understood your original proposal you would just make him report $12,000 of income instead of $10,000. But——

Mr. COHEN. I did not propose that all of the social security income be taxable.

Senator MILLER. How much would be taxable?

Mr. COHEN. Well, I suggested in my statement, either half or some amount above a certain amount.

Senator MILLER. Well, we could start off by starting with the $12,000——

Mr. COHEN. Yes.

Senator MILLER (continuing.) Or the two.

Mr. COHEN. Whatever it is.

Senator MILLER. And then reduce that by the amount of the employee's tax that has been paid because he has already paid income tax on it anyhow.

Mr. COHEN. That is right.

Senator MILLER. And that would get us into somewhat the area of the way we are taxing pensions.

Mr. COHEN. Right. I think there is a good deal of merit in some approach of that kind.

Senator MILLER. Yes.

Then, of course, once his total benefit payments exceeded the amount he had paid in social security taxes, the whole amount would be subject to tax.

Mr. COHEN. I think that is a little harsh, but I think the approach could——

Senator MILLER. It would not be any more harsh than somebody reporting and paying on a pension. Once his contribution on that pension runs out, he pays tax on the whole thing.

Mr. COHEN. Yes. What I am suggesting, if it happened to be a person just at the poverty level, then you might want to make at least some kind of an additional exemption, you see.

Senator MILLER. Well, we are hoping by the time we get through with this tax bill that this type of person will probably not even have to file an income tax return.

Mr. COHEN. Yes. If that is so and they were not taxable, then I think you have got a good point.

Senator MILLER. This has been a stimulating dialog here, and I appreciate it.

Mr. COHEN. Thank you, Senator.

Senator MILLER. One last question: you indicated that you were not in agreement with the House proposal to levy a tax of up to 50 percent, not to exceed $10,000 on a foundation manager engaged in self-dealing; is that correct?

Mr. COHEN. Yes.

Senator MILLER. I might say that I am in agreement with you regarding the harshness of the House approach to the taxation of foundations.

But I cannot get very sympathetic about a foundation manager who is engaged in self-dealing. Why shouldn't he have to suffer the consequences and why shouldn't they be quite severe as a deterrent?

Mr. COHEN. Well, I would only say this, Senator, first, if you are going to do that, then you should do that for all business and everything else. I mean, if there are any—I do not think you should single out a foundation alone.

Senator MILLER. The reason we do is because the foundation is tax-exempt, of course, where businesses are not.

Mr. COHEN. Yes. But what you are trying to do, I think, let me put it this way: as I read that provision, it is a little bit different from the way you stated it. As I read it, if an officer made a grant for——

Senator MILLER. May I read the code here?

Mr. COHEN. Yes, maybe you should.

Senator MILLER. It should save a little trouble. I am reading from page 18 of the House-passed bill, on initial taxes on foundation manager:

> In any case in which a tax is imposed by paragraph (1)—

And paragraph 1 is on the self-dealer—

> there is hereby imposed on the participation of any foundation manager in an act of self-dealing between a disqualified person and a private foundation, knowing that it is such an act, a tax equal to 2½ percent of the amount involved with respect to the act of self-dealing for each year (or part thereof) in the taxable period. The tax imposed by this paragraph shall be paid by any foundation manager who participated in the act of self-dealing.

Mr. COHEN. Well, I see. Then, I'm sorry. I misread it.

Senator MILLER. I want to complete it.

Mr. COHEN. Yes.

Senator MILLER. Then a little further on it talks about additional taxes on the foundation manager:

> In any case in which an additional tax is imposed by paragraph (1), if a foundation manager refused to agree to any part of the correction, there is hereby imposed a tax equal to 50 percent of the amount involved.

Mr. COHEN. I misread it, then.

Senator MILLER. Then it goes on and points out the maximum is $10,000.

Mr. COHEN. Isn't there another provision, then, that provides for a tax of approximately the same amount if he made a grant or a payment to an individual that was ultra vires in terms of the scope of the foundation or something? That is what I, when I read whatever I was reading, I thought was so.

Senator MILLER. There are other provisions. I was dealing with the self-dealing provision, and to that extent you would have no objection?

Mr. COHEN. No. I was talking about what I think I read. I read this all about 3 or 4 weeks ago, and so it is not too easy to recall it. I thought that there was one provision that said if the official made any grant that, in effect, the Internal Revenue Service determined to be a grant that was improper in term of the broad scope of the foundation's activities that were now excluded under his new interpretation such as, let us say, he inadvertently made a grant to an organization that had a voter registration activity or that effectuated some legislative change, then he could be subject to the 50-percent rule.

Did I not read that correctly?

Senator MILLER. What you are talking about relates to another section of the bill entitled, "Taxes on Taxable Expenditures."

Mr. COHEN. Yes.

Senator MILLER. And it says:

There is hereby imposed on each taxable expenditure a tax equal to 100 percent of the amount thereof.

Mr. COHEN. That is the one.

Senator Miller (reading):

The tax * * * shall be paid by the private foundation.

And then the next paragraph, "Tax on Foundation Managers":

There is hereby imposed on any foundation manager who agrees to the making of an expenditure, knowing that it is a taxable expenditure, a tax equal to 50 percent of the amount thereof.

Mr. COHEN. Yes, I think those two provisions are way too——

Senator MILLER. I agree with you with respect to the foundation.

Mr. COHEN. You are talking about the officer.

Senator MILLER. But where you have a manager who knowingly does something like this——

Mr. COHEN. Does it say "knowingly"?

Senator MILLER. Yes, indeed, it certainly does. I will repeat it:

There is hereby imposed on any foundation manager who agrees to the making of an expenditure, knowing that it is a taxable expenditure.

When he takes advantage of a tax-exempt foundation, I must say that I think that we have got to do something about that.

Mr. COHEN. However, though, I think——

Senator MILLER. I do not want to penalize the foundation.

Mr. COHEN. Yes.

Let me say this: I just had not given enough weight to the word "knowingly" there. I think that would change my opinion to a great extent. But I am deeply concerned, Senator, that the language in there that limits the operation of the foundation directly or indirectly, that limits studies that could directly or indirectly have an impact, on legislatures or legislators, I think is very unsound.

Perhaps that conditions my attitude.

Senator MILLER. I think now perhaps we are in a different area, and I agree. The language of the House bill appears to be awfully broad.

Mr. COHEN. Yes.

Senator MILLER. And there have been other witnesses who have indicated concern about that, and I think that once we can agree upon

language which will not be as broad or as far reaching, then you might not object to that particular provision.

Mr. COHEN. Yes. I think if you change that provision, and with the knowledge that the word "knowingly" is in there, I would have a different conclusion.

But I want to say again that I think you are going to, as other witnesses have said so much better than I can say, if you limit the foundations and inhibit them from getting into any areas that would eventually have an impact on legislators or legislatures, I think you are losing the innovative, the creative value of the foundations to suggest new ideas and to develop things that make this country, you know, the kind of country it is, where there are new ideas and a dynamic forward thrust, and I urge very strongly you reconsider that provision.

Senator MILLER. Thank you very much.

I apologize for holding you as long as we have had to, but I think your testimony has been most beneficial.

(Wilbur J. Cohen's prepared statement follows:)

STATEMENT BY WILBUR J. COHEN, PROFESSOR OF EDUCATION, THE UNIVERSITY OF MICHIGAN

It is a distinct pleasure for me to come before this committee again, but in a somewhat different role than my last several appearances.

You might well wonder why a man who has appeared before you so many times for authorization of substantial expenditures should now appear on a tax bill. I do not appear as an expert on taxes although, as you know, the social security and unemployment taxes about which I had some expertise now comprise about 15 percent of the total Federal expenditures.

I appear today because I believe in deciding on the content of this tax bill, you should give consideration to its relationships to expenditures and to other facts such as inflation, employment and unemployment and incentives. Such broad general public policy considerations must be taken into account in your decision on individual proposals and the entire bill.

May I say that since leaving Washington on January 20, due to forces over which I had no control, I have had the benefit of being supported by the University of Michigan to think and write on matters of public interest, and to have the opportunity to review public policy questions with my University Colleagues in a non-partisan manner. I appear before you today only representing myself; and it even may be that subsequently, after reviewing the evidence taken at these hearings, I may modify or repudiate some of the views I express today.

May I first say that, whatever comments and suggestions I make today, I hope my friends on the Committee on Ways and Means will not take them as a personal criticism. They labored hard and very well. They should be congratulated on the scope and daring of their achievement. But as Lord Beveridge said: "The good should not be the enemy of the better." This is a good tax reform bill, but it can and must be made better.

ADDING TO THE INCREASES

There are numerous suggestions pending before your committee on how to produce a greater tax yield in this bill. I support the general outlines of the proposals by Senators Ribicoff, Hart, and Kennedy. I particularly urge you to eliminate accelerated depreciation for high-income and luxury housing, to tighten controls on deductions for farm losses, raise additional taxes from capital gains, authorize withholding of dividends and interest, and decrease the depletion allowances.

PRIORITIES

Why do I make this request? Because our nation is faced with a grave domestic crisis. Our inner cities are rotting away. Our educational system is deteriorating in many places. Air pollution and water pollution are advancing in many places. Congestion on the highways increases. Highway deaths are scandalous.

We have needless hunger and poverty for far too many of our fellow citizens. And our infant mortality rate is way too high for many groups. There are over 5 million of our aged who are living in poverty.

I must put the issue very frankly: our nation will be making a big mistake if the bill you report to the Senate reduces the total tax income of the Federal Government at this time.

You have an HEW appropriation bill pending in the Senate Appropriations Committee which reduces the amount available for training more doctors and nurses, which freezes the medical research capability of this nation, which appropriates only about one-half of the authorization for elementary and secondary education you enacted, and which limits the amount needed for pre-school education. Quite frankly, gentlemen, if you vote for HEW appropriations this year so far below the legislative authorizations and at the same time vote to decrease the total tax yield to the Federal Government, you will be voting for further rebellion and dissension not only on the campus, but in the churches, the streets, the inner cities, and elsewhere. I urge you to consider the seriousness and importance of this tax bill to improving our domestic situation in the next year or two.

A study of a number of countries recently made by OECD shows that during the period 1955–67 the annual growth rate for public expenditures on education in the United States was 8.2 percent while the annual growth rate for the gross national product for the years 1957–66 was 4.2 percent. This meant that for each two points increase in public educational expenditures there was about a one point increase in gross national product. In Yugoslavia, where the annual growth rate for educational expenditures (1952–67) was 17.5 percent, the GNP grew 8.5 percent—more than double that of the United States.

In 12 countries (Austria, Germany, Canada, France, Greece, Italy, Japan, Netherlands, Sweden, Turkey, Switzerland, Yugoslavia) the annual growth rate of the gross national product exceeded that of the United States and in all but one (Switzerland) of these 12 countries, the annual growth rate of public expenditures on education exceeded the growth rate for the U.S.

I urge that you raise more revenue to increase our investment in education this year.

Let me point out that President Nixon's Budget for fiscal year 1970 in the Department of HEW recommends an appropriation of only about $4.6 billion out of the $11.2 billion authorized under existing legislation with specific yearly authorizations. In other words, there is a $6.6 billion gap.

Moreover, existing appropriation requests for uncontrollable items (welfare, medicaid and general revenue contributions for social security and Medicare) which total $9.3 billion for fiscal year 1970, are estimated to rise to $17.4 billion by 1974, with no change in the legislation.

President Nixon has proposed legislative changes reducing Medicaid costs by $400 million in 1970 and by increasing welfare costs by $4 billion by 1972. The latter figure is undoubtedly understated in my opinion.

From the standpoint of inflation, now is the time that you should enact a tax reform bill which would collect much more than you reduced taxes. From this standpoint, I would suggest that this tax bill in 1970 should yield at least $2 or $3 billion more than the total reductions.

A bill which produces more reductions than increases would be grossly shortsighted. A bill which neatly balances reductions and increases may be a good political bill, but it will fail to meet our nation's needs and could be termed an "unstatesman-like" bill. A bill which produces more revenue than reductions would be a recognition that our urgent domestic needs will be given priority.

Every 1% increase in the consumer price index will sooner or later result in an increase of Federal Government expenditures of nearly $2 billion a year. Of course, as prices rise, the tax yield will undoubtedly also be somewhat greater. But the cost of inflation will be built into salary increases, retirement pay increases, medical costs, and purchases.

STRETCHING OUT THE REDUCTIONS

May I point out how easy it was to reduce taxes in 1964 and how difficult it has been to restore them only partially in 1968 and 1969. Perhaps the reduction in 1964 was too much. Perhaps we should ask whether all the reductions in this bill are too much in too short a time. I favor all the reductions, but it may be that some should be spread over a longer period of time. Could I suggest that it might

be both good economics and politics for part or some of any reductions to be effective in 1970, and to stretch the full effect of the reductions over several years, making some part of them effective the magic year of 1972 as well?

CONSERVATION AND THE NATIONAL INTEREST

I hesitate to venture into the field of depletion allowances about which the Chairman of this Committee knows so much more than I do. But I must make this point. If the depletion allowance is necessary to encourage drilling in this country, why do we reduce or exhaust our domestic supplies, before using foreign supplies? Since we are rapidly running out of valuable domestic resources, why don't we reduce the depletion allowances and save more of our domestic resources for our children and grandchildren? This isn't solely a matter of tax yield above, it is a matter of conservation patriotism, long-range planning. The basic argument the oil companies make for retaining the present depletion allowances persuades me to the contrary. I strongly urge you to reduce the depletion allowance to 15 percent in the final bill. To do so, the Senate, in my opinion, will have to pass a 10 percent provision in order to be able to get 15 percent in Conference.

DEPENDENTS' BENEFITS

The present system of allowing an equal amount for each and every dependent is neither well grounded in fact (as any parent can tell you) nor is it intelligent social policy to give a financial incentive to have more children. A more sensible policy would be $700 for the first child, $600 for the second, $500 for the third, $400 for the fourth, $300 for the fifth, $200 for the sixth, and $100 for the seventh. There was one man in one of the Government Departments who had 13 children. Why subsidize him by the tax system to have more children?

This Committee took the leadership in making family planning services available in 1967 under Title V of the Social Security Act. Why not carry out the social policy in your tax reform bill?

WITHHOLDING OF DIVIDENDS AND INTEREST

For the life of me, I can't understand why if withholding is proper for salaries, why it isn't for dividends and interest. There is no question in my mind that you may be losing some taxes by the present policy. This is a real loophole, which should be closed. I strongly urge you to include withholding of dividends and interest in this bill.

HEALTH INSURANCE PREMIUMS

Your Committee has accepted the principle that employer contributions for health insurance are deductible as a business expense. You have concurred in the practice of deducting from gross income one-half of any contributions for health insurance premiums up to $300 a year. Certain medical expenses are deductible.

You have also accepted financial responsibility under Medicaid for a large and growing expenditure, but have neglected to assure yourselves that every possible man, woman and child will be covered by health insurance instead of relying on Medicaid.

I urge you to make as a condition of any employer, corporation, or trust obtaining any tax deduction for any contribution toward a pension, profit-sharing or stock option plan or similar arrangement—that all his employees be covered under a medical policy whose scope is at least as broad as Medicare, and that the employer pay at least one-half of the cost of the employee coverage.

TREATMENT OF THE ELDERLY

I urged the House Committee on Ways and Means to simplify the reporting of income and credits for the elderly. Although this part of the tax return is the most complicated part of the entire return, no action was taken.

The double exemption for the elderly plus the exemption of social security income coupled with the tax changes in the bill will relieve many lower-income elderly persons from taxation. This is to the good. But many high-income elderly persons still obtain a favorable tax advantage by virtue of these special provisions. When you are making these other changes favoring the low-income taxpayer, that is the time to make the reforms affecting the higher-income elderly.

SOCIAL SECURITY CONTRIBUTIONS

I endorse the low income allowance in the bill. I believe you should also consider the employee and self-employed person to claim a refund of one-half of the employee or self-employed social security contribution, if his income is below the new level of non-taxability in the bill.

You might also consider taxing one-half of the social security benefit above a minimum, such as $125 a month.

FOUNDATIONS AND CHARITABLE DEDUCTIONS

The provisions of the House-passed bill relating to Foundations and Charitable contributions raise major matters of social policy. You have been hearing from many people on these provisions and you will hear much more before you complete these hearings. Because there has been adverse publicity on certain grants made by some Foundations is not ample grounds for discouraging the great work of the Foundations which have stimulated some of the great medical, scientific, literary and educational innovations.

I urge you to make any amendments to these provisions effective for only two years and to renew them independently and separately as a matter of long-range national policy.

May I also point out if the 7½ percent tax on net investment income of a private Foundation is a minimum tax, then the principle should apply equally to all other charitable, as well as business, enterprises. A policy of non-discrimination should be applied.

The sanctions in the bill for a violation of the provisions relating to Foundations is clearly punitive. To tax a Foundation 100 percent for any amount paid for a so-called improper purpose is unwise. A 50 percent penalty should be the maximum.

May I point out to the Committee if there is any logic to this provision, then the same penalty should apply to *all* improper expenditures of *any* taxpayer.

If the punitive taxation of any improper purpose is retained in the bill, then I believe expenditures for such purposes should be reported fully and publicly so there can be public review of the impact of such policy on the contribution of foundations to the national interest.

Instead of the special and punitive taxes on Foundations in the House-passed bill, I recommend substitution of filing fees.

COMPARATIVE TAXES WITH OTHER COUNTRIES

I appreciate that the American taxpayer is desirous of both tax reform and tax reduction. But the demands of a dynamic, urban, innovative society cannot be carved out without substantial taxes. The question is how much and who should bear the burden.

In 1965, total tax revenues in the United States (Federal, State, and local) were equal to 27.3 percent of the gross national product. This was made up of 9.3 percent direct taxes on individuals and families, 4.5 percent on corporations, 9.3 percent in indirect taxes (including real estate taxes) and 4.2 percent in social security taxes.

Table 1 shows 12 countries which were paying more than the United States in taxes in relationship to GNP, and 12 countries which were paying less. Note that in the list of those paying more than the U.S. are industrial countries which are in the forefront of industrial development. Among the 12 countries paying less than the U.S., one finds only Australia, Japan and Switzerland; the remainder are smaller, less affluent nations.

Of course, if you ask any individual if he would like his taxes reduced, the answer is going to be close to 100 percent. The truly civilized man would answer —what are the alternatives and consequences of such action?

The fact is that among the industrial, affluent, and incentive economies of the world, we are not paying the highest taxes. This is not an argument for higher taxes, or to retain existing taxes. It is simply a fact that the overall burden of taxes in the U.S. is less than many other countries.

TABLE 1.—TAX REVENUES IN RELATION TO GROSS NATIONAL PRODUCT, 1965, BY COUNTRY

Countries in which the tax revenue as a percentage of GNP in relation to the United States

MORE		LESS	
1. Austria	35.1	1. Australia	24.1
2. Belgium	29.7	2. Bolivia	12.8
3. Canada	31.0	3. Chile	23.7
4. Denmark	29.7	4. Colombia	11.8
5. Finland	29.4	5. Greece	20.8
6. France	38.5	6. Ireland	24.8
7. Germany	34.3	7. Japan	19.8
8. Italy	29.7	8. Korea	9.0
9. Netherlands	34.1	9. New Zealand	26.3
10. Norway	34.9	10. Portugal	19.0
11. Sweden	39.0	11. South Africa	16.9
12. United Kingdom	30.3	12. Switzerland	20.9

Source: "Facts and Figures on Governent Finance," 1969, Tax Foundation, p. 32.

TABLE 2.—TAX REVENUES IN RELATION TO GROSS NATIONAL PRODUCT, 1965, BY MAJOR TAX CATEGORIES

	Total taxes	Direct taxes: On individuals	Direct taxes: On corporations	Social security	Indirect taxes
United States	27.3	9.3	4.5	4.2	9.3
Belgium	29.7	7.0	1.9	8.6	12.2
Canada	31.0	7.4	4.8	2.1	16.7
Germany	34.3	7.9	2.5	9.8	14.2
United Kingdom	30.3	9.3	2.1	4.8	14.1
Sweden	39.0	17.7	2.3	6.2	12 8
Japan	19.8	4.4	4.0	3.5	8.0

Source: See table 1.

FURTHER REVIEW

Mr. Chairman, the economic and social implications of this tax bill are so substantial and so far-reaching it would be foolhardy to think that the final bill will be a model of perfection or unanimity of agreement among all affected. The Surrey tax study was a monumental achievement and Stan Surrey should be given the Treasury Award of Merit for what he and his associates produced.

I suggest you write into the tax bill two provisions:

1. That the Treasury Department issue a comprehensive report with two years after the enactment of the bill which provides the Congress and the American people with all the necessary information on the implementation of this act. The Freedom of Information Act should apply to the tax bill.

2. A Presidential Commission of 12 distinguished citizens should be appointed to review the law and its application and make recommendations to the President and the Congress for any changes. Such a Report should be published on December 1, 1972.

I think such studies should include some way to reduce local residential property taxes as a method of financing elementary and secondary schools. I, for one, am opposed to the President's shared-revenue proposal as long as (1) there are States which do not have a State income tax, and (2) such a proposal does not assure that there will be some reduction in property taxes, and (3) that a substantial portion of the money will be used for education, and (4) Congress

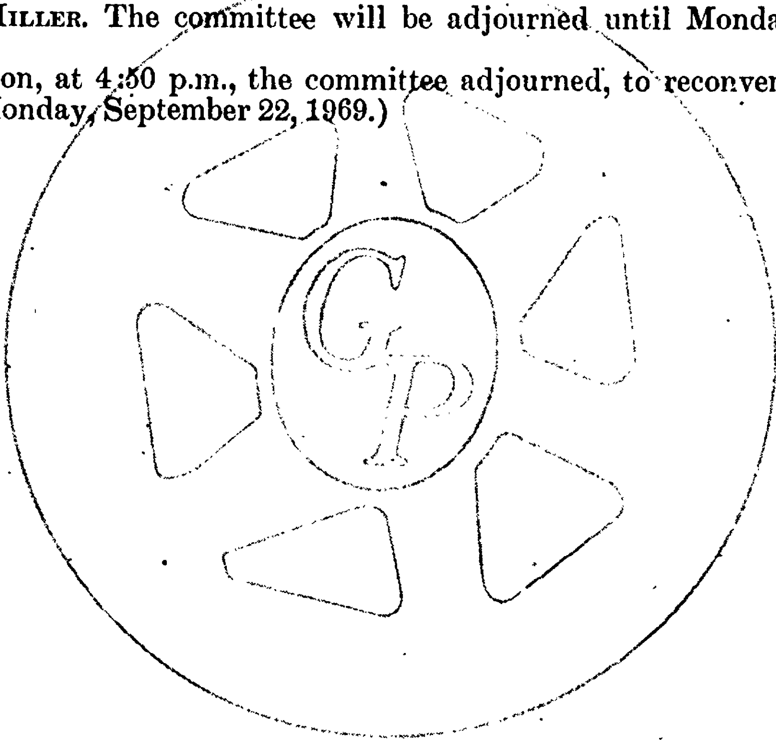
has not appropriated the full amounts authorized under existing education legislation.

I believe the House Committee on Ways and Means, the Senate Committee on Finance, and the Joint Committee on Internal Revenue Taxation should take jurisdiction of the shared-revenue proposal and consider it together with the proposals for overhaul of our welfare system, the tax system, and the improvement of the social security, medicare and medicaid program.

In this connection, I must make clear that I do not support the proposal pending before your Committee for a tax credit for tuition fees for higher education. While there is substantial support for this from the higher income earners, it is wrong in principle and in practice, and would not be helpful to higher education. My criticisms against this kind of proposal are on record while I was an official of the Department of HEW under three Secretaries. I reaffirm my opposition as a citizen and as a Dean of a University School of Education.

Senator MILLER. The committee will be adjourned until Monday morning.

(Whereupon, at 4:50 p.m., the committee adjourned, to reconvene at 10 a.m., Monday, September 22, 1969.)



APPENDIX A

WRITTEN TESTIMONY RECEIVED BY THE COMMITTEE EXPRESSING AN INTEREST IN THE SUBJECT OF FINANCIAL INSTITUTIONS

Written Testimony Received by the Committee Expressing an Interest in the Subject of Financial Institutions

STATEMENT OF WILLIAM H. BODINE, PRESIDENT, SAVINGS ASSOCIATION LEAGUE OF NEW YORK STATE

Mr. Chairman and members of the Committee:

My name is William H. Bodine, President of the Savings Association League of New York State. The Savings Association League of New York State deeply appreciates the opportunity to present its views on H.R. 13270 the tax reform act of 1969 and the treasury proposals as they relate to taxes on thrift institutions.

In 1962, when the Congress last enacted tax legislation directly affecting savings associations, it provided three alternative bad-debt reserve formulas properly recognizing their need for building reserves against possible future losses from their long-term investments in the American home. The Congress clearly appreciated the social need these institutions serve. Savings and loan associations have consistently responded to the public's demands upon them and more than justified the trust delegated to them by the Congress.

When our business was singled out for special tax treatment in 1962, it was the treasury's stated opinion that it would not consider further adjustments for a period of 10 years pending a study of the effect of the '62 bill on the revenue flow. The treasury admittedly states that the revenues anticipated from savings and loan associations have been on target—although those from mutual savings banks have not. For emphasis we reiterate that the savings and loan business has paid taxes anticipated by the Revenue Act of 1962. It did not exploit the special provisions of the '62 law to avoid taxes. The special provisions of this law were used only as an appropriate response to a social desirable public need.

The 1929–32 Depression clearly demonstrated that savings and loan associations need a higher bad debt reserve allowance than other corporate lenders. Restricted as they are on both the asset and liability side of their structures, they require special provisions to insure adequate accumulations of loss reserves. In the depression years ('29–'32) mutual savings banks weathered the storm with loss reserves ranging from 12 to 14 percent of assets. They emerged from that holocaust with little damage. Savings and loan associations went through the same storm with reserves averaging about 5 percent. The result was that only one half of 12,000 institutions survived the crisis. Certainly this clearly demonstrates the need for adequate loss reserves against potential losses from long-term mortgage investments.

The House Bill and the Treasury's proposal would place these institutions in jeopardy. Many of them will be unable under existing competitive pressures to meet mandatory reserve requirements. The forced liquidation which would ensue would seriously reduce the potential supply of residential mortgage funds.

Without attacking the merits of the House or Treasury proposals in their application to the savings and loan business, we feel that a very simple question must be answered. Is there a social need for specialized lending institutions in the housing field—such as savings banks and savings and loan associations? If the answer is affirmative, then the thrift business is entitled to such treatment as will guarantee not only its survival but its effectiveness in serving this special field. Rather than imposing additional taxes—reducing their potential for meeting ever increasing demands—means should be devised for increasing their capacity to render a public service.

These associations do fulfill in a meritorious way the purposes for which they were chartered. The Friend Report (authorized by Congress in 1966 represents the most comprehensive analysis of the savings and loan business ever undertaken) produced by the University of Pennsylvania is a broad endorsement of the business. Rather than restricting these institutions the study is

concerned primarily with maximizing the usefulness of savings and loan associations and of related financial institutional arrangements for advancing the social objectives they are designed to serve. In considering the tax aspects, the study states that "it is likely that commercial banks have been a greater beneficiary of Government policy than savings and loan associations as a result of their ability to provide checking accounts for their customers, the prescription of interest payments on such accounts, the significantly lower cost of time and savings deposits to them than to the associations (perhaps on the order of one-half of 1 percent) as a result of the convenience of one-stop banking, and the limitations placed on the entry of competitors. Commercial banks also receive other benefits from the Government, including a more favorable tax treatment than is accorded to nonfinancial corporations, though not so favorable as the tax treatment extended to the associations." Subsidies directed to specific intermediaries again referring to the Friend Report may be justified on the basis of the belief that this provides greater control over the successful implementation of housing policy than leaving the investment decision in the hands of a diversified lender (though, even with specialized intermediaries, the past effectiveness of housing policy leaves much to be desired).

In summary we concur with the position of the United States Savings and Loan League and the National League of Insured Savings Associations that the Committee retain the present provisions in Section 503 of the Internal Revenue Code of 1954 providingg special bad debt reserve formulas for savings and loan associations.

However, we do go one step beyond their stated position. We feel retention of the 3 percent alternative is desirable for precisely the reasons stated heretofore, buttressed by the fact that this provision provides an additional incentive for a maximum response to a need for housing capital. Its exploitation—the reason given for its proposed elimination—can be prevented by the adoption of two simple conditions limiting its use to institutions truly responding to public demands. We therefore recommend its retention subject to restriction of its use to institutions having at the beginning of a taxable year:

(a) 79% of their assets invested in qualifying loans as defined by the I.R.S., and

(b) having in such assets a total investment not less than that of any preceeding year.

Let us also make the point that a measure of competitive parity should not be restricted to tax considerations. Restrictions on investment options, or access to sources of capital are, in the final analysis far more important as a study of the conclusions reached by the Friend Report will confirm.

Finally, with regard to a measure of subsidies—the special privileges enjoyed by commercial banking—we cite the fact that Dr. Friend, in making an oral summation of his studies before a meeting of the Savings and Loan Advisory Council on June 24 of this year, was asked whether an attempt was made to measure in dollars the value of governmental subsidies enjoyed by our commercial banking system. He reported that this had been done—that the total was so large as to be rated "incredible" and "many, many times" that which thrift institutions by reason of special tax treatment enjoy.

We therefore conclude that the housing market and the needs of our people will best be served by complete retentiton of the present provisions for taxing thrift institutions.

CONGRESS OF THE UNITED STATES,
HOUSE OF REPRESENTATIVES,
Washington, D.C., October 3, 1969.

Hon. RUSSELL B. LONG,
Chairman, Finance Committee,
U.S. Senate, Washington, D.C.

DEAR MR. CHAIRMAN: In spite of a continuous growth record for the last several years, housing in Puerto Rico has not been able to keep up with the needs of our citizens, mostly due to the fact that for the first half of the century there was very little housing construction.

In this respect, mortgage bankers in Puerto Rico depend almost totally on stateside banks and investors as a market for their residential mortgages. A substantial part of their market is made up of mutual savings banks.

The present high level of interest rates has substantially affected housing starts in Puerto Rico just as much as in the rest of the country. Since we are already experiencing a serious limitation in the flow of mortgage funds to Puerto Rico it is of great importance to us that bad debt allowance for mutual savings banks be kept at the present rate and that no changes be made on the investment standards presently applicable to mutual savings banks. Otherwise, due to the limited capacity of Puerto Rico's own financial institutions, housing in the island will undoubtedly be seriously affected.

I trust this matter will receive your Committee's favorable consideration.

Sincerely,

JORGE L. CÓRDOVA.

MECHANICS SAVINGS BANK,
Hartford, Conn., September 22, 1969.

Hon. THOMAS J. DODD,
U.S. Senate, Old Senate Office Building,
Washington, D.C.

DEAR SENATOR DODD: We understand that the Senate Finance Committee, which is considering revising the tax treatment of financial institutions, plans to report a tax reform bill to the Senate by the end of October. We urge you to contact your colleagues on the Finance Committee, urging them not to change the present tax treatment of mutual savings banks. If the Finance Committee decides to change the present law, however, we believe that the provisions in the House-passed Tax Reform bill (H.R. 13270)—with modifications designed to permit mutual savings banks to continue to meet the housing credit and other community needs of our state—would be less harmful than the Administration proposal.

The reasons why the present law should be retained, and the modifications needed in the House bill if the Finance Committee decides to change the law, are indicated below:

1. The present tax provisions relating to mutual savings banks and savings and loan associations accomplish for housing exactly what the Congress intended—a strong stimulus to residential mortgage flows. Furthermore, current tax liabilities of savings banks are rising and will rise significantly further without changing the tax laws. Thus, retention of the present tax provisions is desirable both from the standpoint of housing, as well as from the standpoint of increasing tax payments by thrift institutions in the years ahead.

2. Both the Administration proposal and the provisions in the House-passed Tax Reform bill (H.R. 13270) relating to financial institutions would reduce the supply, and increase the cost, of mortgage credit for housing and urban revitalization programs. Because both proposals will increase tax payments of mortgage-oriented thrift institutions more sharply than those of commercial banks, the competitive position of thrift institutions will be weakened and savings will be diverted increasingly to nonmortgage uses. Commercial banks already have important competitive advantages because of their broader powers. Ultimately, many thrift institutions might feel it necessary to convert into commercial banks and adopt their nonmortgage lending orientation. In any event, if thrift institutions are not permitted to set aside realistic bad debt reserves, they will have to provide for future losses from after-tax dollars, further increasing the cost of mortgage credit.

3. If the present law must be changed, however, the House-passed bill, with modifications, would be less harmful to housing than the Administration proposal, because the House bill at least recognizes the need of thrift institutions for a bad debt reserve allowance for future mortgage losses. While mortgage losses have been small in the postwar inflationary boom, history shows that losses can be concentrated and substantial in a future economic decline or even in a period of relatively stable prices and real estate values.

4. Therefore, the bad debt provision proposed by the Administration, which would be based on a six-year moving average of recent actual loss experience, would be totally unrealistic and would compel prudent lenders to shift funds away from mortgages to less risky investments. Moreover, according to industry estimates, the Administration-proposed "special deduction" of 5 per cent of gross interest income from residential and certain other loans could not be used by about one-half of the savings banks. Thus, the "special deduction" proposed by the Administration would provide a poor "incentive" for residential lending. Savings banks, in any event, need no special incentive for residential lending, but rather a realistic bad debt reserve provision for future mortgage losses.

5. In order to provide for a realistic bad debt reserve provision, and reduce the harmful impact on housing and urban revitalization programs, the House bill should be modified to:

(a) Permit inclusion of all mortgage loans, rather than only residential and certain other loans, for purposes of meeting the 72 per cent investment standard, in order to avoid discouraging the flow of funds into types of mortgage lending essential to the rebuilding of our cities; and

(b) Retail the 60 per cent of income bad debt reserve allowance in the present law, rather than reduce it to 30 per cent over a ten-year transition period as in the House bill, so that mortgage-oriented thrift institutions can compete more effectively for savings with commercial banks which have much broader powers and competitive advantages.

6. In summary, if the Congress decides to adopt either the Administration proposal, or the House bill without these modifications, another dimension will be added to the present mortgage and housing crisis, and the costs of housing America will be permanently increased. Whether, or by how much, these costs are increased, is for the Congress to decide.

Sincerely yours,

RICHARD B. HASKELL, *President.*

RHODE ISLAND HOSPITAL TRUST NATIONAL BANK,
August 22, 1969.

Hon. JOHN O. PASTORE,
New Senate Office Building,
Washington, D.C.

DEAR JOHN: As President of a large commercial bank in Rhode Island, I feel it is important that you should be aware of the potential adverse ramifications in the business community of this state if the proposed legislation pertaining to the tax treatment of gains and losses on securities and bad debt reserves is enacted.

The Tax Bill which has been reported out by the Ways and Means Committee includes a proposed change in the treatment of capital gains on securities transactions of banks. Presently, banks are subject to capital gains rates on net long-term profits. I understand the proposal is to subject such profits to taxes at full rates. To be sure, the existing system has been an advantage enjoyed by banks and has encouraged them to purchase longer term bonds issued both by the U.S. Government and state and local Governments, especially when the market made such investments available at a discount. As you no doubt realize, banks have been an extremely important factor in these markets. In fact, they are recognized to have been the dominant factor in the municipal bond market over a period of recent years. A change in the tax treatment would clearly have a discouraging effect in this regard, and I suspect you would find that security purchases by banks would thereafter be generally confined to shorter term issues, especially avoiding those which sell at a discount because by their very nature, discount issues carry inferior coupons.

Such a change in attitude would, in my opinion, be a severe blow to the workings of the high-grade bond markets because a very important source of intermediate to longer term buying power would disappear, and the ability of the U.S. Treasury and local Governments to finance their needs in the longer term markets would be curtailed, perhaps drastically. If, as a result, such financings were confined to shorter term borrowings, the effect on the overall economy could be most unsettling.

While the proposed legislation might seem to be closing a "loophole," I think the advantage which the Treasury Department would hope to gain is far more apparent than real. If my earlier reasoning is correct, which I think it is, then banks would avoid purchasing those discount securities which promise future capital gains at maturity. Therefore, there would be no capital gains to tax regardless of the rate. Granted there could be a short-term advantage to the Treasury Department because of those securities which are already owned at discounts, but this too could be considerably diluted as portfolio managers moved out of these issues at little or no profit prior to maturity for reinvestment in other areas.

In summary, I think the advantage which is available to the banks under the present system creates many desirable side effects in the workings of the markets for Government bonds and the orderly financing of federal, state, and local

projects. Furthermore, to remove this advantage would in large part merely redirect the strategies of investment officers so that, in fact, the Government would realize very little additional revenue.

Also included in the proposal are restrictions on Bad Debt Reserves. Since 1960 this country has been in an unparalleled economic trend. Business has been virtually bursting at the seams. This of course has meant greater prosperity for the business community, and failures have been at a minimum, giving a somewhat distorted picture of loan losses to banks.

Present government policies are aimed to curb the mounting inflation resulting from the free-wheeling period of the past few years. Undoubtedly as these policies begin to take hold, business failures and resulting loan losses could become a major problem for the banking industry. Many businesses today are built on the psychology of inflation and could be vulnerable in a period of extremely tight money or recession. In this situation the inability of the banking industry to rely on established reserves will bring on a reluctance to venture rescue dollars. One of the results of volatile growth in the economy in recent years is that the bank depositor is practically the forgotten man. He has been replaced by the glamour of the investor. Historically banks have the strongest responsibility to the depositor and this fact should not be overlooked. We must cite the position of the various regulatory agencies supervising banks. In periodic examinations these agencies classify loans in such categories as "substandard" and "doubtful" far in excess of actual losses. In many instances these are so-called "work-outs" and require a great deal of attention to salvage to avoid substantial losses to the bank, and in periods of economic stress the bank and the depositor become vulnerable.

Banks today are being asked to participate in so-called Ghetto loans, which by their very nature are marginal at best. Again with the protection of depositors in mind, banks will be reluctant to participate to any great extent in a program of this nature unless they are fully guaranteed from loss by the Government, or adequate protection is provided by reasonable reserves.

It is also apparent that there is a lack of equality in allowed reserves for similar financial institutions. Savings and Loan Associations and Mutual Savings Banks have long enjoyed a competitive advantage in the way reserves are calculated. If Commercial banks are to generate and maintain a strong position in mortgage financing in direct competition to these other financial institutions, they should at least be competitively equal in respect to allowed reserves.

The thoughts that I have set forth above are a sincere desire on my part to inform you of the possible consequences of further restrictive legislation against the financial community. I hope that in your deliberations in the Congress as a Senator of the State of Rhode Island, you will give every thought to making it possible for the banking industry in this state to provide the necessary financial impetus to help in keeping the business community in a position to meet the economic needs of its citizens.

Kindest personal regards,

Most sincerely,

CLARENCE H. GIFFORD, Jr.,
Chairman of the Board and President.

THE FIRST NATIONAL BANK
OF SCOTTSBORO, ALA.,
August 16, 1969.

Hon. RUSSELL LONG,
Senate Office Building,
Washington, D.C.

DEAR SENATOR LONG: This letter is addressed to you as an individual Senator as well as Chairman of the Senate Finance and Taxation Committee. It has to do with some provisions of the Tax Revision Law which affect all of us.

No doubt you will have received the attached statement on two of these items from other sources, but these are so well expressed in these statements that I feel that this would do a better job than I can do in explaining my personal feelings in the matter.

In regard to the tax treatment of capital gains and losses on bonds and other evidences of indebtedness of banks, I certainly do not ask any special favors for banks, but I do call attention to the fact that banks are quasi-public in nature

and have done a great deal of work in helping to handle the government bond marketing as well as helping to stabilize the markets on other securities.

Our particular import would be the treatment of capital gains on bonds already held by banks. Our purchase of bonds in many cases has been with the understanding that the appreciation in value would be treated as a capital gain and would be taxed in this manner. For this to be changed on bonds already in our portfolio would mean a tremendous loss to our bank and we feel would not be just. Certainly if this change is to be made, some provision should be made about a cut-off date so that bonds purchased in good faith by banks and which show a capital gain would still be treated as a long term gain and taxed as such rather than as ordinary income. It will mean a tremendous loss to us to have this done otherwise.

I am sure that it is recognized that if this change is made, the price of low coupon bonds would go down considerably on the market, and this would have a bad effect on the assets of many institutions.

The attached statement on bad debt reserves is also very reasonable and I trust will receive the attention of the committee. It has long been recognized as being in the interest of the public for banking institutions to set up reserves for bad debts which would partially cushion against losses which could occur in the event of a deflationary period in our economy.

You may be sure that your consideration of these matters in a favorable light will be most highly appreciated.

Thanking you and with best wishes, I am

Sincerely yours,

JOHN W. GAY, *President.*

TAX TREATMENT OF CAPITAL GAINS AND LOSSES ON BONDS AND OTHER EVIDENCES OF INDEBTEDNESS OF BANKS

Commercial banks can treat losses on sales of debt securities as deductions from ordinary income and profits as capital gains. Thus, the tax saving on any net losses is at the marginal corporate income tax rate (now 52.8 percent including the 10 percent surcharge) and the tax paid on long-term gains is at the capital gains rate (now 27½ percent including the 10 percent surcharge). These tax provisions apply equally to savings and loan associations and mutual savings banks although commercial banks have had to bear all of the criticism for this nonsymmetrical tax treatment.

These gain and loss provisions are now in the process of being changed. The proposed legislation would continue to treat losses on debt securities as ordinary losses but would treat both short and long-term gains as ordinary income.

Although the proposed change in tax treatment is likely to have a strong effect on bank portfolio management and procedures, its effect on such operations and profits is likely at this point to be less important to Congressmen than its effect on the Government and the economy. For example, the tax change would probably have a significantly adverse effect on the smooth functioning of the Government securities market, the attainment of debt management goals, the execution of Federal Reserve monetary policy, and the general flow of bank credit to serve the economy.

But there is also a question of equity and in this connection it is possible that many members of Congress are not fully aware of the immediate consequences of the proposed legislation. Most banks now hold discount Government bonds which were bought in good faith that they would continue to have capital gain treatment. These issues were acquired at a low yield to maturity and only under the existing capital gains rules would the yields after tax match those on high coupon securities issued more recently. Indeed, the change in tax treatment as presently written is already having a sharply adverse impact on Government security prices which is harmful for all investors. More particularly, the enormous losses in market values already pose a very serious problem regarding the adequacy of the capital funds of most banks.

Aside from the immediate consequences, in terms of safeguarding the public interest, it should be stressed that the legislative history of the present nonparallel gain and loss treatment shows that it was not given to banks for their own profit. The intent of the Treasury and the Congress was to provide an effective mechanism for easing the problems of public debt management, smoothing the flow of Government securities to ultimate investors, and facilitating the normal expansion of loans to private borrowers.

It is generally recognized that a viable dealer market is essential to Government financing as well as to the effective execution of monetary policy. But the proposal is bound to have a harmful impact on the Government securities market since it would reduce bank investment, underwriting and trading in Government securities, especially in intermediate and longer-term issues where the risk of loss is greater than on short-term issues. The market is already thin in these areas and the consequences of the change in tax treatment would be to make it even thinner. As a result, the Government securities market would suffer not only in terms of lessened activity but also in regard to the ability of dealers who make the market function, to match sales and purchases.

Reduced participation by banks as investors and underwriters could seriously hamper the achievement of long-range Government debt management objectives. Banks are a very large and active part of the Government security distribution system. They initially acquire more than 60 percent of all Treasury coupon issues allotted to private investors. Lessened bank participation especially in handling intermediate and longer issues would interfere with attempts to lengthen the average maturity of the debt and would increase the congestion in near-term maturities. If banks are less willing to underwrite and hold new intermediate-term issues, the Treasury would find it necessary to pay substantially higher rates on such offerings than might otherwise be required.

This would drive up other key rates such as on mortgages and municipal securities with a consequent harmful impact in these sensitive areas of the economy. It should also be stressed that bank gains and losses on securities are largely the result of normal day-to-day operations. In conducting such operations banks typically absorb Governments during recessions when bond prices are rising and sell Governments when credit demands are high during recovery periods when bond prices are falling. This economic function is often performed at a loss. To the extent that changes in tax treatment increase risks and decrease profitability, the flexibility in the flow of bank credit to business and consumers would be impeded. The proposed tax treatment change is likely to make the task of the Federal Reserve in controlling bank credit expansion more difficult. To avoid risk, many bankers would tend to concentrate most of their investments in the short-term area of the market which would provide greater liquidity for expanding loans during inflationary periods.

What is most important for Congressmen of all persuasions to realize is that the present treatment of bank gains and losses is wholly in the public interest, since it is an essential factor in the smooth distribution and marketing of Government securities, in the execution of monetary policy, and in maintaining the flow of bank credit. When viewed from that perspective, changing the present provisions is likely to prove far more expensive to the Government than the immediate tax gain involved.

Bad Debt Reserves

The House Ways and Means Committee has reported tax reform legislation, which would revise bad debt reserve provisions. The legislation provides that commercial bank bad debt reserves would be limited to a six-year moving average of actual losses. As a transitional rule, actual losses (presumably in excess of recoveries) would be allowed as a deduction and not charged against the present reserve. Thus, if the bad debt reserve of a bank is larger than its latest six-year loss average, the present level could be maintained, but could not be increased until the average loss experience exceeded the existing bad debt reserve level.

A new bank would be allowed to use the industry average based upon losses in the current and five preceding years for their first 10 years if it produces a larger bad debt deduction than that based upon the individual bank's actual experience.

Two important questions are raised by these changes: (1) Would the reserves be adequate? (2) Would the proposals result in equitable treatment of all banks?

In response to the first question, it should be emphatically pointed out that reserves would not be adequate. The bad debt reserve of any bank should be more than an allowance for ordinary loan losses. In reality it should be its first line of defense against sharp losses in the event of a business downturn. No informed person today would deny that a severe recession could happen. In fact, one of the concerns of those now leading the fight against inflation is that the economy might be pushed too far, and into a recession.

The effect of an economic downturn on loan losses of banks is clearly demonstrated by the Treasury's own figures in its "Tax Reform Studies and Proposals." Actual commercial bank losses (net of recoveries) during the moderate 1960–61 recession increased nearly fourfold from $54 million in 1959 to an average of almost $200 million in 1960 and 1961.

The figures also show that loan losses of commercial banks rose sharply in the 1960's and amounted to more than one-half of allowable bad debt deductions for tax purposes in 1966. Moreover, during this period of unparalleled economic expansion, the rate of actual losses to the deductions for reserves rose from 34 percent in the first full recovery year of 1962 to 52 percent in 1966. Thus, it is clear that establishing bad debt reserves on the basis of a moving average of past years' losses would result in inadequate reserves, if a future recession of some severity should occur.

Banks occupy a crucial position in the economy as suppliers of credit and as depositories for most of the nation's money supply. Thus, the closing of a bank has more serious consequences for a community than the failure of some other business of comparable size. This unique role of commercial banks is responsible for the elaborate supervisory system devised by the States and the Federal Government to maintain bank safety and continuity.

An important present day factor is the growing pressure in Government circles in and out of Congress for banks to expand their lending to small business, particularly in the inner cities. One may well ask if it is reasonable to expect loans to marginal borrowers to be expanded when simultaneously the allowable reserves against losses on such loans are being significantly reduced.

On the question of equitable treatment, the proposals clearly discriminate against new banks or those not fully up to the present 2.4 percent ceiling. It is important to put all banks, established as well as new, on a par with regard to losses relative to loans outstanding. This can be done only through a uniform percentage ceiling.

Significantly, when the present reserve formula was established in 1962, the Treasury fully agreed with the banking industry that a uniform ceiling as a percentage of eligible loans was the fairest and most logical approach to the problem.

In summary, the first line of defense against excessive losses by banks in high loss periods is the bad debt reserve. Although the FDIC instills public confidence in the banking system, it cannot prevent loan losses, nor can it prevent the disruption that truly serious losses might bring. An adequate level of bad debt reserves is clearly an economic necessity. If the possibility of a severe recession cannot be ruled out, the present formula is not excessive.

Moreover, on the grounds of equity, the proposed treatment of new banks, or of banks which are building toward the present reserve ceiling, is clearly discriminatory. The fairest approach is to treat all banks on the same basis. In that respect, the present percentage formula is both logical and equitable.

The Ways and Means Committee has also approved a change in the taxation of the mutual financial institutions, which over a ten-year transition period would limit their bad debt reserve allocations to 30 percent of net income rather than the presently authorized 60 percent of net income, which most savings and loan associations use, or 3 percent of the increase in qualified real property loans, which most mutual savings banks use, and which would be eliminated outright.

However, the Committee is making no change in the provision permitting thrift institutions a ceiling of 6 percent of total mortgage loans outstanding. In contrast, the Committee is eliminating the commercial bank ceiling of 2.4 percent of loans outstanding. This is discriminatory. Commercial bank reserves are effectively frozen to current levels, while mutual savings banks and savings and loan associations can, within the 60–30 percent of net income restriction, continue to add to their reserves up to their 6 percent ceiling. Not only is the present ceiling of thrift institutions higher than for commercial banks but, what is worse, the amount of the thrift institution ceilings will continue to rise as their loans expand. Thus, the Committee is increasing the present advantage thrift institutions enjoy in building reserves. This is moving in the wrong direction with respect to tax uniformity among financial institutions. August 1, 1969.

FIDELITY BANK OF COLONIE,
Latham, N.Y., October 2, 1969.

Senate Finance Committee,
Washington, D.C.

DEAR MR. VAIL: I appreciate the opportunity to direct the attention of the Committee on Finance to the adverse effects section 441 of the Tax Reform Act of 1969 (H.R. 13270), as passed by the House of Representatives, will have on

the small commercial banks organized since 1964. As so frequently is the case, the plight of small businesses is largely overlooked by organized industry representatives as they present the positions of the giants of their industry. I believe this has happened in connection with section 441 of the Tax Reform Act.

PROBLEMS OF NEW BANKS GENERALLY

The success of a new bank in establishing and maintaining its existence as an independent banking institution corresponds generally with its ability to attract deposits, which in turn is to a great extent dependent upon the establishment of a vigorous program of extending loans to prospective depositors. In pursuing a vigorous loan policy, a new bank cannot exercise the loan selectivity possible by an established bank. This undoubtedly causes new banks to meet a need for banking services in the community which would not otherwise be satisfied and is therefore socially desirable. It does, however, result in greater bad debt experience for new banks, necessitating a larger reserve for bad debts in their case. Moreover, because of the smallness of a new bank's loan portfolio, a few bad debts can have a disproportionately large effect. The Tax Reform Act as passed by the House makes no distinction between established and new banks, but rather determines a new bank's bad debt reserve essentially on the basis of the experience of old established banks. Moreover, the ten-year net operating loss carry back rule it provides is, of course, of little or no benefit to new banks in weathering adverse bad debt experience.

THE BAD DEBT PROVISIONS OF THE ACT DISCRIMINATE AGAINST NEW BANKS

The bad debt reserve provisions of the House passed version of the Tax Reform Act of 1969 aggravate the competitive problems of new banks, particularly those banks which were organized and capitalized between 1964 and 1969 with the expectation that they would be permitted by the Federal income tax laws to establish bad debt reserves comparable to those established by their long-established competitors, without impairing their capital.

REVENUE RULING 65-92

April 5, 1965, the Internal Revenue Service promulgated Revenue Ruling 65-92, 1965-1 Cum. Bull. 112, which revised the method of computing bad debt reserves of banks. Under the ruling a bank was allowed to establish and maintain bad debt reserves in an amount equal to 2.4% of its outstanding loans. The ruling provided that permitted increases in a bank's bad debt reserve did not have to be made in any particular year, but generally, could be made (and the deduction therefor taken) in later years. This latter provision was significant to new banks since in the usual case a new bank is not in a position to increase bad debt reserves without impairing its capital. This was not a problem for established banks since they had earnings from which bad debt reserves could be established. As a result, during the period from 1965 to the present, many established banks have been able to accumulate sizable bad debt reserves under Rev. Rul. 65-92 which obviously puts them in a competitively stronger position.

PROVISIONS OF SECTION 441 OF THE TAX REFORM ACT

Under section 441 of the Tax Reform Act, bad debt reserves of banks will be based upon the individual bank's bad debt experience for the taxable year and the five preceding taxable years. In the case of a new bank, for the first ten years of its existence bad debt reserves will be determined upon the basis of the experience of financial institutions generally during the six years preceding the taxable year. Generally, if the bad debt reserves of a bank at the end of its last taxable year beginning before July 12, 1969, exceed the bad debt reserves computed on the new basis, section 441 provides that the bank may continue to maintain reserves at that higher level. The effect of this is to permit an established bank that has been able to build up substantial reserves under Rev. Rul. 65-92 to maintain those reserves. I have no quarrel with the reasonableness of this provision. It constitutes a fair transition rule as applied to established banks. However, it is of little benefit to a new bank established during the period Rev. Rul. 65-92 was applicable which has not been able to accumulate a significant bad debt reserve. Rather, it puts such a bank in a disadvantageous competitive situation relative to its long-established competitors. I believe that banks

created during the applicability of Rev. Rul. 65–92 on the assumption that the rules therein contained would permit them to accumulate bad debt reserves comparable to those of their competitors should also be provided a transition rule designed to meet their situation.

THE FIDELITY BANK OF COLONIE, UPSTATE NEW YORK

The Fidelity Bank of Colonie was organized in October of 1965 and opened its doors for business on January 3, 1966. It was capitalized by stockholder subscriptions of $1,650,000.

During its first several years of operation, Fidelity was unable to establish a provision for bad debts without creating a deficit undivided profits account, thereby producing an impairment of its capital to which the bank regulatory authorities would undoubtedly have objected. Moreover, under section 441 of the Tax Reform Act, Fidelity will not be permitted in the future to accumlate a reserve out of earnings comparable to that which its competitors have been permitted to accumulate in the past.

PROPOSED AMENDMENT TO SECTION 441 OF TAX REFORM ACT

I believe section 441 of the Act should be amended to permit banks organized after April 5, 1965 (the date of Rev. Rul. 65–92), and before July 11, 1969, to continue to compute their bad debt reserves on the basis provided by Rev. Rul. 65–92 for a period of ten years from their creation. Such an amendment would have a very moderate immediate effect on revenue collections and in the long run would have no appreciable effect. It would be fair to long-established banks and would provide a reasonable benefit to new banks to offset the competitive advantage prior bad debt reserve rules have created for old banks. Absent such an amendment, these new banks, which were capitalized on the assumption that the Federal income tax bad debt reserve rules contained in Rev. Rul. 65–92 would apply to them, will find themselves unfairly disadvantaged by the enactment of section 441.

If such an amendment is not adopted, Congress should, as a very minimum, provide rules similar to those contained in section 832(e) of the Internal Revenue Code under which banks created during the period of applicability of Rev. Rul. 65–92 would be permitted for a period of ten years to continue to compute their bad debt reserves in accordance with that ruling if they invest the tax benefit of the differences between the yearly increases in such reserves under section 441 of the Tax Reform Act and the amount determined under the ruling in noninterest bearing Treasury "tax and loss" bonds. Such bonds should be redeemed by the Treasury in future years as, and to the extent, the difference between the reserve determined under Rev. Rul. 65–92 and the reserve determined under section 441 of the Act narrows. Moreover, the bonds should be issued in such form as will permit their use as collateral for deposits of public funds.

Respectfully,

PATRICK J. RYAN, *President.*

SEPTEMBER 10, 1969.

The Honorable Members of the Senate Finance Committee,
U.S. Senate, Washington, D.C.

GENTLEMEN: As suggested by your Chief Counsel, Mr. Tom Vail, I would like to direct your Committee's attention to a serious problem that exists in the interpretation of sections 541 through 565 of the Internal Revenue Code (personal holding companies) and its application to banks of limited powers and the inability of many lending or finance companies to meet the exemptions afforded in section 542(c)(6).

First of all, permit me to thank your for the opportunity of having this testimony included in the printed record of the hearings on tax reform legislation.

The problem that has arisen in this matter to do primarily with the interpretation and application of section 542(c) which section defines exceptions from the personal holding company designation as defined in section 542(a).

Section 542(c)(2) states that a bank as defined in section 581 of IRC is to be afforded an exemption from personal holding company taxes. At the present time, it appears that IRS is not willing to interpret section 581 so as to include industrial loan associations, Morris plan type banks, etc., regardless of the fact

that these type of institutions have already been determined to be banks within the meaning of section 581 in four previous cases decided in the Federal Courts. The cases referred to are as follows: (1) Valley Morris Plan vs. Commissioner, 305 Fed. 2nd 610; (2) Morris Plan Bank of New Haven vs. Smith, Collector 125 Fed. 2nd 440; (3) Staunton Industrial Loan Corporation vs. Commissioner, 120 Fed. 2nd 930; and (4) Mutual Savings and Loan, Inc., vs. C.I.R., 1941 B.T.A. 1204.

Section 581 states than "bank means a bank or trust company incorporated and doing business under the laws of the United States (including laws relating to the District of Columbia), of any State, or of any Territory, a substantial part of the business of which consists of receiving deposits and making loans and discounts, or of exercising fiduciary powers similar to those permitted to national banks under section 11(k) of the Federal Reserve Act (38 Stat. 262; 12 U.S.C. 248(k)). and which is subject by law to supervision and examination by State. Territorial, or Federal authority having supervision over banking institutions." I will attempt herein to bring to light some of the injustice built into the personal holding company portion of the tax code, and to offer some suggestions with regard to affording the relief required to permit legitimate companies to remain in business.

At this writing, Norfolk Industrial Loan Association (NILA), of which I am President, is embroiled with IRS over the question of whether NILA is afforded an exemption from personal holding company taxes by the exceptions afforded in section 542(c)(2) and/or 542(c)(6). The tax year involved are 1964, 1965 and 1966.

To give you some background on this case, I would like to state that NILA was licensed in 1959 as "a bank of limited powers" under Chapter 5, sections 6.1-227 through 6.1-242 inclusive of the Code of Virginia. NILA is subject to supervision and examination by State Bank Examiners of the Bureau of Banking, State Corporation Commission of the State of Virginia. As of December 31, 1964, NILA had loans and discounts in the aggregate sum of $1,604,415.06 and more on December 31, 1965.

With regard to a substantial part of the business being that of receiving deposits, NILA had outstanding as of December 31, 1964, certificates of debenture in the amount of $770,500, part of which represented funds placed with the Association through fiduciary relationship. In 1964 NILA had a total of $357,157 in funds which it had received from guardians of estates, infants, incompetents, etc. In many instances these funds were placed with the Association by order of Courts of Record of the State of Virvinia. As you gentlemen can readily see there is no reason why this Association should not meet the definition of a bank as defined in section 581. Yet the facts of the matter are that NILA has been declared by IRS as not meeting the definition of a bank as defined by section 581 and has been assessed $95.246 in additional taxes and interest (no penalties) for the years 1964 and 1965. A claim has been filed in the United States District Court in Norfolk, Virginia, for the return of these taxes which NILA feels were improperly and excessively assessed.

Section 542(c)(6) outlines exemptions afforded lending or finance companies if they meet certain tests as defined in subsections (A) through (D) inclusive. There is no way that a great many lending and/or finance companies can meet the requirements of these tests unless they are willing to greatly change the type of business they are handling, plus dismiss key executives, managers and employees who are also shareholders so as to be in a position to meet the test outlined in subsection (C) which subsection refers to expenses directly allocable to the active and regular conduct of lending and finance business. To qualify expenses must equal or exceed 15% of the ordinary gross income from active and regular conduct of lending and finance business. This section states in effect, and has been interpreted to mean, that when attempting to meet its requirements you cannot consider salaries paid to officers, managers and employees who are shareholders, or members of their families, even if they are not stockholders, nor can you consider interest paid on funds borrowed for relending when attempting to meet the 15% test. As you gentlemen can readily see, the largest expense a lending or finance company generally has is the salaries of its principal officers, managers, employees, and the interest it pays on funds borrowed. When you eliminate these two items, you eliminate the larger portion of expenses that a lending or finance company has and thereby create a situation whereby many lending and finance companies fail to meet the tests outlined for the exemption afforded by section 542(c)(6).

Our research into the legislative history of the personal holding company tax section indicates that it was never the intent of Congress to subject legitimate industrial loan associations, Morris Plan banks, and lending or finance companies to the unreasonable taxes (70% of undistributed personal holding company income) called for in the personal holding company tax section.

In fact, Mr. Sidney L. Cohen, CPA, Boston, Massachusetts, in an article written for Prentice-Hall, Inc. in their 1966 edition states, "Section 542(c) (6) is a revelation in tax legislation, since it simplified its prior counterpart by streamlining the PHC exemptions for finance companies. Thus, the lending and finance company exception provides a more comprehensive and livable escape hatch for the PHC classification." He further states, "The House report on the Revenue Act of 1964 concluded that it would be desirable to have one exclusion available for all four of the above categories of lending or finance companies. At the same time it saw no need for purposes of the personal holding company provision to restrict the type of loans which these companies could make since this is properly a matter of regulation of State law governing these lending or finance businesses."

Mr. Cohen further stated, "Because of the harshness of the penalty of the surtax, the Courts have commented that if Congress had intended otherwise it would have provided for relief. They have gone along with the letter of the law and applied the technical rules as the law provides. However, a study of the legislative history shows that with the lapse of time, Congress has provided more and more relief to deserving legitimate cases. Insofar as certain types of finance companies are concerned this relief has taken the form of a percentage expense test, favorable treatment given to rentals, group affiliates, bank affiliates, a redefinition of the gross income percentage test and other technical changes."

Therefore, as you gentlemen can see, the intent of Congress is one thing while the interpretations and application of the exceptions from the personal holding company taxes are in reality another.

It is the opinion of this Association, its CPA's and attorneys that section 542 (c) (6) is in fact a trap that many legitimate licensed institutions are subject to being caught in. If relief is not forthcoming, or if IRS does not take a more reasonable attitude toward it, you are going to see a situation develop where many companies including this Association are going to be forced to liquidate or merge with large publicly held companies because of their inability to meet the exceptions afforded in the sections referred to herein.

Now I'm sure, some of you gentlemen will suggest that escape from PHC classification can be obtained by meeting the stock ownership test outlined in section 542(2) by selling its stock to a larger number of shareholders and thereby avoiding the five individuals owning 50% or more in value stock ownership test. This again does not necessarily work on the main streets of America. In fact, in the case of this Association, NILA has been attempting since 1959 to go public with no less than six stock brokerage firms including some of the largest on the East coast. In addition, NILA has mailed more than 60,000 pieces of mail in an attempt to interest residents of the State of Virginia in purchasing its securities which include common and preferred stock. At this writing, NILA has 132 common and preferred stockholders, and still has a situation whereby five stockholders own more than 50% in value of its stock. The reason being that from time to time NILA is forced to sell stock to its existing principal stockholders in order to avoid being subject to the thin corporation doctrine.

The problem with the present tax code as I view it from Granby Street here in Norfolk, Va., is that it is no longer workable. It is far too complicated. As a corporate executive I can truthfully say that I have never personally met a CPA or an attorney who has sufficient knowledge of the present tax code to satisfy the requirements of corporate executives. What is happening in this Country is that the Federal bureaucracy has been tremendously successful in alienating the younger generation and the system is now being extended to promote a tax revolt the likes of which this Country has never witnessed before. In my opinion, approximately 70% if not all of the present tax code should be completely scrapped and a greatly simplified code should be adopted in its place. The present code is filled with traps and pitfalls that defy the abilities of tax experts to understand. There is very little solid ground left that CPA's and tax attorneys can use to state without question that their judgment in a particular matter is sound and unassailable. There is no reason that the code cannot be simplified so that the average CPA can understand it. As I see it, most corporate taxpayers do not object to paying reasonable taxes; but they want the traps removed so that they know where they stand and what they owe and that the advice they

are forced to rely on can be trusted. I personally have reached the point where I have lost complete confidence in CPA's and tax lawyers because of events that have transpired in our dealings with IRS in the last several years.

I would like at this point to go into some detail in an effort to point out the unreasonableness and the injustice which is the end result of a corporation caught in the personal holding company trap.

In the case of NILA it should be noted that IRS arrived at a determination of its assessment for additional corporate income taxes by substantially reducing the addition to reserve for losses set up by the taxpayer from $42,000 to $2,019; however, this is another matter which will soon be litigated in court. If we accept the Internal Revenue Service's adjustment in the reserves for losses account of the taxpayer, we arrive at a 1964 corporate income of $30,786.77 for the calendar year ended December 31, 1964. On this regular corporate income, NILA has paid an assessed tax of $50,576.22, which represents 164% of its normal corporate income, assuming that it was not a personal holding company.

The situation for the year 1965 is that NILA has been assessed and has paid a tax equal to 120% of its regular corporate income, again assuming that it is not a personal holding company.

The effect of the payment of these taxes and interest (not including any penalties whatsoever) on the Association's financial position is that they wipe out all but $2,019 of NILA's reserve for losses account, completely eliminates its retained earnings account, plus eliminates all of its paid in surplus and impairs the capital structure of the Association. By their action, IRS has endangered and impaired the safety of hundreds of thousands of dollars in funds deposited with NILA by guardians of estates, infants, incompetents, and the savings of numerous elderly people and small hard working day to day workers whose investment in NILA's certificates of debenture in many cases represents most of their cash savings.

If any of you gentlemen can offer a defense for this type of injustice, I would like to hear it.

In the event this Committee is desirous of affording some measure of relief for small closely held industrial loan association, Morris Plan type banks, and lending or finance companies, it would be my suggestion that section 581 of the code be amended so as to eliminate the following portion, "a substantial part of the business of which consists of receiving deposits." This would have the effect of recognizing industrial loan associations and Morris Plan type banks for what they are and that is, banks of limited powers, legitimately licensed and supervised by the various states.

In addition, it would be my recommendation that subparagraph (i) of section 542(c)(6) subparagraph (B) Exceptions, be eliminated entirely or amended to read 120 months, in place of 60 months.

I furthermore recommended that section 542(c)(6) subparagraph (C) be amended to permit as a deduction of expense in arriving at the 15% expense test of ordinary gross income so as to include compensation of employees of lending or finance companies regardless of whether or not they are shareholders and interest expense paid for the borrowing of funds for the conduct of its lending or finance business. I see no reason why small lending or finance companies should be forced into a position of dismissing or requiring its officers, managers and/or employees to sell shares of stock that they might own in the company which they are employed by in order to meet the 15% deductions test outlined in this section. To me this is gross discrimination against small lending and finance companies.

Unless some relief is forthcoming promptly you will see a situation in which hundreds of small companies will be forced to merge or liquidate in order to escape the injustice of the personal holding company tax.

I sincerely hope that this Committee will see fit to amend the Internal Revenue Code so as to permit small closely held legitimate licensed industrial loan associations, Morris Plan type banks and lending or finance companies to survive. Thank you.

Respectfully submitted.

D. H. BURLAGE, *President.*

STATEMENT OF J. AUSTIN WHITE, J. A. WHITE & CO., CENTRAL TRUST TOWER, CINCINNATI, OHIO

Probably the most widespread and vocal opposition to the tax reform bill, as passed by the House, is against two sections: (1) the proposal to include interest from state and municipal bonds in the "limit on tax preferences" (Sec. 301 of

the bill); and (2) the proposal to include such interest in the "allocation of deductions" (Sec. 302 of the bill)—and I'm opposed to both of these proposals.

But in this statement I should like to concentrate on one provision of the bill (Sec. 443) about which there is not heard so much hubbub of opposition, but which, if allowed to stand as is, will cause undue and unjust hardship to thousands of banks throughout the nation. In the words of the House Ways and Means Committee (on page 130 of its "House Report No. 91-413, Part 1), this Sec. 443 "eliminates the present preferential treatment accorded to financial institutions' transactions in corporate and Government bonds and other evidences of indebtedness by providing parallel treatment of gains and losses on these transactions. Under the bill, financial institutions are to treat net gains from these transactions as ordinary income instead of as capital gains; they will continue to treat net losses from such transactions as ordinary losses as under present law."

Now this sounds fairly innocuous. But I beg your indulgence while I try to point out an amendment that should be added to prevent both undue and unjustly harsh treatment that will result to the thousands of mostly smaller banks across the nation, from the broad application of this Sec. 443 if it is not amended.

By way of introduction, let me say that I am the proprietor of a relatively small municipal bond house, J. A. White & Company, established in Cincinnati in 1937. I own no stock in any bank, and I presently have practically no bonds to sell to banks. But for thirty-five years, since 1934, I have specialized in selling bonds to commercial banks. This, and much "extra-curricular" work done chiefly for my bank clients over these 35 years, give me, I think, a sound basis to speak authoritatively and intimately of the investment policies and problems of commercial banks.

First, let me quote again from "House Report No. 91-413, Part 1" wherein on page 129 under "Reasons for change" the House Ways and Means Committee states (underscoring is mine) "*Transactions* of financial institutions in corporate and government bonds and other evidences of indebtedness do not appear to be true capital *transactions;* they are more akin to *transactions* in inventory or stock in view of the size of the bank holdings of these items and *the extent of their transactions* in them. Moreover, financial institutions now maximize their tax advantages by arranging their *transactions* in bonds in the light of existing market conditions in order to realize gains in selected years and losses in other years."

Right here, let me state unequivocally that of the 14,000 or so banks in the nation, probably 85% to 90% of them do *not* follow such a practice of "arranging their transactions in bonds." Those that do follow such a practice are the larger banks. If this Sec. 443 is allowed to become law without an amendment such as I suggest later, the Committee's effort to get at a practice followed by only a relatively few large banks will penalize unduly and, I repeat, unjustly, the many thousands of smaller banks who do not even follow that practice.

Second, please note from the above quotation that the Ways and Means Committee refers five times to "transactions" in bonds. This constant use of the word transactions, would infer that the Committee's attention was concentrating on at least fairly frequent buying and selling of bonds, as contrasted to the far more common practice amongst the thousands of banks of simply buying bonds *once* as an investment and *holding* them to collect at maturity.

My point is that a distinction should be made between "transactions" of buying and selling bonds, and the one-time purchase of bonds for investment that are held constantly to maturity and simply collected when due. When a bank buys a bond and holds it for a year, or three years, or five, ten or twenty years, and then sends it in for collection at maturity, that could hardly be considered "transactions" in bonds, especially in the light of the Committee's further reference as a "reason for change" that "financial institutions now maximize their tax advantages by arranging their transactions in bonds in the light of existing market conditions in order to realize gains in selected years and losses in other years."

Quite possibly the Committee did not intend to penalize the legitimate one-time purchase of bonds held to maturity as an investment. Indeed, the actual wording of the bill itself (H.R. 13270, page 264) reads as follows (italics mine): "(c) BOND, ETC., LOSSES AND GAINS OF FINANCIAL INSTITUTIONS.—For purposes of this subtitle, in the case of a financial institution to which section 585 or 593 applies, the *sale or exchange* of a bond, debenture, note, or certificate, or other evidence of indebtedness, shall not be considered a sale or exchange of a capital asset." Now certainly sending a bond in for collection when

it matures (or is called for payment), could hardly be properly called a sale of the bond. But I cannot be so sure that some Internal Revenue Agent might not call the collection of a bond at maturity an "exchange," for cash, though certainly that would seem to be a strained interpretation of the meaning of the word "exchange."

Our problem here is that many thousands of banks, if indeed not all of them, have purchased bonds at prices below par, for investment, and they fully expect to hold such bonds to maturity. When such bonds are collected at maturity at par (their face value), the bank technically has a gain, which is the difference between the purchase price below par, and the par value collected at maturity. Under a broad interpretation of Sec. 443, without some amendment, this "gain" will far too likely be taxed in full as ordinary income, particularly in view of the broad comment of the Ways and Means Committee quoted at the outset of this statement (from page 130 of "House Report No. 91-413, Part 1"): "Under the bill, financial institutions are to treat net gains from these transactions as ordinary income instead of as capital gains."

But, as I have indicated above, the "net gains from these transactions" should be considered quite differently from the technical "gain" which a bank earns when investing in a bond at a discount below par and holding it to maturity and then sending it in for collection at par. This latter type of gain is not the type of gain which I feel the Committee wanted to tax as ordinary income, since it is really a delayed collection by the bank of part of the investment return at which it agreed to invest in the bond when the bank originally purchased the bond for investment.

At the risk of being too technical, allow me to go into this point a bit further as it forms the basis of my argument for a protecting amendment to Sec. 443. Due to the high interest rates prevailing generally over the past four years (not just in 1969), probably 75% to 85% of the bonds that have been available in the market have had to be sold at discount prices below par, because they were issued in prior years when interest rates were lower. For example, a bond issued say in 1962 with an interest rate of 3¾% has not been worth its face value, or par, for the past several years, because of rising interest rates in general. No one would buy such a bond today, nor last year, nor the year before at its face value. But, a bank might have been willing to invest in such a 3¼% bond in 1967 at a yield of 5%. This means of course that the bond would have to be purchased at a discount price, below its par or face value, let us say at 90 cents on the dollar, or 90% of its par or face vaue. Now, the bank which buys that bond at 90, and holds it to maturity is not reaping a gain of 10% of its face value in the normal connotation of gain, nor, I think, in the sense that the Ways and Means Committee considered "gains from transactions." Rather, this 10% of face value which the bank collects after holding the bond to maturity is just as much a part of the investment return, or yield, as the interest coupons collected semi-annually while the bank owned the bond. The only difference between this "gain" and the interest coupons is that the bank had to wait two years, or five, ten or twenty years to collect this part of its interest, whereas the bank collected the 3¼% coupons each year.

So, for all of the above reasons, and, I repeat, to protect many thousands of banks across the country from undue hardship from too broad an interpretation of Sec. 443, I earnestly urge the Committee on Finance to add an amendment to this Sec. 443 to make certain that its does not apply to bonds purchased for investment and held to maturity (or call payment date). This could be accomplished, I believe, by adding the following italicized words to this paragraph quoted above from page 264 of H.R. 13270: "(c) BOND, ETC., LOSSES AND GAINS OF FINANCIAL INSTITUTIONS.—For purposes of this subtitle, in the case of a financial institution to which section 585 or 593 applies, the sale or exchange of a bond, debenture, note, or certificate, or other evidence of indebtedness, shall not be considered a sale or exchange of a capital asset," *but a bond, debenture, note, or certificate, or other evidence of indebtedness purchased for investment and held to maturity, or to the call payment date if called prior to maturity, shall be considered a capital asset.*

Now if, after considering all of the above points, you should perchance still refuse to amend this Sec. 443 to differentiate between "gains from transactions" and the one-time purchase of bonds for investment that are held constantly to maturity, then let me point out the injustice that will be done to many thousands of banks across the nation by the retroactive feature of this Sec. 443 as it stands now. There is no "grandfather clause" in the section as now drawn.

There is no consideration given to the effect of this Sec. 443 on prior commitments by a bank, which would be represented by bonds still owned and not yet matured but purchased a year, or three, five, ten or even twenty years ago. The effective date of this Sec. 443 reads simply as follows (from page 265 of H.R. 13270)—"The amendments made by this section shall apply with respect in taxable years beginning after July 11, 1969."

In other words, this Sec. 443 as now drawn will require bluntly that starting next year *all* bonds owned by a bank will no longer be considered capital assets, regardless of whether the bonds represent new purchases or purchases made five, ten or twenty years ago! I sincerely hope you will agree that it is eminently unfair thus to make this change retroactive.

As stated above, over the past four years or so because of high interest rates, probably 75% to 85% of the bonds available in the market have had to be priced at discounts below theier face value, because the bonds had been issued in previous years of lower interest rates—and for the five or six years before that perhaps half or more of the bonds available in the market had to sell at discount prices for the same reason.

This situation has been true of all bonds, Government, municipal and corporate, and as a result, over the past decade practically all of the 14,000 banks throughout the nation have purchased, in the aggregate, hundreds of millions of dollars worth of bonds that had to be purchased at discount prices below face value in order to compete with the declining market, and, most important, many millions of dollars worth of such discount bonds are still owned by many thousands of banks.

Now, here is the important point that deserves your careful and honest consideration. In all of those purchase commitments involving these millions of dollars of bonds, a very important consideration in the making of these commitments was the realization that such bonds would be considered capital assets, and the "gain" represented by the appreciation to par at maturity would be taxed as a long term capital gain. As of course you know the maximum tax rate on such long term capital gains has been 25%, and it was on the basis of such a tax rate that these commitments were made. And now, if you do not amend this Sec. 443 to keep it from being retroactive, you are about to double that tax rate, on commitments made previously, even as long as years ago. I earnestly hope you will agree this would be unjust.

Sec. 443, as now worded, will result in banks having to put into ordinary income taxed at regular rates the full amount of the "gain" represented by the appreciation to par at maturity of the discount on bonds purchased below par. Of the 14,000 banks in the nation, relatively few now earn net taxable income of less than $25,000; so that the vast maojrity of them pay the regular corporate tax rate now at about 50% (48% plus the surtax). Hence. I repeat, if you do not amend Sec. 443 to keep it from being retroactive, you will in effect be doubling the tax rate retroactively on commitments made even years ago. In the example mentioned previously, of a bank that purchased a few years ago a 3¼% bond at 90, the bank in making the commitment understood that the 10% appreciation to par at maturity would be subject to a maximum tax rate of 25%. It would be unfair, and an injustice, to make that bank pay twice as high a tax rate on that appreciation just because the bond matures in 1970 or beyond. The injustice that would be thus done is magnified to great proportions if you realize, as you should, that this simple example would be repeated in hundreds of thousands of commitments *previously* made by thousands of banks across the nation.

I most strongly urge you to eliminate at least these injustices by amending Sec. 443 with some such wording as the following underscored words added to Sec. 443 as quoted from page 264 of H.R. 13270: "(c) BOND, ETC., LOSSES AND GAINS OF FINANCIAL INSTITUTIONS.—"For purposes of this subtitle, in the case of a financial institution to which section 585 or 593 applies, the sale or exchange of a bond, debenture, note, or certificate, or other evidence of indebetdness," *purchased after July 11, 1969* "shall not be considered a sale or exchange of a capital asset."

Thank you for your consideration.

FARM CREDIT ADMINISTRATION,
Washington, D.C., September 12, 1969.

HON. RUSSELL B. LONG,
Chairman, Committee on Finance,
U.S. Senate, Washington, D.C.

DEAR MR. CHAIRMAN: On behalf of the 13 banks for cooperatives and the Federal Farm Credit Board, I request the attached statement be given favorable consideration by your Committee in its deliberation on H.R. 13270, the Tax Reform Act of 1969.

Our request is only for clarification of the tax treatment of the 13 banks for cooperatives. We believe this could be accomplished through the addition of three sentences to the report that will be issued by the Committee on H.R. 13270.

The specific language suggested for that report is included in the attached statement under the heading, "Summary of Proposal."

The first sentence is introductory.

The second sentence is intended to assure that the additions to the bad-debt reserve accounts by the banks for cooperatives be treated in the same manner as those of commercial banks whenever the banks for cooperatives have repaid the investment of the Government and become subject to Federal income tax.

The third sentence suggested for the report would confirm the position of Congress that a small part (over the years it has averaged less than 5 percent) of gross income of the banks for cooperatives should be accepted as patronage income for income tax purposes, which was clearly the intent of Congress as stated in the legislative reports and history when Public Law 88-528 was considered in 1964.

We appreciate your consideration.

Sincerely,

E. A. JAENKE, *Governor.*

Attachment.

STATEMENT

Summary of proposal

In view of the specific provision in section 441 of H.R. 13270 as to the deduction to be allowed commercial banks generally for Federal income tax purposes, for additions made to a bad-debt reserve, and the scope of the Tax Reform Act of 1969 in other respects, the Farm Credit Administration urges that there should also be clarification of the Federal income tax treatment of the 13 banks for cooperatives which operate under its supervision:

First, to assure that the banks for cooperatives, each of which first became subject to Federal income tax when it recently retired all of its Government capital, and whose loans are similar to the loans made by commercial banks generally, may be allowed a deduction for annual additions to a reserve for losses on loans which does not exceed that allowable to commercial banks generally for taxable years before the tax reform bill becomes effective; and

Second, to assure that a deduction may be allowed for the full amount of patronage dividends paid by a bank for cooperatives, so far as concerns such amount representing net earnings from business done with or for borrowers from the bank, in accordance with the intention indicated by the congressional committees which in 1964 recommended enactment of Public Law 88-528 to amend the Farm Credit Act of 1933.

It is suggested that such clarification can be accomplished, even without specific amendment of the bill, by including something like the following in the report of the Senate Committee on Finance on the Tax Reform Act of 1969:

The Committee considered two aspects of the Federal income tax treatment of the 13 banks for cooperatives, which operate under the Farm Credit Act of 1933 and the supervision of the Farm Credit Administration to make loans to farmer cooperatives, and is of the view that there can be clarification without additional legislation. Because of the similarity of the loans made by the banks for cooperatives and the loans made by commercial banks generally, it is considered that a bank for cooperatives for the years since it recently became subject to Federal income tax may and should be allowed on annual deduction for additions to a bad-debt reserve as is allowable for commercial banks generaly under Revenue Ruling 65-92 while that ruling continues applicable. Further, the Committee believes that the relatively insignificant portion of patronage dividends paid by a bank for cooperatives which is from temporary investments rather than interest collected on loans may and should be accepted as from business done with or

for the farmer cooperatives that borrow from the bank, in accordance with the intention heretofore indicated in connection with the enactment of Public Law 88-528 (Sen. Rep. No. 1453, H.R. Rep. No. 1368, 88th Cong., 2d Sess.).

Banks for cooperatives

The 13 banks for cooperatives, one in each of the 12 farm credit districts and a Central Bank in the District of Columbia, were established under the Farm Credit Act of 1933 to make loans to eligible farmer cooperative associations engaged in marketing farm products, purchasing farm supplies, or rendering farm business services. The loans are made with funds obtained by selling the consolidated debentures of the banks in the public securities market. The lending is on a self-sustaining basis; and each bank is required to operate on a cooperative basis for the benefit of the farmer cooperatives which borrow from the bank and now own its capital stock, and without profit to anyone else.

Each of the 13 banks for cooperatives was started with capital stock owned by the United States and became subject to Federal income tax only after all of its Government capital was retired: Two each year on June 30 of 1965, 1966, 1967, and 1968; and the other five on December 31, 1968. The first year for which a bank for cooperatives is subject to Federal income tax, therefore, is the year after all of its Government capital was retired.

Further information about the banks for cooperatives will be included as may be helpful in the separate explanation of the two deductions, and the desired clarification of each, which now follows.

Bad-debt reserve deduction

As developed in more detail later under this heading, the similarity of loans made by a bank for cooperatives to loans made by a national or other commercial bank has been considered to entitle a bank for cooperatives to the same Federal income tax treatment as is allowed such other banks for annual additions made to a reserve for losses on loans. The basic statutory provision is section 166 of the Internal Revenue Code which allows "a deduction for a reasonable addition to a reserve for bad debts" (in lieu of a deduction for debts which become worthless). In 1965, Revenue Ruling 65-92 (C.B. 1965-1, 112) in effect specified the annual deduction which would be commercial banks for additions to a bad-debt reserve, until the accumulated reserve equals 2.4 percent of outstanding loans. Section 441 of H.R. 13270 would cut back the deduction allowed commercial banks for additions to bad-debt reserve and base it on the ratio of losses to outstanding loans for the current year and the 5 preceding years. However, whatever provision in this respect is included in the tax reform bill as finally enacted, it is urged that a bank for cooperatives should be allowed a deduction for annual bad-debt reserve additions which does not exceed that provided in Revenue Ruling 65-92 for commercial banks generally for the years that ruling is applicable.

By its terms, Revenue Ruling 65-92 is applicable only to "banks", as therein defined, "a substantial part of the business of which consists of receiving deposits and making loans and discounts". Although the banks for cooperatives make loans and discounts, their business does not include receiving deposits. Because of this, Revenue Ruling 65-92, by its terms, is not applicable to a bank for cooperatives. Thus far, too, the Internal Revenue Service has not seen fit to broaden Revenue Ruling 65-92 to include banks for cooperatives; or to apply a similar ruling to them; although either course is considered to be within the present statutory authority of the Internal Revenue Service to allow a deduction for a "reasonable" bad-debt reserve addition. In any event, as developed in the next three paragraphs, the loans made by the banks for cooperatives are of the same general character as those made by commercial banks, and such similarity is considered to warrant a deduction for annual additions to a bad-debt reserve which does not exceed that allowed commercial banks generally under Revenue Ruling 65-92 for the years that ruling is applicable.

Under the Farm Credit Act of 1933, as amended, the banks for cooperatives are authorized to obtain loan funds by selling their consolidated debentures in the public securities market (12 U.S.C. 1134m) and to make loans to cooperative associations as defined in the Agricultural Marketing Act, as amended (12 U.S.C. 1134c). The types of loans made by a bank for cooperatives are generally indicated by the following from the Agricultural Marketing Act definition of a

farmer cooperative association to which such loans may be made (12 U.S.C. 1141j):

> * * * the term "cooperative association" means any association in which farmers act together in processing, preparing for market, handling, and/or marketing the farm products of persons so engaged, and also means any association in which farmers act together in purchasing, testing, grading, processing, distributing, and/or furnishing farm supplies and/or farm business services * * *

A bank for cooperatives makes loans for all of the foregoing purposes. This includes seasonal loans (usually payable within 12 months) to help finance inventories of farm products and supplies for farm production, receivables, and operating expenses. It also includes term loans (payable over more than 12 months, but ordinarily not in excess of 20 years) to help finance construction of physical facilities and purchase of equipment required by the cooperatives to render needed services for their members.

At June 30, 1969, the banks for cooperatives were financing 2,955 farmer cooperatives with total loans outstanding of $1.6 billion. The average amount of loans outstanding to a borrower at that time was $540,000. About 78 percent of the 2,955 accounts had loans totaling $300,000 and under. However, 22 percent of the number had 87 percent of the loan volume outstanding. Studies by the U.S. Department of Agriculture have shown that the banks for cooperatives provide about 60 percent of the credit used by farmer cooperatives in the United States.

Commercial banks make the same types of loans to both private and cooperative corporations with similar security and repayment provisions. However, commercial banks, in financing a wide diversity of individuals and businesses, avoid the risks of lending to a single industry. Opportunity for such loan portfolio diversification and risk diminution is not available to the banks for cooperatives.

In the circumstances, it is urged that the Committee may see fit to indicate, in its report on the tax reform bill or otherwise, that it sees no objection to a bank for cooperatives being allowed a deduction for annual additions to a bad-debt reserve which does not exceed that provided under Revenue Ruling 65-92 while that ruling is applicable as to commercial banks generally, for any year that a bank for cooperatives is subject to Federal income tax. This is all the more deemed reasonable because overall the total deductions claimed by the 13 banks for cooperatives for their taxable years thus far have actually been only about half of the deductions allowable under the revenue ruling for commercial banks generally.

Patronage dividend deduction

In its report on the tax reform bill or otherwise, it is urged that the Committee on Finance also express approval or recognition of the intention heretofore indicated by Congress in 1964, in connection with the enactment of Public Law 88-528, as to the deduction to be allowed for patronage dividends paid to its borrowers by a bank for cooperatives when it becomes subject to Federal income tax. The intention is that all of such patronage dividends should be accepted as from business with or for borrowers from the bank; and that the relatively insignificant amounts, if any, from temporary investments, need not be distinguished in this respect from the interest collected from borrowers on their loans. This intention was expressed in reports of the Agriculture Committees of Congress which in 1964 considered and recommended Public Law 88-528 inasmuch as it involved an amendment of the Farm Credit Act of 1933 to enable a bank for cooperatives to meet certain requirements of the Internal Revenue Code. To meet an objection that the intention was not heretofore before the Committees of Congress which have jurisdiction on tax legislation, the matter is now being presented to the Committee on Finance.

The Farm Credit Act of 1933, as amended in 1955, requires a bank for cooperatives, at the end of each fiscal year, to pay patronage dividends to the farmer cooperative associations that are borrowers from the bank (12 U.S.C. 1134*l*). All patronage dividends are paid in the proportion that the amount of interest earned on the loans of each borrower bears to the total interest earned on the loans of all borrowers during the fiscal year. From 1955 to 1964, the Farm Credit Act required such patronage dividends to be in surplus account allocations and class C stock, and there was no authority to pay patronage dividends in money.

In 1964 the intention of each bank for cooperatives was to complete retirement of its Government capital within the next several years after which it would be subject to Federal income tax. It then would be necessary to meet the

requirements of the Internal Revenue Code applicable to any corporation operating on a cooperative basis (subchapter T of chapter 1, §§ 1381–8), if the patronage dividends of a taxable bank for cooperatives were to qualify for deduction from gross income in computing taxable income. One of such requirements is that at least 20 percent of a patronage dividend be paid in money (§ 1388(c)(1)). To meet this requirement, Public Law 88–528, approved August 31, 1964, added a sentence to the Farm Credit Act (12 U.S.C. 1134*l*(b), last sentence) which in effect requires a bank for cooperatives to pay such portion of its patronage dividends in money (presently 20 percent) as will permit its taxable income to be determined without including such patronage dividends.

What we are now concerned with, so far as concerns the patronage dividends of a bank for cooperatives qualifying for deduction, is the definition in the Internal Revenue Code to the effect that the patronage dividends should represent net earnings from business done with or for borrowers from the bank (§ 1388(a)(3)). The banks for cooperatives exist only to make loans to eligible farmer cooperative associations, mostly with funds obtained by periodically selling their consolidated debentures in the public securities market. All of the earnings of a bank for cooperatives consist of interest collected on loans made to farmer cooperatives except that there are relatively insignificant earnings from funds on hand which may be invested in interest-bearing securities or loaned to other Farm Credit Banks temporarily. Inasmuch as each bank for cooperatives must keep on hand a sufficient amount of funds so that it at all times may be in a position to make loans as required in its district, it is considered that any earnings from the funds so held are no less from business done with or for the farmer cooperative associations that borrow from the bank than is the interest paid by such cooperatives on their loans. This is supported not only by the terms of the 1964 amendment to the Farm Credit Act, but also by the following from the reports of the congressional committees which recommended the 1964 amendment (Public Law 88–528) to the Farm Credit Act (Sen. Rep. No. 1453, p. 5, H.R. Rep. No. 1368, p. 4, 88th Cong, 2d Sess.):

> Another requirement of subchapter T, if the patronage allocations and refunds of a bank for cooperatives are to be deductible from its gross income in computing taxable income, is that the amounts involved shall come within the definition of a patronage dividend as that term is defined in subchapter T. One element of the definition is that such amounts come out of earnings from business done with or for patrons. In the case of a bank for cooperatives, practically all or at least as much as 95 percent of its gross income comes as a result of the loans made to the farmers' cooperatives that borrow from the bank. There also may be a very minor amount of income from securities in which a bank may invest and from temporarily surplus funds that it may have loaned to other banks of the cooperative farm credit system. These latter amounts are relatively insignificant and the intention is that it should not be necessary to distinguish them from the interest collected on loans insofar as concerns being derived from business with or for the borrowing cooperatives.

Thus far the Internal Revenue Service has not seen fit to acknowledge concurrence in such intention, presumably only because the 1964 amendment to the Farm Credit Act was recommended by the Agriculture Committees and was not then considered by the Committees of Congress which have jurisdiction of the tax provisions of the Internal Revenue Code. It is to meet this objection on the part of the Internal Revenue Service that the matter is offered for review by the Committee on Finance. Based on such review, it is hoped that the Committee on Finance may see fit to indicate that there is no objection to giving effect to Public Law 88–528, as to the deduction for the full amount of patronage dividends, in accordance with the intention indicated in connection with its enactment in 1964 (Sen. Rep. No. 1453, H.R. Rep. No. 1368, 88th Cong., 2d Sess.). Overall the amounts involved, as noted above, are no more than 5 percent of gross income; and in terms of net earnings or patronage dividends, the percentage involved is even less, if any.

MEMORANDUM OF MARINE MIDLAND BANKS, INC., SUBMITTED BY J. FRED SCHOELLKOPF IV, CHAIRMAN OF THE BOARD

The purpose of this memorandum is to bring to the Committee's attention some of the serious economic issues presented by the provisions of H.R. 13270 affecting commercial banks. Marine Midland feels most strongly that the Committee should be aware of these issues before acting upon the provisions and that thus far these issues have not been adequately presented to the Committee.

H.R. 13270 is the most comprehensive revision of our income tax code since its inception. One of its major purposes, in which Marine Midland concurs, is to cure existing tax inequities.

Marine Midland has followed the course of H.R. 13270 from the Tax Reform Studies and Proposals of the Treasury Department published early this year through the present hearings before your Committee. Although much has been said of the revenue effects of the House bill, no study has been made of the effect of the proposals concerning financial institutions on the nation's monetary system, the heart of which is the commercial banks. The absence of such fundamental considerations concerns Marine Midland greatly, in view of the precariousness of the nation's economy and our almost uncontrolled inflation.

H.R. 13270 would adjust taxes on commercial banks by treating net long-term capital gains on securities as ordinary income, and by changing the measure of the bad debt reserve computation.

The existing law providing for non-parallel capital gains treatment of bank securities portfolios was enacted to encourage banks to liquidate security holdings to satisfy private sector loan demands. Clearly the intended effect has been realized in the continued economic growth of this nation since the end of World War II. Having proved to be an effective tool, should it now be eliminated permanently?

What effect will this proposal have on the bond market generally? Certainly it will further reduce an already thin market. In addition, it undoubtedly will increase the cost of money to every state and municipal government, as well as the Federal government. In this inflationary time, is it wise to enact permanent legislation which either would add to inflation or severely restrict public improvements? Will the commercial banking system be as willing to invest in municipal and other government securities to the substantial extent it has in the recent past? Or, is the intent of Congress to shift the supply of money for Federal, state and municipal governments away from the commercial banking system?

Furthermore, the assumption is that parallel treatment is equitable treatment. This is not necessarily so. There are many instances in the Internal Revenue Code of "non-parallel" treatment for the same transaction, such as Section 1231, involving trade or business assets of corporations, none of which are changed by H.R. 13270.

In any case, is there a sound reason why such treatment should apply retroactively to securities held on July 11, 1969 as provided in the bill? These securities were acquired with the expectation that gains would be taxed as capital gains and their effective yields were computed on that basis. Is it equitable to alter the tax treatment for securities held prior to the announcement of this change?

With respect to the proposed bad debt reserve provisions, no study has been made of the effect of the decrease in capital which commercial banks will suffer. Commercial bank capital is the ultimate measure of the strength of our banking system, as well as the confidence of the public in that system. The basic question is whether it is more in the public interest to continue the incentive to commercial banks to develop and hold their own capital funds out of current income as protection against severe losses, or whether the government should underwrite those capital requirements in the future through tax loss carry-backs.

Overall it would appear that these two provisions will require commercial banks to shoulder a disproportionate share of the additional revenue anticipated under H.R. 13270. The additional revenue anticipated from commercial banks by these provisions totals $300 million, which constitutes over 12% of estimated additional revenue from the bill. Excluding the anticipated revenue from the repeal of the investment credit, the provisions affecting commercial banks are the third largest source of additional revenue anticipated by the bill.

This result has been justified on the basis thaat the effective rate of tax paid by commercial banks has declined considerably in recent years. Substantially increased investment in tax-exempt securities accounted for virtually all of this decrease in effective tax, and almost none of this decrease is attributable to increases in bad debt reserves or gains on the sale of bonds. Yet, should commercial banks be penalized for responding to the burgeoning money needs of state and local government?

Moreover, the Committee should be aware that in computing the alleged decline in effective tax rates, no allowance has been made for the higher interest yield on taxable securities which the banks have foregone by investment in lower yield tax-exempt securities. If the interest foregone by commercial banks were added to economic income, taking into consideration the additional tax which would have been paid, the effective tax rate on commercial banks would have actually increased since 1964.

As we have said, Marine Midland's concern is that with respect to commercial banking, which occupies such a unique and sensitive position in our national economy, there has been no in-depth economic study sufficient to justify the enactment of these proposals.

It may well be that these proposals would be justified by stuch a study. But can the nation take the risk that it might be otherwise? Marine Midland does not believe so and respectfully urges the Committee to defer action on these proposals until their economic and monetary effects have been adequately studied and the results of such studies presented to Congress.

Such a study need not be time consuming, and Marine Midland stands ready to assist in any way this Committee may desire to help accomplish such a study as expeditiously as possible. We believe that the Congress should fully understand the ramifications and effects of these proposals which so fundamentally affect our financial system before acting upon the provisions in H.R. 13270 affecting commercial banks.

LOPER MORTGAGE Co.,
San Antonio, Tex., September 29, 1969.

Senator RALPH YARBOROUGH,
Old Senate Office Building,
Washington, D.C.

DEAR SENATOR YARBOROUGH: On behalf of continuing to make FHA and VA loans in our San Antonio area, we respectfully urge you once again to contact your colleagues on the Senate Finance Committee and urge them not to change the present tax treatment of mutual savings banks.

We close approximately 150 FHA and VA loans per month in our office. Many of these loans are on low-cost housing and, under normal conditions, 90% of our money comes from eastern mutual savings banks.

We feel that tax proposals by the Administration thus far would certainly impair the flow of funds into the FHA and VA programs in our area, and we are surely fearful of having another dimension added to the present mortgage and housing crisis.

Your understanding and consideration in this matter will be sincerely appreciated.

Very truly yours,

JOE LOPER, *President.*

CITIZENS STATE BANK,
Dickinson, Tex., August 29, 1969.

Hon. RALPH W. YARBOROUGH,
Old Senate Office Building,
Washington, D.C.

DEAR RALPH: I am handing this to you while you are in League City for the Labor Day party, which is Sunday, August 31, with the hope that you will be able to read it possibly on the plane or some other time when you are not busy with telephones, etc. The House of Representatives passed H.R. 13270, which includes a change in the reserve for losses for bad loans as regards banks. The new provision would permit banks to set up reserves (before taxes) of only .2% of outstanding loans. This means a reserve of $2,000.00 for each $1,000,000.00 of loans. Frankly, this is absurd and obviously so. Heretofore, the reserve has been 2.4%; and while this has been more than adequate in good times, it is certainly not out of line during times of business recession. Bank reserves are not created

for the purpose of what is apt to happen in good times, but for eventualities of what could happen in bad times.

Nothing is more vital to a sound and growing economy than a banking structure in which people have confidence, and which is able to take legitimate risks. The present law, of course, permits no adding to the reserve once it has reached 2.4%. It does permit keeping the reserve at that size. This enables the bank to take legitimate risks, which they obviously could not do with reserves as proposed in this new bill.

It is my belief that all of the authorities, State and National, which have responsibilites towards bank operations and soundness will raise their voices against this ridiculous provision. Banks are generally in good condition now due to substantial reserves. This is particularly true of the older banks. Under the proposed law, a substantial reserve could be eroded away by losses until the reserve is reduced to .2%. This would mean banks would naturally not make loans which they felt had any element of risk. This would not be in the public interest.

It is inconceivable that the Senate would concur in all parts of the House bill; and certainly I cannot believe that it will go for this section on reserve for losses, because by weakening the reserve provision and thereby weakening the banks, it will damage the public as it will force the banks to be far more restrictive in the kind of credit they extend.

I would appreciate your reactions to these points and any suggestions you have as to what we might do towards getting a proper approach from the Senate.

Thanking you, I am cordially yours,

W. G. Hall.

Victoria Savings and Loan Association,
Riverside, Calif., September 17, 1969.

Hon. George Murphy,
Senate Office Building, Washington, D.C.

Dear Senator Murphy: The Tax Reform Bill passed by the House of Representatives would gradually raise the effective tax rate from 17% to almost 34% for savings and loan associations by reducing the permissible bad debt deduction 3% each year for the next 10 years. Consequently, at the end of the 10-year period, savings and loan associations would be deducting only 30% of net income for bad debts rather than the existing 60% of net income.

I have just completed a study of the impact on the housing market by doubling the amount of taxation of savings and loan associations for the California Savings and Loan League. I realize the high national priority Congress has placed on new housing during the next decade and though you might be interested in a copy of this background material in order to help you make a decision at the time this matter is presented to the United States Senate for final action.

In the event there is any additional information you should desire, please call upon me and I will attempt to provide it.

Sincerely yours,

Donald O. Nelson,
Senior Vice President.

Enclosure.

A Study of the Impact on the Housing Market by Doubling the Amount of Taxation of Savings and Loan Associations

A. Statement of Problem Under Review

The Tax Reform Bill passed by the House of Representatives would gradually raise the effective tax rate from 17% to almost 34% for savings and loan associations, by reducing the permissible bad debt deduction 3% each year for next 10 years. Consequently, at the end of the 10-year period, savings and loan associations would be deducting only 30% of net income for bad debts rather than the existing 60% of net income.

B. High National Priority of Housing During Next Decade

Housing Secretary George Romney has stated that housing must become the top priority item for our nation once the war in Vietnam is over and inflation is licked.

The special Governmental Commission established by Congress in May, 1968, and headed by Harvard Professor James S. Duesenberry, has emphasized that inflation must be controlled if the nation hopes to meet its goal of building 26 million new housing units in the next 10 years.

National Association of Home Builders' President Eugene Gulledge, has stated that housing starts will fall in 1969 by as much as 40% from 1968 levels. This is before doubling the tax rate of savings and loan associations which provide the major source of funds for housing. The trend towards lower housing starts will intensify in 1970, at a time when demand for housing exceeds 2 million units per year. Unless availability of funds for housing increases this year, starts will dip to an annual rate of 1 million units before the year 1969 is over. If taxes on savings and loan associations are doubled, money for housing will be even shorter in supply.

Recently, Dr. Miles L. Colean, noted economist, stated the major provider of funds for home mortgages, both in the past and future, are savings and loan associations and the Federal National Mortgage Association.

Chairman Wright Patman of the House Banking and Currency Committee, informed the House during the recent tax reform debates that "housing starts are expected to drop to 1 million this year, far short of the average 2.6 million needed each year for the next 10 years. Everyone familiar with the matter knows that the single major source of funds for one-to-four family housing units is the savings and loan association. The Committee reports show that savings and loan associations have been paying taxes at a rate anticipated by Congress; that, indeed, it is necessary to preserve the inducement for them to continue investing in real estate mortgages."

Housing Subcommittee Chairman William A. Barrett of Pennsylvania, told the House members:

"It is well known that our Nation is witnessing a dangerous decline in home construction and the shortage of housing credit is reaching crisis proportions. At no time in my memory has the home buyer had so much difficulty in obtaining home financing and this is one of the most pressing social and environmental needs of the American people.

"Only a small portion of mortgage loans of savings and loan associations are at the current rate and yet they must pay dividends at the current rate—so the difference between their income on mortgage loans and the cost of money makes it most difficult for them to supply the money needed for housing.

"Therefore, I was greatly concerned to learn that this tax reform bill would worsen the situation by imposing additional taxes on the Nation's savings and loan associations who are by far the largest providers of home mortgages. Surely it is pennywise and pound foolish to impose additional expenses at this time—on the savings and loan associations who we look to for the bulk of our home loans.

"I appreciate the desire to treat all financial institutions in a like manner, but I hope that the tax bill that is eventually enacted will not contain a heavier tax load on the hard pressed thrift and home financing industry so they may continue in the struggle to meet our housing goals. Tax equity is indeed important—provided we do not lose sight of the net effect upon the important national goals established by this Congress."

C. IMPORTANCE OF SAVINGS AND LOAN ASSOCIATIONS IN FURNISHING MAJOR PORTION OF FUNDS NECESSARY TO MEET THE NATIONAL HOUSING GOALS ESTABLISHED BY CONGRESS

Savings and loan associations are about the only investors maintaining heavy commitments in the home mortgage market. Other housing investors have abandoned the field to take advantage of higher yields in other investment sectors. For example, the commercial banks are bidding for Eurodollar funds at rates as high as 13% which is even more lucrative than their short-term investments. Life insurance companies left the home mortgage field in favor of commercial mortgages where they can get a "piece of the action" as well as the higher interest yields on this type of lending. Mutual savings banks eased off on home mortgages in favor of equity loans. Savings and loan associations are the basic home mortgage lenders and by law and regulation (IRS also) are restricted to this field and need a lower effective tax rate if they are to supply the necessary funds for the home mortgage market. Because of their long-term credit, greater reserves are required to meet unforseen economic recessions and depressions.

Commercial banks, who are involved in short-term credit with commensurate higher yields require lesser reserves.

The following information, charts and graphs, reproduced from the United States Savings and Loan League Fact Book for 1969, reflect very succinctly and clearly that during the twenty-year period from 1947 to 1968, the residential mortgage need has grown more rapidly than any other single type of capital or credit requirement. Further, that savings *and loan associations are specialized institutions limited by law and regulations to the financing of residential dwellings to the extent that at year-end 1968, they had allocated 91.7% of their total savings balances to loans on homes and apartments.* And finally, that savings and loan associations hold approximately 44% of all such residential mortgages with the commercial banks a distant second with about 14% of the total.

Residential Financing

Since the end of World War II, the housing market has been one of the largest users of borrowed funds in the American economy. This is the one fact that must be emphasized in any review of residential housing.

When Americans scan their nation's landscape, they see great steel mills, massive automobile and aircraft factories, a huge network of public roads, big offices and a complexity of public buildings ranging from town halls to state capitols, small schoolhouses to enormous publicly supported universities.

This view creates the impression that demands by government and industry for borrowed funds outstrip demands for mortgage money to finance homes and apartments. *But the fact is that the residential mortgage need has grown more rapidly than any other single type of capital or credit requirement.*

In the years since the end of World War II, total corporate debt has grown more than mortgages outstanding on homes and apartments (Table 22). However, when the capital and credit requirements of corporations are separated on the basis of their maturities, the growth of both short- and long-term borrowing by corporations trails behind the growth in mortgages.

The increase in residential mortgages has been more than double the growth in consumer debt and the debt of state and local governments, and almost seven times the growth in farm debt.

TABLE 22.—POSTWAR GROWTH IN MAJOR TYPES OF DEBT

[In billions of dollars]

Type of debt	Yearend 1947	Yearend 1968 [1]	Increase
Federal debt	222.4	314.1	91.7
Nonfarm mortgage debt on:			
Residential properties	34.8	298.5	263.7
Commercial properties	9.1	70.9	61.8
Consumer debt	11.6	112.8	101.2
State and local government debt	15.0	129.5	114.5
Corporate debt:			
Short term	62.8	292.5	229.7
Long term	46.1	293.5	247.4
Farm debt	8.6	50.0	41.4

[1] Preliminary.

Source: Federal Reserve Board.

Another perspective of the size and growth of mortgage debt emerges by comparing mortgages with all other kinds of private debt and all other private debt of individuals (Table 23). Residential debt as a percentage of all other private debt rose from 21.9% in 1940 to a high of 41.4% in the early 1960s. Stated another way, by the mid-1960s borrowings secured by homes and apartments rose to a point where such financing was nearly half the total credit extended to American businesses and families.

Residential debt has always played a big role in the balance sheets of individuals, families and unincorporated businesses. By 1950, the mortgage debt of $55.3 billion had moved ahead of all other debts of individuals. This relative advance continued into the early 1960s. While the rise of residential mortgages has since eased, it remains the largest market for loans in the noncorporate segment of our economy.

Types of mortgage loans

The data on mortgage loans outstanding are reported on the basis of the type of property securing the loan. The classifications include residential loans, which are subdivided into one- to four-family and multifamily loans. The other classifications are mortage loans on farms and on commercial properties.

These classifications recognize the difference in the motives and stimuli in both the extension of credit and the assumption of the obligation. This method of reporting also permits each type of loan to be studied separately to determine its response to social, economic and financial changes.

An improvement in statistical reporting in recent years is represented by the separation of the data on multifamily and commercial mortgage loans. Until quite recently these two items were combined into a single figure, making it difficult to observe the changes that were taking place in the important area of apartment financing.

At year-end 1968, loans outstanding on one- to four-family homes represented the largest segment of mortgage loans. They totaled $251.5 billion, 63.4% of all mortgage loans (Table 24). Multifamily loans accounted for $47 billion, or 11.8%. These segments brought residential mortgages to $298.5 billion, or 75.2% of all debt secured by the real estate (Chart 13). Commercial property loans amounted to $70.9 billion, or 17.9%. Trailing far behind were mortgages secured by farms, at $27.5 billion, or 6.9%.

Holders of mortgage loans

TABLE 23.—COMPARISON OF RESIDENTIAL MORTGAGE DEBT AND ALL OTHER TYPES OF PRIVATE DEBT

[In billions of dollars]

Year end	Total residential mortgage debt	All other private debt [1]	Other private debt of individuals [2]	Residential mortgages as a percentage of— All other private debt	Residential mortgages as a percentage of— Other private debt of individuals
1940	$23.1	$105.5	$29.9	21.9	77.3
1945	24.3	115.7	30.4	21.0	79.9
1950	55.3	191.0	48.9	29.0	113.1
1955	102.5	289.1	77.0	35.5	133.1
1960	161.6	404.1	101.3	40.0	159.5
1961	176.1	432.6	108.3	40.7	162.6
1962	192.3	467.7	119.5	41.1	160.9
1963	211.2	510.6	134.5	41.4	157.0
1964	231.1	559.0	149.1	41.3	155.0
1965	250.1	618.5	166.2	40.4	150.5
1966	263.8	681.8	183.5	38.7	143.8
1967	279.8	731.6	197.2	38.2	141.9
1968 [3]	298.5	805.3	219.3	37.1	136.1

[1] All private debt outstanding less residential mortgages.
[2] All private debt outstanding less residential mortgages and corporate debt.
[3] Preliminary.

Source: Federal Reserve Board.

Savings and loan associations tower over all other lenders in the amount of credit extended to the mortgage market. Of the $396.9 billion outstanding at year-end 1968, $130.8 billion, or 33% of the total, was held by associations (Table 25). Far below were life companies at $70.1 billion, 17.7% of the total. They were followed by commercial banks with $65.7 billion, or 16.6%, and mutual savings banks at $53.5 billion, 13.5% of the total.

Other holders of residential mortgages accounted for $76.8 billion, or 19.3% of the total. Within this grouping are the federal agencies, which held $21.8 billion, or 5.5% of the total. The agencies include the Federal National Mortgage Association, the Federal Housing Administration, the Veterans Administration, and the Farmers Home Administration. The balance is held by such diverse organizations as the trust departments of commercial banks, pension funds, nonprofit institutions, credit unions, real estate companies and individuals. Six states hold mortgages as a result of direct lending programs embarked upon in the immediate postwar period.

ALLOCATION OF SAVINGS RESOURCES

The savings which the public entrusts to financial institutions have been the major source of funds for residential loans over the years. *Besides differences in mortgage loan holdings, there are great differences among financial institutions in the portion of savings placed in mortgage loans.*

TABLE 24.—MORTGAGE DEBT OUTSTANDING, BY TYPE OF PROPERTY

[In billions]

Year end	Residential properties: 1- to 4-family	Residential properties: Multi-family	Residential properties: Total	Commercial properties	Farm properties	All properties
1940	$17.4	$5.7	$23.1	$6.9	$6.5	$36.5
1945	18.6	5.7	24.3	6.4	4.8	35.5
1950	45.2	10.1	55.3	11.5	6.1	72.8
1955	88.2	14.3	102.5	18.3	9.0	129.9
1960	141.3	20.3	161.6	32.4	12.8	206.8
1961	153.0	23.0	176.1	36.4	13.9	226.3
1962	166.5	25.8	192.3	41.1	15.2	248.6
1963	182.2	29.0	211.2	46.2	16.8	274.3
1964	197.6	33.6	231.1	50.0	18.9	300.1
1965	212.9	37.2	250.1	54.5	21.2	325.8
1966	223.6	40.1	263.8	59.9	23.3	347.0
1967	236.1	43.7	279.8	64.5	25.5	369.8
1968 [1]	251.5	47.0	298.5	70.9	27.5	396.9

[1] Preliminary.

Note: Components may not add to totals due to rounding.

Source: Federal Reserve Board.

Savings and loan associations are specialized institutions limited by law and regulations to the financing of residential dwellings. Thus, a high proportion of the savings they hold are placed in residential loans. At year-end 1968, they had allocated 91.7% of their total savings balances to loans on homes and apartments (Table 26). This high percentage has been characteristic of associations over the years.

Mutual savings banks have the power to invest in a wider range of assets than savings and loans, but they have allocated a high percentage of their savings balances to the residential sector of the economy. At year-end 1968, their holdings of loans on homes and apartments amounted to 72.5% of their total savings balances.

TABLE 25.—MORTGAGE LOANS OUTSTANDING, BY TYPE OF LENDER AND TYPE OF PROPERTY, YEAREND 1968

[In billions of dollars]

Type of lender	Farm properties	Commercial properties	Residential properties: Multi-family	Residential properties: 1-to 4-family	Residential properties: Total	Total mortgage debt
Savings and loan associations	(2)	10.1	10.6	110.1	120.7	130.8
Mutual savings banks	0.1	6.6	11.7	35.0	46.7	53.5
Commercial banks	3.8	20.5	2.7	38.8	41.4	65.7
Life insurance companies	5.8	21.9	12.7	29.6	42.4	70.1
All others	17.8	11.8	9.3	37.9	74.3	76.8
Total	27.5	70.9	47.0	251.5	298.5	396.9

[1] Preliminary.
[2] Less than $50,000,000.

Note: Components may not add to totals due to rounding.

Source: Federal Reserve Board.

Commercial banks and life companies are at the other end of the scale. The banks placed a much smaller 22.5% of their time and savings deposits in residential loans. Such loans accounted for 22.6% of the total resources of the life companies.

One- to four-family home loans

The bulk of the mortgages financing one- to four-family homes are held by savings and loan associations (Chart 16). Their $110.1 billion of such loans at year-end 1968 accounted for 43.8% of the total (Table 27 and Chart 17).

In recent years the commercial bank share of such loans has tended to rise, bringing their year-end 1968 holdings to 15.4% of the total, close to the share they held in the late 1950s. Life companies, on the other hand, have held an increasingly smaller percentage. Their current 11.8% is down sharply from 20% of the total typical of the early 1950s.

Slowdown in home loan growth

There was an abrupt slowdown in mortgage loan growth in 1966, largely concentrated in the one- to four-family sector. Loans secured by such homes grew each year by a net of over $15 billion from 1963 through 1965. This growth dropped to $10.4 billion in 1966 as tight money hit the mortgage market (Table 28). Multifamily home financing also slowed in 1966, with the annual growth dropping to $2.9 billion from $3.6 billion in 1965. This contraction was not as dramatic as the one which occurred in one- to four-family home loans.

The contraction in growth of home loans becomes even more dramatic when an adjustment is made for the support given the market by federal agencies, mainly the Federal National Mortgage Association.

When the increase in holdings of federal agencies is subtracted from the total annual increase, the resulting figures show the change in one- to four-family loans held by financial institutions and individuals. In 1965 such private lenders added a net of $15 billion to their home loan portfolios. In 1966 their net acquisition dropped to a low $7.9 billion.

TABLE 26.—SHARE OF SAVINGS DEPOSITS ALLOCATED TO RESIDENTIAL MORTGAGE LOANS

[In percent]

Yearend	Savings and loan associations	Mutual savings banks	Commercial banks [1]	Life insurance companies [2]
1964	92.4	74.7	24.8	23.9
1965	92.7	76.5	24.1	24.2
1966	93.0	76.8	23.9	24.3
1967	90.6	74.3	22.4	23.5
1968 [3]	19.7	72.5	22.5 [4]	22.6

[1] Residential mortgage loans as a percentage of total savings and time deposits of individuals, partnerships and corporations.
[2] Residential mortgage loans as a percentage of total assets.
[3] Preliminary.
[4] June 30.

Source: Federal Reserve Board.

TABLE 27.—MORTGAGE LOANS OUTSTANDING ON 1- TO 4-FAMILY NONFARM HOMES, BY TYPE OF LENDER

[In millions of dollars]

Yearend	Savings and loan associations [1]	Mutual savings banks	Commercial banks	Life insurance companies	Federal Government agencies	Individuals and others	Total
1950	13,116	4,312	9,481	8,478	1,468	8,315	45,170
1951	14,844	5,331	10,275	10,610	2,063	8,588	51,711
1952	17,645	6,194	11,250	11,757	2,523	9,131	58,500
1953	20,999	7,373	12,025	13,195	2,770	9,732	66,094
1954	25,004	9,002	13,300	15,153	2,770	10,448	75,677
1955	30,001	11,100	15,075	17,661	3,015	11,398	88,250
1956	34,004	12,990	16,245	20,130	3,534	12,134	99,037
1957	37,996	14,110	16,385	21,441	4,687	12,998	107,617
1958	42,890	15,640	17,628	22,374	4,662	14,493	117,687
1959	49,535	16,887	19,200	23,583	6,256	15,393	130,854
1960	55,386	18,369	19,242	24,879	7,136	16,275	141,287
1961	62,395	20,022	20,038	25,641	7,310	17,588	152,994
1962	69,761	22,149	22,129	26,374	7,359	18,710	166,482
1963	79,058	24,717	24,910	27,331	6,169	20,002	182,187
1964	87,172	27,394	27,220	28,525	6,001	21,265	197,577
1965	94,225	30,064	30,401	29,589	6,396	22,262	212,937
1966	97,423	31,673	32,803	30,233	8,876	22,637	223,645
1967	103,327	33,467	35,275	29,763	10,730	23,498	236,060
1968 [2]	110,145	35,047	38,765	29,570	13,194	24,750	251,471

[1] Beginning in 1966, includes real estate sold on contract, 1967 and 1968 data exclude mortgage holdings of several associations in liquidation.
[2] Preliminary.

Source: Federal Home Loan Bank Board.

TABLE 28.—ANNUAL CHANGE IN MORTGAGE LOANS OUTSTANDING ON 1- TO 4-FAMILY NONFARM HOMES, BY TYPE OF LENDER

[In millions of dollars]

Year	Savings and loan associations [1]	Mutual banks savings	Commercial banks	Life insurance companies	Federal Government agencies	Individuals and others	Total
1950	$1,999	$948	$1,525	$2,385	$292	$402	$7,551
1951	1,728	1,019	794	2,132	595	273	6,541
1952	2,801	863	975	1,147	460	543	6,789
1953	3,354	1,179	775	1,438	247	601	7,594
1954	4,005	1,629	1,275	1,958	0	716	9,583
1955	4,997	2,098	1,775	2,508	245	950	12,573
1956	4,003	1,890	1,170	2,469	519	736	10,787
1957	3,992	1,120	140	1,311	1,153	864	8,580
1958	4,894	1,530	1,243	933	−25	1,495	10,070
1959	6,645	1,247	1,572	1,209	1,594	900	13,167
1960	5,851	1,482	42	1,296	880	882	10,433
1961	7,009	1,653	796	762	174	1,313	11,707
1962	7,366	2,127	2,091	733	49	1,122	13,488
1963	9,297	2,568	2,781	957	−1,190	1,292	15,705
1964	8,114	2,677	2,310	1,194	−168	1,263	15,390
1965	7,053	2,670	3,181	1,064	395	997	15,360
1966	2,858	1,609	2,402	644	2,480	375	10,368
1967	6,030	1,794	2,472	−470	1,854	861	12,541
1968 [2]	7,083	1,423	3,490	−193	2,464	1,252	15,519

[1] Preliminary.
[2] Beginning in 1966, data include real estate sold on contract; 1967 and 1968 data exclude mortgage holdings of several associations in liquidation; 1968 data reflect adjustments for conversion of a savings and loan association to a mutual savings bank. Net increases for these years have been adjusted to eliminate the effect of these changes.

Source: Federal Home Loan Bank Board.

The snail-like recovery of housing starts in early 1966 held the growth in home mortgage loans in 1967 to the low level of $12.5 billion. Federal agencies accounted for $1.9 billion of this increase, leaving financial institutions and other private lenders with an increase of only $10.7 billion, a growth that was less than that of the recession year of 1961.

The increase in home mortgage loans climbed back to the $15 billion level in 1968, bringing these loans back to their pre-1966 growth. However, federal agencies again gave a powerful assist by building up their portfolio holdings by $2.5 billion, leaving financial institutions and other lenders with a growth of $13.1 billion in their home mortgage loan holdings.

This growth approximated that of 1962, when they added $13.4 billion in loans. These figures, particularly the acquisitions by nonfederal lenders, support the conclusion that home mortgage lending has not fully recovered from the monetary knockdown of 1966. It has shown no real recovery during the past two years.

Mortgage versus other private debt

There are many ways to structure figures on financial flows to test the premise that the home mortgage market is not obtaining its share. One method compares the increase in residential mortgage debt with the increase in other debt of individuals and unincorporated businesses (Table 29).

In each of the five-year periods between 1940 and 1965, the increase in mortgage loans was substantially larger than the increase in other types of debt or credit outstanding in the private, noncorporate sector of the economy.

In the years from 1965 to 1968 the relationship reversed. The amount of credit extended for nonhousing activities rose more than did the credit extended for residential mortgages. This change in the credit picture can be traced to the unusual monetary conditions that have made the last three years so different from any other period since World War II.

Mortgage loans not competitive

Much of the slow down in growth of residential and home mortgage loans can be traced to the reduced savings flows into the specialized financial institutions such as mutual savings banks and, particularly, savings and loans. These institutions provide the bulk of the funds entering the mortgage market, and a slow growth of their resources retards the growth of their loans outstanding.

D. EFFECT OF INCREASED TAXATION OF SAVINGS AND LOAN ASSOCIATIONS ON FUNDS AVAILABLE FOR HOME MORTGAGES

Reserves have long been considered as the means of providing long-term mortgage lenders with a cushion that would permit these lenders to absorb losses on real estate arising from an economic collapse similar to the depression of the 1930's.

Naturally, we must have faith in the ability of the fiscal and monetary authorities to avoid severe recessions, but we must look to the reserves of the associations as the first line of defense against any such catastrophe.

The ratio of reserves of all savings and loan associations in the United States to total mortgage loans outstanding as of December 31, 1958, was 8.3%; whereas, on December 31, 1968, the reserve ratio had dropped to 7.8%.

Savings and loan associations have paid taxes during the past 6 years as follows:

	Amount
U.S. Treasury data:	
1963	$115,000,000
1964	122,000,000
1965	126,000,000
1966	98,000,000
Federal Home Loan Bank Board data:	
1967	95,000,000
1968	150,000,000
Total	706,000,000

If the savings and loan associations had been subject to the proposed doubled taxation during this 6-year period, *the additional taxes would have amounted to approximately $700 million. Since associations had to allocate 5 to 6 percent of loan growth to reserves, such increased taxes would have prevented us from making about $11 billion in real estate loans during this 6-year period,* because

we would not have had the retained income to provide the necessary reserves for growth in loans. This $11 billion is approximately 20 percent of the $52 billion in loan growth actually experienced by the savings and loan associations during this 6-year period. This tax increase would amount to approximately 750,000 residential units lost to the housing market.

By using the most conservative projections, it is estimated that savings and loan associations over the next 10 years would pay, under the proposed tax reform, $660 million in addition to our existing taxes. Because of our reserve requirement for loan growth, this tax increase would amount to a withdrawal of about $11 billion from the home mortgage market which equates to approximately 750,000 housing units.

By using more realistic standards based upon our normal growth pattern, the additional tax burden could amount to $1 billion which would mean a withdrawal of approximately $16 billion from the housing market or the equivalent of about 1 million residential units.

After the 10-year period when the full impact of the proposed doubled taxation is in effect, the loss in mortgage funds could approximate $5 billion per year which is the equivalent of about 325,000 housing units annually.

E. CONCLUSIONS

In summarizing the impact of doubling the amount of taxes to be assessed to the savings and loan associations, the following facts stand out very clearly:

1. The amount of money available by savings and loan associations for home mortgages would be greatly curtailed, and
2. A vacuum would be created in meeting the national housing goal of 26 million new units over the next 10 years as set by Congress with the withdrawal of the savings and loan associations to a lesser role in providing needed home mortgage funds, and
3. Based upon the record of performance over the past 20 years by other financial intermediaries, it is rather clear that they will not fill this vacuum, particularly during periods of tight money and high interest rates, and
4. If the Government is going to meet its obligation to provide the required 26 million new housing units, it certainly should consider subsidizing an already proven home financing industry in the private sector of our economy rather than turning to some new rapacious governmental agency.

COLONIAL MORTGAGE CO.,
Montgomery, Ala., September 29, 1969.

Hon. JAMES B. ALLEN,
New Senate Office Building,
Washington, D.C.

DEAR SENATOR ALLEN: We understand that the Senate Finance Committee is considering revising the tax treatment of financial institutions, including mutual savings banks. The present tax treatment has strongly stimulated the flow of savings bank mortgage funds into Alabama. We urge you to contact the members of the Finance Committee to ask that they leave the tax treatment of mutual savings banks as it is.

If, however, they insist that the present law should be changed, we believe that the provisions in the House-passed Tax Reform bill (H.R. 13270), with modifications designed to permit mutual savings banks to attract savings and channel out-of-state mortgage funds into Alabama and other capital-short areas, would be less harmful than the Administration proposal.

The present tax provisions relating to mutual savings banks and savings and loan associations accomplish for housing exactly what the Congress intended—a strong stimulus to residential mortgage flow. Both the Administration proposal and the provisions in the House-passed Tax Reform bill relating to financial institutions would reduce the supply, and increase the cost, of mortgage credit for housing. Because both proposals will increase tax payments of mortgage-oriented thrift institutions sharply, the competitive position of thrift institutions will be weakened and savings will be diverted increasingly to non-mortgage uses. If thrift institutions are not permitted to set aside realistic bad debt reserves, they will have to provide for losses from after-tax dollars, further increasing the cost

of mortgage credit. You are well aware that we are extremely dependent upon out-of-state funds for mortgage credit. Obviously, we would be one of the first to suffer from any overall reduction in mortgage credit.

If the present law must be changed, the House-passed bill, with modifications, would be less harmful to housing than the Administration proposal. At least the House bill recognizes the need of thrift institutions for a bad debt reserve allowance for further mortgage losses. In order to provide for a realistic bad debt reserve provision, and reduce the harmful impact on housing and out-of-state lending programs, the house bill should be modified to:

1. Permit inclusion of all mortgage loans, rather than only residential and certain other loans, for purposes for meeting the 72% investment standard, in order to avoid discouraging the flow of funds into commercial loans which we also sorely need.
2. Retain the 60% of income bad debt reserve allowance in the present law, rather than reduce it to 30% over a ten year transition period, so that mortgage-oriented thrift institutions can compete more effectively for savings.

We know that you are acutely aware of the present mortgage and housing crisis. We are afraid that if the tax laws pertaining to the thrift institutions are materially changed another dimension to this crisis will be added. Please use your influence to help minimize this crisis.

Sincerely,

B. PHIL RICHARDSON, *President.*

Hon. RUSSELL B. LONG,
Chairman, Committee on Finance, U.S. Senate,
Washington, D.C.

DEAR MR. CHAIRMAN: I am very much concerned by reports that section 442 of the pending tax reform bill would have serious adverse effects on the institutions that finance more than half of our nation's housing. As Chairman of the Senate Banking and Currency Committee and its Housing Subcommittee, I have continuously endeavored to further our nation's housing goals. Mortgage credit is the key to meeting these goals, and any impairment of the traditional source of credit flowing from the thrift institutions would make it impossible to attain our national objectives.

It seems inconsistent to me for the Congress, on the one hand, to pass legislation designed to increase and update our nation's housing goals and, at the same time, consider tax measures which would adversely affect the thrift institutions that are primarily financing home buyers. In fact, I am told that the Treasury Department's proposals, the taxation of thrift institutions, particularly savings and loan associations, would encourage these associations to increase the rate of interest on home mortgages and also encourage them to invest in other types of loans that have a much higher rate of return.

The Treasury Department has taken the position that commercial banks, savings and loan associations and mutual savings banks should all be taxed at the same effective rate. The Treasury would remove that section of the Internal Revenue Code which requires savings and loan associations to invest 82 percent of their assets in home loans and necessary operating investments. The removal of these investment standards presumably implies that the Congress will do this. The Federal Home Loan Bank System was set up to encourage thrift and home financing, and I do not, as a Senator or as Chairman of the Legislative Committee with jurisdiction over these institutions want to see them go into automobile financing or the commercial lending business in general. The homebuilding industry is in serious trouble. The cost of money is already out of sight and the availability of home financing is at dangerously low levels. Housing starts are down 30 percent on a seasonally adjusted basis, and we can expect a further drop during the balance of this year.

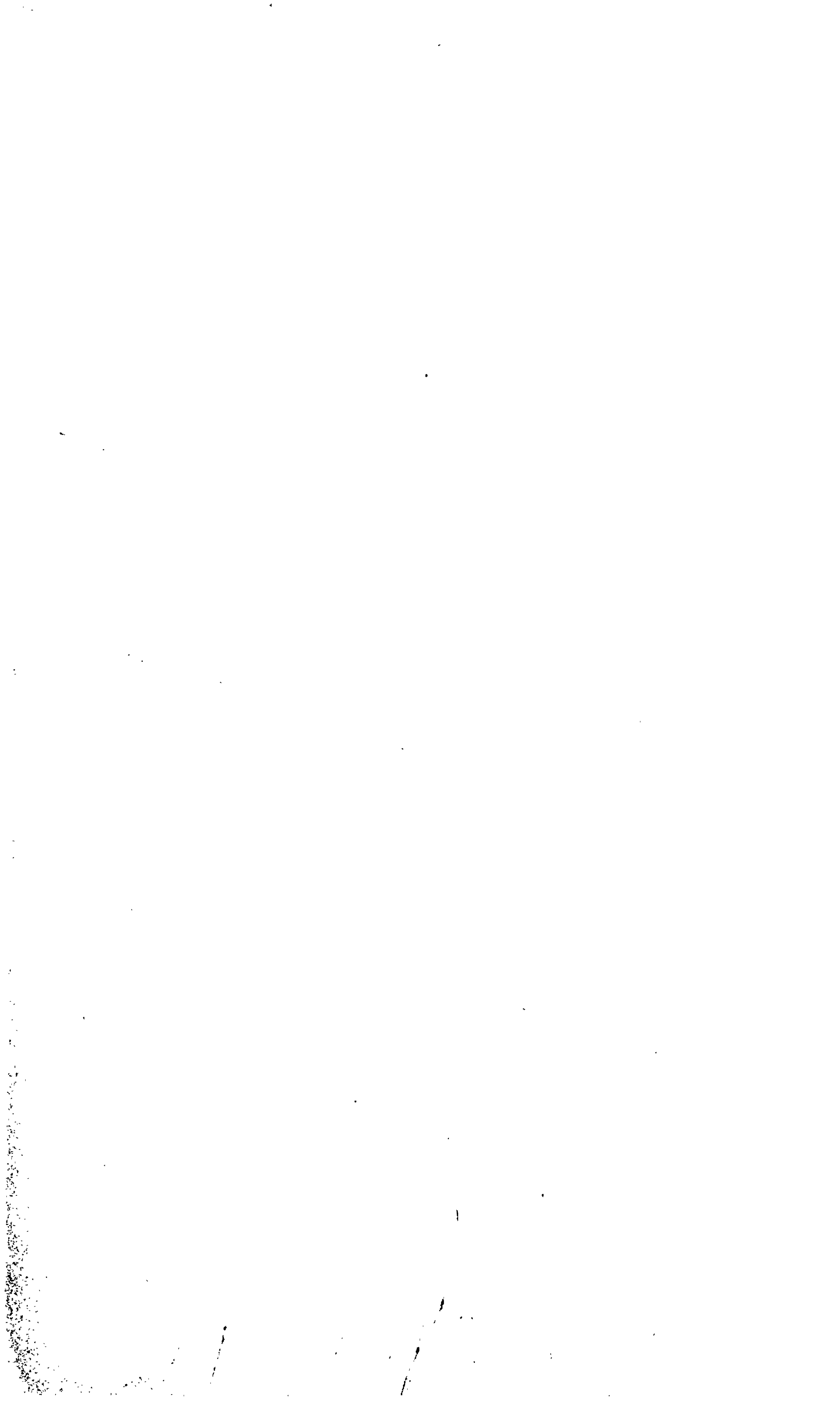
For these reasons, I hope the Senate Finance Committee will oppose any tax increase on thrift institutions at a time when every dollar we can possibly obtain is needed to aid our sagging homebuilding and home financing industry.

Sincerely,

JOHN SPARKMAN.

APPENDIX B

WRITTEN TESTIMONY RECEIVED BY THE COMMITTEE EXPRESSING AN INTEREST IN THE SUBJECT OF CAPITAL GAINS



Written Testimony Received by the Committee Expressing an Interest in the Subject of Capital Gains

STATEMENT OF JOHN C. BOGLE, CHAIRMAN, BOARD OF GOVERNORS OF THE INVESTMENT COMPANY INSTITUTE

This statement is presented on behalf of the Investment Company Institute, 61 Broadway, New York, New York, and is directed to the changes proposed to be made by sections 511 and 514 of H.R. 13,270 in the Federal capital gains tax structure.

We oppose removal of the 25% "ceiling" rate on "long-term" capital gains and extension of the holding period from 6 to 12 months. In this connection, we note that the Administration, speaking through Secretary of the Treasury Kennedy, strongly recommended on September 4, 1969 to the Senate Finance Committee the continuation of the 25% ceiling rate and retention of the 6 months holding period.

We take this position because in our view the effect of imposing such additional burdens on capital gains will be to discourage desirable investment in business, particularly new enterprises, to reduce rather than increase tax revenues, and, of particular importance to mutual funds and their over 5 million shareholders, to impair the depth and liquidity of the national securities markets and to interfere with the orderly carrying out by mutual funds of sound investment policies.

The Investment Company Institute is an association of 261 mutual funds (technically known as open-end investment companies) and their investment advisers and principal underwriters. Our member mutual funds have over 5 million shareholders, assets of over $45 billion and represent approximately 93% of the total assets of all U.S. mutual funds.

Mutual funds provide their shareholders with diversification of investment risk, skilled professional management and a variety of other services. Mutual funds thus make available to the investor of modest means the type of investment management and diversity that was once available only to the wealthy investor who could afford to hire a private investment counselor. Mutual fund assets are invested in a very wide selection of common stocks, preferred stocks, bonds and U.S. government debt obligations.

The mutual fund is a unique investment vehicle in that, in addition to continuously offering its shares to the public, it stands ready to redeem its own shares at any time at the then current net asset value per share. It therefore serves investors, small and large, as an excellent medium not only for the accumulation of an equity investment over a period of time but also for easy liquidation of such investments when investment goals have been realized. The amount invested in the average mutual fund account is $5,100.

As of June 30, 1969, the mutual fund members of the Investment Company Institute had in their shareholder accounts:

2,605,892 regular shareholder accounts where the dividends and capital gain distributions were being automatically reinvested in mutual fund shares. This is a favored form of systematic savings;

257,770 shareholder accounts which were "systematic withdrawal" accounts—providing for periodic payments (usually monthly) to the shareholders. These are a favored type of account for retired persons.

Over $2.3 billion dollars of long-term capital gain dividends were distributed to shareholders of mutual funds in 1968.

I. GENERAL

We believe that the provisions of Sections 511 and 514 of H.R. 13,270 which would eliminate the alterative capital gains tax rates and extend the holding period from 6 to 12 months, would be regressive in their effect. They would have a harmful effect on both mutual funds and their shareholders. The direct effects

on mutual fund shareholders, while similar to the effects on the holders of any other security, are even sharper in impact.

Mutual funds are advised and managed by highly trained and skilled money managers who are in the business of determining on a continuous basis the investment merit of companies in whose securities they invest. An increase in the tax rates on portfolio changes resulting from prudent investment decisions is, in substance, the exaction of a penalty on the investment skill of the manager. Furthermore, the proposed increase in the holding period would have the unhealthy effect of deterring a fund manager from making a desirable portfolio change for an inordinate period of time. The tax impact of realizing a short-term rather than a long-term gain would be a powerful factor in freezing an investment when sound investment discretion calls for disposing of it.

On the other hand, we have seen nothing that gives true economic support to these proposals. The justifications in the Ways and Means Committee Report for the proposed alternative tax rate changes and those in the "Summary of H.R. 13,270" prepared for the Finance Committee, do not rest on any statistical or economic base. They rely wholly on discussions of "equity" as between taxpayers and the need for deriving additional tax revenue from the "super rich" (Summary, p. 81) and "high income" taxpayers (Committee Report, p. 146).

We urge that these are superficial and far too limited considerations on which to erect a sound capital gains structure. The importance of capital transactions to the economic life of the country demands that capital gains tax rules reflect a proper balance between revenue yield to the government from a capital gains tax, and burdens on capital formation and mobility.

Tested by these criteria we do not believe that there is any justification for making the federal income tax on capital gains more burdensome than it already is.

II. INCREASE IN CAPITAL GAINS TAX BURDEN—REMOVING THE 25-PERCENT CEILING

A removal of the 25% ceiling on capital gains would obviously increase the capital gains tax on many transactions.

The present capital gains tax structure is an immense producer of tax revenue to the government as shown by the figures on the following table:

"NET CAPITAL GAINS" INCLUDED IN ADJUSTED GROSS INCOME ON TAX RETURNS

Year	Amount	Number of tax returns
1963	$5,700,000,000	4,900,000
1964	7,900,000,000	5,300,000
1965	10,200,000,000	5,900,000
1966	9,950,000,000	6,000,000
1967	13,500,000,000	6,900,000

Note: These are the amounts included ... adjusted gross income on income-tax returns; tax collections on capital gains are not reported separately. From Commissioner's annual report and statistics of income.

These figures clearly show the importance of capital gains revenues to the national economy, and warn that only a well documented statistical and economic case should provide the basis for tampering with the structure producing these revenue yields.

We do *not* believe that an economic case against the present capital gains tax structure can be made out on the basis of a relatively few taxpayers of very high income and high deductions.

The fact is, as Congress has recognized, that increased burdens on capital gains place in jeopardy the tax revenues from capital gains. People with savings available for investment will naturally be more reluctant to risk their savings in capital transactions when the prospects for capital gains are diminished by an increased rate of tax or by an undue protraction of the period when their investment must remain at risk despite an adverse change in circumstances. To the extent that people refrain from sales of capital assets, whether it is a relatively richer person selling stock or a relatively poorer person selling his private home to move into an apartment, the determination of whether these sales will take place will be substantially affected by how much of the proceeds will be taken from the investor by federal and state taxation. With respect to those transactions which do not take place because of adverse effects of these pro-

posals the federal government would be in a position of having given up 25% of something in return for 38½% or 32½% of nothing.

What seems to have been glossed over in the proposal for an increase from 25% to a 38½% capital gains tax ceiling in the last five months of 1969, 35% in 1970, 33¾% in 1971 and 32½% in 1972, is the burden of state income taxation which, as is widely known, is steadily increasing. Most states have income taxes; many are "federalized". In New York the rate on capital gains is 7% plus 1% more for those in New York City. The tax burden on a sale is not just the federal rate—it is the federal plus the state rate.

Investors will naturally shrink from "selling into" a high capital gains tax. This has been repeatedly recognized by the Congress. In 1942 the House Ways and Means Committee stated:

"It has been shown that too high a capital gains tax will result in loss of revenue to the Government. *This is because the question of whether or not a gain will be realized is entirely within the discretion of the taxpayer.*" (Italic supplied)

In fact, the validity of this reasoning has been publicly recognized by the House Ways and Means Committee and Senate Finance Committee in 1921, in 1938 and in 1942. Attached hereto as an Annex is a summary history of federal taxation of capital gains since 1913. The reports of the House Committee on Ways and Means and the Senate Committee on Finance over the years warn against regressive capital gains tax rules as an economic evil and as having a negative impact on tax revenues.

Thus, we urge this Committee to consider carefully the real danger that heavier tax burdens on capital gains will lower the revenue yield to the government and also slow down the growth and development of the American economy because of regressive effects on the nation's capital markets.

III. THE HOLDING PERIOD—6 TO 12 MONTHS

The proposal to increase the holding period from six to twelve months is in itself a dangerous change and can have a serious effect on the nation's securities markets.

We believe that the justifications supporting the proposal which are contained in the House Committee Report and the "Summary" (p. 85), are—

1. It is a step ". . . necessary to restore the original concept of the capital gains tax . . ."

2. "A person who holds an investment for little more than six months is primarily interested in obtaining speculative gains * * * which may be taxed at favorable rates. * * * Further, a study made in 1962, of gains from corporate stock transactions revealed that almost 90% of all capital gains in that year arose from sales occurring after one year of possession. * * *"

As to restoring the "original concept of the capital gains tax", reference is made to the Annex hereto which shows that the "concept of the capital gains tax" cannot be considered separately from revenue collection and capital formation and mobility.

The speculator versus investor "finding" seems to be no more than an unstudied opinion on a dividing line that is bound to be obscure at best. Beginning with the Revenue Act of 1942 (see Annex) and for 27 years, the Congress has been satisfied with six months as the dividing line. This dividing line was first proposed by the Senate Committee on Finance (see Annex). Also, as shown in the Annex, in the course of development of the Revenue Act of 1950, the House Committee on Ways and Means, the House of Representatives and the Senate Committee on Finance all thought the holding period should be reduced from six months to three months.

In this connection, the Senate Committee on Finance in its Report on the Revenue Act of 1950 (Int. Rev. Rul. C. B. 1950–2, p. 523) stated:

"In the opinion of your committee the 6-month holding period requirement used in existing law is longer than necessary and there are good reasons for reducing the requirement to the minimum consistent with the fundamental policy of the Congress on the taxation of capital gains. A long holding period has a disturbing effect on prices in the markets for capital assets, which is most unfortunate. When prices rise, as has been the case in the security markets during the last year and notably in the commodity markets during recent weeks, sales which would otherwise have occurred do not take place until they can qualify the gains as long-term and obtain the resulting tax benefits. The consequence is that a check on the price movement which would otherwise appear is missing.

"In the opinion of your committee the reduction in the holding period from 6 months to 3 will not impair its effectiveness as a device for confining the more favorable tax treatment to the investor group."

The findings of the Finance Committee in 1950 are as valid in 1969 as they were in 1950. Since these findings support a reduction to three months they certainly support at least the maintenance of the present six months rule, and are inconsistent with the proposal for an extension of twelve months.

This brings us to a major point of concern on behalf of mutual fund companies and their shareholders. Extension of the holding period is bound to be seriously disruptive of the depth and liquidity of the securities markets of the country and will therefore tend to inhibit sound portfolio management.

In 1968, mutual funds purchased and sold for their portfolio over $38 billion of securities in the nation's securities markets. Mutual funds and their shareholders thus have a vital stake in the preservation of soundly functioning markets.

The concepts of depth and liquidity are critical to the efficient functioning of a securities market.[1] In this context liquidity means the ability of the market quickly to absorb or produce securities, while depth means the ability of the market to absorb or produce a reasonable amount of stock at prices reasonably related to previous transactions within a reasonable time.

An efficient market will have "sufficient depth or liquidity to maximize the likelihood that both sides of a transaction will be available and to prevent disruptive price fluctuations in response to relatively small fluctuations in supply and demand . . . [T]he . . . effectiveness of the Exchange market depends upon maximizing the volume of transactions brought to it . . ."[2]

The depth and liquidity of the American securities markets are the envy of the world and have been a constructive force in the free enterprise system. There can be no doubt that extension of the 6 months holding period to 12 months will discourage many securities transactions and thus detract from depth and liquidity. No one can predict the actual extent to which this will occur. However, it must be recalled that the 6 month holding period has been law for 27 years—since 1942. The securities markets and investor of the country are "tuned" to it. This depth and liquidity should not be threatened by what clearly seems to be an undocumented case that 12 months is the proper period of time for defining a long-term capital gain.

Certain statistics, based entirely on corporate stock transactions during 1962, have been advanced, from which it might be inferred that the depth and liquidity of the markets would not suffer from increasing the holding period from 6 months to one year. Thus the House Report (p. 150) states that almost 90% of all capital gains on corporate stock in 1962 arose from sales occurring after 1 year of possession." In evaluating such statistics we think it most important that 1962 saw the greatest market break since the great depression. In a break as deep and as serious as that which began in May 1962 a very significant part of the volume of selling comprised distress sales, forced sales and sales out of sheer panic.[3] To take the holding periods of sales which occurred in the year 1962 and insert them as a "norm" to prove a case for a 12 month holding period seems subject to serious question.

Not only would the ability of individuals and institutional investors to achieve fair prices in the securities markets be compromised by this proposal but a complicating adverse factor would be added to portfolio management. The requirements of the federal securities laws—primarily the Securities Act of 1933 and the Securities Exchange Act of 1934—have produced large quantities of current and reliable information about the affairs of publicly traded enterprises which has never previously in the history of securities trading been readily available. No longer does the individual investor or the professional money manager have to wait from annual report to annual report to appraise the business success or failure of a particular company. Interim reports and reports of material changes are readily available and regularly disseminated as required by the securities laws and the rules of the major securities exchanges.

Today investors can withdraw capital from a faltering enterprise on the basis of current and timely information and reinvest it elsewhere as a result of con-

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[1] See Report of Special Study of Securities Markets of the Securities and Exchange Commission (1963), Part 2, pages 17–20, 828–829.

[2] Brief of the U.S. Department of Justice, *Inquiry into proposals to modify the Commission Rate structure of the New York Stock Exchange* (April 1, 1968), pages 19, 26

[3] See Report of Special Study of Securities Markets of the Securities and Exchange Commission, Part 4, pages 812–859.

tinuing investment analysis and re-appraisal. The free enterprise system is strengthened by such capital mobility. The creation of an additional 6 month holding period to achieve capital gains treatment would involve an artificial roadblock against the free mobility of capital based on pure investment considerations.

Thus we believe that the 12 month holding period proposal contains the grave potential of serious disruption of the depth and liquidity of securities markets, would interfere with sound portfolio management by institutional and individual investors by holding out a tax advantage for freezing an investment, and is not based on any showing related to revenue needs or tax equity.

IV. INDIRECT TAX BURDENS ON CAPITAL GAINS

The same considerations thus far outlined in this statement as to the effect of a more burdensome capital gains tax on (a) capital gains tax revenues, and (b) capital formation and mobility, warrant the exclusion of long-term capital gains from those provisions of the Bill respecting limitation on tax preferences and allocation of deductions.

The deduction allocation proposal seems to be based on an assumption that the 50% of long-term capital gains is exempt income on the order of tax exempt interest on municipal bonds, or is a tax preference on the order of intangible drilling costs, etc. But the fact is that since 1942 long-term capital gains have always been regarded as 100% taxable income, with a ceiling of 25% on the tax.

Perhaps the biggest impact of the allocation of deduction provision would be in the area of reducing the deduction for state taxes. For example, a taxpayer in New York City in 1970 contemplating whether or not to make a sale resulting in long-term capital gain would, as to 100% of such gain, have a federal ceiling rate of 35% and a New York ceiling rate of 8% (7% state and 1% city)—a total of 43%. Actual rates imposed on the one-half of long-term gain used in the income computation on the tax return (if the taxpayer decides to "realize" the gain—he has the election not to sell) would be 70% federal and 16% New York, a total rate of 86% on 50% of his long-term gain.

This taxpayer is being told by the Bill that if he realizes that gain and pays a New York tax of 16% on 50% of the gain, the other 50% of the gain will be used to reduce his federal deduction for the New York tax he paid. In other words, the burden of the New York tax on his gain *will be increased* by using the 50% long-term gains that are left out of the federal tax calculation to deny him part of his federal deduction for this state taxation.

Faced with this dilemma, many taxpayers will *not* sell their securities or will delay sale for an extended period. The problems this creates are discussed in the earlier part of this statement.

V. CONCLUSION

For the foregoing reasons we respectfully urge that it is not in the public interest to place further burdens on capital gains and recommend that if consideration is to be given to changes in the federal capital gains structure such changes should be in the area of (a) reduction of the "ceiling" rate on long-term capital gains, and (b) reduction of the present six months holding period to three months.

ANNEX TO THE STATEMENT OF THE INVESTMENT COMPANY INSTITUTE

I. GENERAL

The provisions of the bill imposing higher tax burdens on capital gains—both directly and indirectly—and a longer holding period, run counter to the lessons of United States income tax history in experience with capital gains taxation.

This history teaches that high tax burdens and long holding periods on capital transactions:

(a) Reduce federal revenue from the taxation of capital gains.

(b) Handicap and reduce capital formation in the United States.

This history is a matter of public record, in some detail, in the reports of the House Committee on Ways and Means and the Senate Committee on Finance on major federal tax bills that have been reported by these Committees over the years.

II. BRIEF CHRONOLOGY

A brief chronology of the federal capital gains tax structure (individuals) from 1913 to date is as follows:

1913 to 1921: no distinction between capital gains and ordinary income; such gains included in taxable income.
1922 to 1933: two year holding period to determine capital gain.

Ceiling rate: 12½%.
1934 to 1938: capital gains taxed at regular rates, but taxable capital gain amount determined by a variety of holding periods:

Holding period:	*Taxable portion (percent)*
1 year	100
1 to 2 years	80
2 to 5 years	60
5 to 10 years	50
over 10 years	30

1938 to 1942: ceiling rate of 30%, and taxable capital gain amount determined by holding periods:

Holding period:	*Taxable portion (percent)*
18 months	100
18 to 24 months	66⅔
Over 24 months	50

1942 to date: ceiling rate 25%—holding period 6 months.

Notes to foregoing:

1. Over this period there have been a number of variables in rules for the deduction of capital losses, including the portion deductible against ordinary income; also as to capital loss carry-overs.

2. In the development of the Revenue Act of 1950 both the House Committee on Ways and Means and the Senate Committee on Finance *and* the House of Representatives, approved *reduction* of the holding period *from six months to three months.* For reasons not explained in the conference report, this provision was dropped from the bill.

III. PROPOSALS OF H.R. 13270

H.R. 13270 proposes as direct changes in the capital gains tax structure:

(a) To lengthen the holding period from 6 months to 12 months.

(b) To eliminate the "alternative" capital gains tax rate for individuals—the 25% "ceiling," as of July 25, 1969.

Thus imposing these rate "ceilings" as to individuals:

Balance of 1969: 38½% (with surtax).
1970: 35%.
1971: 33¾%.
1972: 32½%.

(c) To increase the corporate "alternative" capital gains tax rate to 30%.

(d) To reduce by 50% the amount of loss that can be deducted by individuals against "ordinary" income.

A number of other provisions of H.R. 13,270 put indirect and new burdens on persons realizing capital gains and losses. For example:

The provision containing the "Limitation on tax preferences" as to individuals. (Section 301)

The provision imposing rules for "allocation of deductions" as to individuals. (Section 302)

The provision imposing restrictions where an individual has investment interest deduction in excess of $25,000. (Section 221)

H.R. 13,270, by giving zero effect to the burden of state income taxes on capital gains, accepts another indirect burden—and the impact of this stems from (a) impact of state tax on top of federal, and (b) ignoring the severe effect of the deduction allocation rule in denying part of the impact of state income taxes on the taxpayer. Most states have income taxes; many states are federalized; state

tax rates are high and the trend is for steady increase. In New York the rate is now up to 14% and those who live in New York City have another 2% burden.

IV. REVENUE ACT OF 1921

It will be remembered that prior to the Revenue Act of 1921, capital gains were taxable as "ordinary" income. That Revenue Act provided for "favorable" capital gains treatment that lasted until 1934 (page references are to the reprint of this report in C.B. 1939-1):

Ways and Means Report No. 350, 67th Cong. (page 176)

"Section 206: The sale of farms, mineral properties, and other capital assets is now seriously retarded by the fact that gains and profits earned over a series of years are under the present law taxed as a lump sum (and the amount of surtax greatly enhanced thereby) in the year in which the profit is realized. Many such sales, with their possible profit taking and consequent increase of the tax revenue, have been blocked by this feature of the present law. In order to permit such transactions to go forward without fear of a prohibitive tax, the proposed bill, in section 206, adds a new section (207) to the income tax, providing that where the net gain derived from the sale or other disposition of capital assets would, under the ordinary procedure, be subjected to an income tax in excess of 15 per cent, the tax upon capital net gain shall be limited to that rate. It is believed that the passage of this provision would materially increase the revenue, not only because it would stimulate profit-taking transactions but because the limitation of 15 per cent is also applied to capital losses. Under present conditions there are likely to be more losses than gains."

Senate Committee on Finance, Report No. 275, 67th Cong. (page 189)

"Section 206 limits the rate of taxation upon gain derived from the sale of capital assets. Under the present law many sales of farms, mineral properties, and other capital assets have been prevented by the fact that gains and profits earned over a series of years are under the present law taxed as a lump sum and the amount of surtax excessively enhanced thereby. In order to permit such transactions to take place without fear of prohibitive tax, section 206 provides that only 40 per cent of the net gain derived from the sale or other disposition of capital assets shall be taken into account in determining the net income upon which the income tax is imposed. This automatically reduces the rate of taxes applicable to such income by 60 per cent. The maximum rate (normal and surtax) upon ordinary income after January 1, 1922, will be 40 per cent, and the maximum rate applicable to capital net gain will be 16 per cent. The House bill placed a similar limitation upon both capital gains and losses, but this limitation was not applicable to corporations nor to certain classes of taxpayers having net income less than $29,000. The Senate provision would permit a taxpayer to deduct the entire loss sustained in a capital transaction and is applicable to all classes of taxpayers. In Great Britian capital gain or loss is ignored or eliminated in computing the net income. Section 206 takes an intermediate position between the extreme views embodied, respectively, in the present American and British laws."

V. REVENUE ACT OF 1934

This Revenue Act begins the period when the two tax writing committees fell into error—which they confessed later in 1938 and 1942—and imposed a very burdensome capital gains tax structure (page references are to the reprint of these reports in C.B. 1939-1):

Ways and Means Report No. 1492, 73rd Cong. (page 561)

"Our present system has the following defects:

"First. It produces an unstable revenue—large receipts in prosperous years, low receipts in depression years.

"Second. In many instances, the capital-gains tax is imposed on the mere increase in monetary value resulting from the depreciation of the dollar instead of on a real increase in value.

"Third. Taxpayers take their losses within the 2-year period and get full benefit therefrom, and delay taking gains until the 2-year period has expired, thereby reducing their taxes.

"Fourth. The relief afforded in the case of transactions of more than two years is inequitable. It gives relief only to the larger taxpayers with net incomes of over $16,000.

"Fifth. In some instances, normal business transactions are still prevented on account of the tax.

"Your Committee has examined the British system, which disregards these gains and losses for income-tax purposes. The stability of the British revenue over the last 11 years is in marked contrast to the instability of our own. In that period the maximum British revenue was only 35 per cent above the minimum, while in our own case the percentage of variation was 280 per cent.

"Your Committee, however, has been unable to reach the conclusion that we should adopt the British system. It is deemed wiser to attempt a step in this direction without letting capital gains go entirely untaxed. Your Committee recommends the following plan:

"First. To measure the gain or loss from the sale of property by an individual according to the length of time he has held the property, only the following percentages of the recognized gain or loss are taken into account for tax purposes:

"One hundred per cent if the capital asset has been held for not more than one year.

"Eighty per cent if the capital asset has been held for more than two years.

"Sixty per cent if the capital asset has been held for more than two years but not more than five years; and

"Forty per cent if the capital asset has been held for more than five years.

"Second. In the cases where the losses taken into account as above exceed the gains so taken into account, the excess losses are entirely disallowed.

"Third. In the case of corporations the graduated percentage reduction of gains and losses does not apply. However, capital losses sustained by corporations are allowed only to the extent of capital gains. Under the present law corporations are allowed to offset capital losses against ordinary income.

"Fourth. The plan outlined above is not made applicable, for obvious reasons, to stock in trade or property which is included in the taxpayer's inventory.

"It is believed that the adoption of this plan will result in much greater stability in revenue, will give all taxpayers equal treatment, will encourage normal business transactions, and will yield substantially greater revenue. The method proposed is safe from a revenue standpoint, inasmuch as capital losses can not be used to reduce ordinary income, while gains are taxed in full or in part in proportion to the time which the property has been held. The existing method which has been in force since 1921 can be defended only on the ground of expediency."

Senate Finance Committee Report No. 558, 73rd Cong. (pp. 594–596)

Restates the Ways and Means Committee comment and adds a very significant statement. It is "significant" in the sense that it is shown by later events to be erroneous:

"*Substantially increased revenues are expected* from this new system of treatment of capital gains and losses. The changes made are either to prevent tax avoidance or to bring about greater equity. *No consequential amount of revenue is lost by the changes.*" (emphasis supplied)

VI. REVENUE ACT OF 1938

These are the reports when both committees confess the 1934 error and begin the retreat to a more rational capital gains tax structure (page references are to the reprint of these reports in C.B. 1939–1):

Ways and Means Report No. 1860, 75th Cong. (page 732)

"Considerable complaint has been made in respect to the present method of taxing the capital gains and losses of individuals. It is claimed that the present tax is so high, especially in the case of taxpayers subject to high surtax rates, that assets become frozen and few transactions take place. It is claimed that, if some relief were given, transactions would take place and the revenues be increased. Some fault has also been found with the percentage brackets governing the amount of gain or loss to be taken into account. * * * It has been claimed that these sharp reductions in the percentages of gain or loss taken into account encourage taxpayers to delay taking gains and, on the other hand, stimulate them to realize losses.

"It must be recognized that differences exist in the characteristics of ordinary income in comparison with the characteristics of income from capital gain. For example, no matter how high the rates, a taxpayer always benefits from an increase in salary. On the other hand, there is no tax on the appreciation in value of property unless such appreciation is realized through sale or exchange. *Thus, it becomes optional with a taxpayer whether to pay a tax on capital gains, since he avoids the tax by refraining from making the sale. It is the opinion of the committee that too high taxes on capital gains prevent transactions and result in loss of revenue.* On the other hand, the committee is also of the opinion that there is no justification for a lower tax on a speculator on the stock market than on an individual receiving a like income from salary or business.

"The committee has endeavored to revise the tax on capital gains so as to improve the system without loss of revenue; in fact, it is hoped the revenue from this source may even be increased.

* * * * * * *

"The principal improvements which will be obtained from the adoption of the proposed system are believed to be as follows:

"(1) The sudden reduction permitted at certain annual periods in the percentage brackets under existing law has been eliminated.

"(2) The maximum rate of tax on a capital gain, where the asset has been held over 5 years, will be 16 per cent. This is because only 40 per cent of the gain is taken into account, and a maximum tax rate on this reduced amount of 40 per cent is provided for. The 40 per cent rate will also give limited relief in the case of property held for more than one year and for not more than five years. It is believed that this proposal will tend to stimulate business transactions.

"(3) Speculative transactions, in a practical way, are separated from investment transactions by the system of short-term capital gains and losses and long-term capital gains and losses.

"(4) The present minimum percentage bracket of 30 per cent is changed to 40 percent, which should increase the revenue to some extent.

"It is the hope of the committee that the changes proposed, if adopted, *will be of benefit to the public interested in making long-term investments and will permit transactions to be made which are now prevented by the existing tax system.* The proposed system is explained in detail in the latter part of this report. (emphasis supplied)

Senate Finance Committee Report No. 1567, 75th Cong. (page 783)

"While it may be recognized that the House provision is a considerable improvement over existing law, the committee believes that the plan proposed in the House bill is excessively complicated and will not permit of a free flow of capital into productive enterprises. *The Committee is convinced that at the present time transactions are prevented by the capital-gain tax and that the result has been a material hindrance to business and a considerable loss of revenue.*

"There is an essential difference between income derived from salaries, wages, interest, and rents and income derived from capital gains. It is always to the advantage of the taxpayer to receive the first class of income, no matter what the rate of tax as long as it is less than 100 per cent. On the other hand, the tax in respect of capital gains is optional—the taxpayer is not obliged to pay any tax unless he realizes a gain by the sale of the asset. There is no tax under existing law if a taxpayer transfers his money from one bank to another, but there may be a very heavy tax if he wishes to transfer his investment from a bond in one company to a bond in another company. *Thus, an excessive tax on capital gains freezes transactions and prevents the free flow of capital into productive investments.* The effect of the present system of taxing capital gains is to prevent any individual with substantial capital from investing in new enterprises. This is most unfortunate, because it adversely affects the employment situation. (emphasis supplied)

* * * * * * *

"The Committee believes that this treatment of capital gains and losses will stimulate transactions, facilitate the flow of capital into new enterprises, release frozen capital and increase the revenues of the Government." (emphasis supplied)

VII. REVENUE ACT OF 1942

It was the Revenue Act of 1942 which established, basically, the present capital gains tax structure—erected around a 25% ceiling rate and six months holding period. It should be noted that when the Bill left the House side for the Senate it reduced the holding period to *15* months (not six) but established the ceiling rate of 25%. It established the present pattern of two forms of gain—"short term" and "long term." The present six months holding period resulted from Senate changes in the Revenue Act of 1942 (page references are to the reprint in C.B. 1942–2):

House Report No. 2333, 77th Cong. (pp. 396–399)

"Your committee has given careful consideration to the taxation of capital gains and losses. *It has been shown that too high a capital gains tax will result in a loss of revenue to the Government. This is because the question of whether or not a capital gain will be realized is entirely within the discretion of the taxpayer. If the rates are too high, taxpayers will not dispose of their property.* This will result in the Government losing not only income taxes but also stamp taxes on transfers of property. *Too high a capital gains tax will also have the effect of discouraging taxpayers from investing in new or productive enterprises.* Suppose an individual with a large net income desires, as a matter of investment, to place some of his money in an airplane factory. It might be a new factory in which he is interested or he might come to the rescue of an existing factory which is desperately in need of capital. The usual way in which this is accomplished is for him to buy securities in the corporation. In order to do this, he will be compelled to sell certain of his property in order to raise money to make the investment. If the capital gains tax is too high, it will prevent him from undertaking the enterprise. (emphasis supplied)

* * * * * * *

"One of the chief complaints against the 1934 system was that the sharp reduction in the percentage of gains or losses dependent upon the time of holding the capital asset had a tendency to delay the taking of gains and on the other hand stimulated the realization of losses. Statistics for 1934 indicate that of taxpayers with incomes of over $100,000, 70 percent of their net capital gains were derived from transactions involving assets held over 10 years, whereas in the case of taxpayers with incomes not exceeding $25,000, only 25 per cent of their capital gains came from transactions in assets held over 10 years.

* * * * * * *

"*However, your committee realizes that since the realization of a capital gain is solely a matter within the discretion of the taxpayer, a too high capital gain tax rate will lose rather than gain revenue for the Government. With a top normal tax and surtax rate of 88 per cent, it is not believed that a moderate increase in the capital gain rate will retard capital transactions.*" (emphasis supplied)

Senate Report No. 1631, 77th Cong. (pages 544, 545)

The Finance Committee accepted the philosophy of the House Report and went further in the revision of the capital gains tax structure by reducing the holding period requirement to six months. It noted:

"Your committee has made the following changes in the capital gains and loss section:

"The House bill defined short-term capital gains or losses as those held for 15 months or less. Your committee has reduced the holding period to six months. Therefore, gains and losses from assets held over six months are treated as long-term gains or losses, and gains and losses from assets held for six months or less are treated as short-term gains or losses. The realization of a capital gain is entirely a matter within the discretion of the taxpayer. If the rates are too high, the Government will lose not only income taxes but also stamp taxes upon the transfer of property. The net receipts from capital gains and losses have been steadily declining as shown by the following table:

"ESTIMATED NET REVENUE FROM TAX TREATMENT OF CAPITAL GAINS AND LOSSES OF INDIVIDUALS AND TAXABLE FIDUCIARIES, 1926-40[1]

[In thousands]

"Calendar year	Estimated net revenue from capital gains and losses	Estimated tax liability on other income	Total tax liability
1926	$225,485	$506,990	$732,475
1927	296,879	533,760	830,639
1928	576,001	588,253	1,164,254
1929	420,971	580,967	1,001,938
1930	−15,226	491,941	476,715
1931	−89,001	335,128	246,127
1932	−79,917	409,879	329,962
1933	16,167	357,953	374,120
1934	17,197	494,203	511,400
1935	85,257	572,182	657,439
1936	201,941	1,012,076	1,214,017
1937	58,188	1,083,381	1,141,569
1938	52,873	712,960	765,833
1939	26,995	901,699	928,694
1940 [2]	12,868	1,481,271	1,494,139

"[1] The estimates are restricted to returns with net income, including, however, in 1938-40 taxable deficit returns. Estimated net revenue from capital gains and losses is the difference between (a) total tax liability under the provisions of the particular Revenue Act applicable to each specified income year and (b) estimated tax liability on other income if capital gains and losses had been entirely excluded from the tax computation.

"[2] Preliminary.

"Source: Treasury Department, Division of Research and Statistics, Mar. 9, 1942.

"*Your committee believes that the lowering of the holding period will have the effect of encouraging the realization of capital gains and thereby result in added revenue to the Treasury. It is believed that a holding period of six months will be a sufficient deterrent to the speculator as contrasted with the legitimate investor.*" (emphasis supplied)

VIII. REVENUE ACT OF 1950

This Revenue Act is significant in that both of the Committees and the House approved a provision which would have *reduced* the holding period from *six* months to *three* months. For reasons not explained in the conference report (page 585, amendment No. 83), the change was not made and the holding period contined at six months (page references are to the reprint of these reports in C.B. 1950-2):

Ways and Means Report No. 2319, 81st Cong. (page 425)

"Under existing law the more favorable treatment accorded capital gains is restricted to gains on capital assets held for more than 6 months. Section 209(e) of your committee's bill reduces this holding period from 6 months to 3. Essentially the distinction between long- and short-term gains and losses is intended to confine the more favorable tax treatment to the gains and losses realized by 'investors' and the holding period requirement is the test by which the 'investor' is distinguished from the 'speculator,' whose individual ventures in the markets for capital assets tend to be of comparatively short duration.

"In the opinion of your committee the 6-month holding period requirement used in existing law is longer than necessary, and there are very good reasons for reducing the requirement to the minimum consistent with the fundamental policy of the Congress on the taxation of capital gains. A long holding period has a disturbing effect on prices in the markets for capital assets, which is most unfortunate. When prices rise, as has been the case in the security markets during recent months, sales that would otherwise have occurred do not take place because the owners of the assets desire to hold them until they can qualify the gain as long-term and obtain the resulting tax benefits. *The consequence is that a check on the price movement which would otherwise appear is missing. Your committee's action in reducing the holding period from 6 months to 3 will reduce this tendency, thus contributing to the stabilization of the security markets which is highly desirable, since it tends to encourage the flotation of new issues and improve the flow of venture capital so essential to the continued progress of our economy.* (emphasis supplied)

"In our opinion of your committee the reduction in the holding period from 6 months to 3 will not impair the effectiveness of this test as a device for confining the more favorable tax treatment to the investor's group."

Senate Committee on Finance Report No. 2375, 81st Cong. (page 523)

"Under existing law the more favorable treatment accorded capital gains is restricted to gains on capital assets held for more than 6 months. Section 211(c) of your committee's bill reduces the period for determining long-term gains and losses from 6 months to 3. Essentially the distinction between long- and short-term gains and losses is intended to confine the more favorable tax treatment to the gains and losses realized by 'investors.' The holding period requirement is the test by which the 'investor' is distinguished from the 'speculator,' whose individual ventures in the markets for capital assets tend to be of comparatively short duration.

"In the opinion of your committee the 6-month holding period requirement used in existing law is longer than necessary, and there are good reasons for reducing the requirement to the minimum consistent with the fundamental policy of the Congress on the taxation of capital gains. *A long holding period has a disturbing effect on prices in the markets for capital assets, which is most unfortunate. When prices rise, as has been the case in the security markets during the last year and notably in the commodity markets during recent weeks, sales that would otherwise have occurred do not take place because the owners of the assets desire to hold them until they can qualify the gains as long-term and obtain the resulting tax benefits. The consequence is that a check on the price movement which would otherwise appear is missing.*

"In the opinion of your committee the reduction in the holding period from 6 months to 3 will not impair its effectiveness as a device for confining the more favorable tax treatment to the investor group." (emphasis supplied)

IX. OTHER REVENUE ACTS

It should also be noted that since 1942 in the course of several very major Congressional reviews of the entire federal tax structure no changes were made in the basic fundamentals of the capital gains tax structure—the 25% ceiling rate and the six months holding period. These included:

1. The Revenue Act of 1951—proposal to increase capital gains tax rate.
2. The complete recasting of the Internal Revenue Code in 1954—to create the Internal Revenue Code of 1954.
3. The Revenue Act of 1962.
4. The Revenue Act of 1964—and its major tax rate changes.

As to the *Revenue Act of 1951*, there is more instructive history as to the importance of *not* increasing the rate of taxation of capital gains.

The Revenue Bill of 1951, as it left the House, proposed general income tax increases, including an increase in the alternative capital gains tax ceiling rate of 12½ percent—to a little more than 28 percent. The Senate Finance Committee, with the later support of the Senate, *refused* to agree to the increase in the capital gains tax ceiling rate. The Senate Finance Committee stated in its report (I.R.B. 1951-2, page 463):

"Although the House bill increases the alternative tax on capital gains to a little over 28 percent, your committee's bill retains the ceiling rate in this tax at 25 percent. Your committee recognizes that capital gains are different from ordinary income in that the time of realizing a capital gain, to a substantial degree, is subject to the control of the taxpayer. Therefore, *in this case, particularly* high tax rates tend to discourage the realization of gains. Congress has recognized this as far back as the Revenue Act of 1942 by placing an effective ceiling rate of 25 percent on capital gains income. *Since that time, although individual income tax rates have been both substantially increased and decreased, this ceiling rate has remained the same. In view of this your committee does not believe that it is appropriate to consider a change in this ceiling rate at this time.*" [Emphasis supplied.]

The House-Senate conference on the Revenue Act of 1951 was one of the longest of tax bill conferences. Finally, to settle the dispute between the two Houses on the ceiling capital gains rate, a compromise was reached of adding one percentage point, for one year, to the 25 percent ceiling rate.

X. TAX "VERY HIGH" INDIVIDUAL INCOME TAX RATE BRACKETS—1945 TO DATE

It is especially to be emphasized that the 25% ceiling rate as to capital gains, and the 6 months holding period, have endured since 1945—and that during these 27 years the individual income rate brackets have been *very high indeed.*

[In percent]

	1945 [1]	1950	1955	1963	1968
Income:					
$10,000	38	38	38	38	23
$32,000	65	65	65	65	55
$100,000	89	89	89	89	70
$200,000	91	91	91	91	70

[1] To these rates should be added the 3 percent "normal tax" in effect in this year.

STATEMENT BY THE INDEPENDENT RADIONIC WORKERS OF AMERICA, CHICAGO, ILL., SUBMITTED BY RONALD T. BERG, PRESIDENT

SUMMARY

I. House Report No. 91–413 (Part 1, 91st Congress, 1st Session, pp. 9–10) clearly shows that the general purpose of the Tax Reform Act of 1969, R.R. 13270 is to:

(A) Eliminate loopholes whereby a small minority of high income individuals escape tax on a large proportion of their income.

(B) Provide for payment of substantially the same tax by those with substantially the same incomes and to insure that the graduated income tax structure is working fairly as between different income levels.

II. House Report No. 91–413 (Part 1, 91st Congress, 1st Session, p. 154) states that the general reason for the tax revision on limitation on capital gains treatment effected by Sec. 151, H.R. 13270 on distributions from employee pension and profit sharing trusts is to correct the present capital gains tax treatment of qualified lump-sum distributions to highly compensated employees (which constitute deferred compensation) by taxing employer contributions after December 31, 1969 as ordinary income.

III. Neither the general purposes of tax reform, nor the specific purpose of Sec. 515 are applicable to distributions from employee pension and profit sharing retirement trusts to hourly paid production and maintenance workers because:

(A) Limitation of capital gains treatment to distribution from employees' pension and profit sharing trusts to such employees do not constitute "substantial amounts of deferred compensation" which Sec. 515 taxes at ordinary income tax rates.

(B) Such distributions to such employees constitute their principal, and in most cases, only asset for retirement purposes (in addition to Social Security Retirement Benefits).

(C) Sec. 515 imposes an additional tax burden on those least able to afford it.

(D) Sec. 515 is inequitable in that it penalizes the little man (hourly paid employee) to get at the big fellow (highly paid corporate executive).

IV. Independent Radionic Workers of America recommends to the Committee on Finance, United States Senate, that the above inequities inherent in Sec. 515, H.R. 13270. can be cured by restricting the limitation on capital gains tax treatment to distribution from employee profit sharing and pension trusts.

(A) To employees whose compensation for services to an employer, computed on an annual basis, exceeds $25,000 annually or

(B) Whose lump-sum distribution from qualified employee pension and profit sharing trusts exceeds $100,000.

STATEMENT

The description of submittor of statement

This statement in opposition to the enactment into law of Sec. 515—Total Distributions From Qualified Pension, etc., Plans, H.R. 13270 (p. 290, 11. 7–24 inclusive, p. 291, 11. 1–5 inclusive) is submitted by Independent Radionic Workers

of America, Ronald T. Berg, President, 5812 West Grand Avenue, Chicago, Illinois, 60639 (I.R.W.A.). The I.R.W.A. is an independent local union affiliated with the National Federation of Independent Unions, 910 17th Street, N.W., Washington, D.C. The I.R.W.A. is the certified bargaining representative of approximately 10,000 production and maintenance employees employed by Zenith Radio Corporation in Chicago, Illinois.

Reason statement submitted

On April 28, 1950, Zenith Radio Corporation (Zenith), Chicago, Illinois, established the Zenith Profit Sharing Retirement Plan (the Plan) for the benefit of its employees. All the members of I.R.W.A. who qualify under the terms of the Plan have been and are beneficiaries. In the intervening 19 years the Plan has provided the means by which I.R.W.A. members (1) have been able to retire from lifelong service of producing for the American economy with self-sufficient dignity not possible on Social Security benefits alone; (2) have received lump-sum benefits (having qualified by length of service) even though they did not continue in Zenith's employ until retirement; and (3) have left lump-sum benefits to designated beneficiary(ies) when death terminated Zenith employment.

The distribution payments to member-retirees or members whose employment is terminated for any other reason constitutes, in the vast majority of cases, the principal asset to support retirement or of a deceased member's estate. As the maximum considered compensation under the Plan presently is $11,500.00, its major percentage impact and benefit accrues to I.R.W.A. member-employees as compared with non-bargaining unit employees who are generally higher paid in supervisory and executive categories. *While the treatment of all employees is the same, the group of employees to whom this Plan means the most, particularly in retirement, are the hourly rated I.R.W.A. member-employees.*

The foregoing comment is stressed to emphasize that the Zenith Plan is not a "favorable tax shelter" for deferred compensation of high-paid corporate employees designed for the purpose of avoidance of an equitable share of the tax burden. On the contrary, the Plan provides the economic substance by which senior citizens who have labored as blue-collar workers all of their working lives can retire or look forward to retirement at a decent level of living without burdening national and state welfare funds. They are thus enabled to live the evening of their lives in self-respect as free and independent American citizens. It is submitted, therefore, that any revision of the Federal Income Tax law which imposes an increased burden on the amount distributed to such member-employees is not in the best interest and welfare of all of the citizens of the United States of America.

The issue

The specific issue presented by this Statement to this honorable Committee, in consideration of H.R. 13270, is whether the Committee should recommend passage of Sec. 515 of H.R. 13270 as it is now written. That section provides that part of the distribution from a plan such as Zenith's, beginning with the plan years commencing after December 31, 1969, which consists of what has accrued to the benefit of an employee during any plan year beginning before January 1, 1970, plus any part of the benefits accrued after December 31, 1969, which does not consist of an employer's contribution for the benefit of an employee shall receive the favorable long-term capital gain tax treatment provided for by Sec. 402(a) (2) of the Internal Revenue Code. The effect of Sec. 515 is to subject to income tax rates an employer's (such as Zenith's) contribution to each employee's account made for each plan year beginning after December 31, 1969. This places additional ordinary income tax burden under he five-year forwarding income averaging formula on retired employees, beneficiaries of deceased employees and employees whose employment is terminated for other reasons. In the latter case, the income would be added to earned income, thus raising the effective rate in most cases on earned taxable income.

Analysis of the reasons for revision effected by sec. 515, H.R. 13270

On the surface it appears that the revision effected in Sec. 515 is based on the equitable theory of closing a loophole for avoidance of income tax on deferred compensation. The general principle is not opposed. However, Sec. 515, H.R. 13270 employs a shotgun approach that shoots down the little sparrows and the economic fat geese with one blast.

Examination of House Report No. 91–413 (Part 1, 91st Congress, 1st Session) makes it crystal clear that Sec. 515 was aimed at subjecting large amounts of deferred compensation paid by corporations to their highly paid corporate executives, by means of contributions to profit sharing or pension trusts, to ordinary income taxation treatment. Sec. 515 seeks to remove the favorable long-term capital gain treatment from such company contributions in plan years beginning after December 31, 1969. That this is the primary motivation for the revision accomplished by Sec. 515 clearly appears from the Report of the Committee on Ways and Means, House of Representatives. That Report states (House Report No. 91–413, Part 1, 91st Congress, 1st Session, p. 154) :

"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.*

"The manner in which the present treatment of qualified lump-sum pension distributions enable *highly compensated* employees to convert *substantial amounts of deferred compensation* from its regular ordinary income treatment to capital gains may be illustrated by the following example: Assume the case of a corporate executive who has an average *taxable* income of $100,000.00 for the 4 years prior to the distribution; receives a $500,000.00 (net of any employee contribution) lump-sum pension distribution in January, 1970, after retiring in December, 1969. . . ." (emphasis supplied)

Then follows a detailed explanation of the income tax effect of the revision written in Sec. 515 compared to the existing law. This is the sole example cited by the Committee on Ways and Means of the House of Representatives illustrating the general reasons for the revision incorporated in Sec. 515. The Report then continues (supra, p. 155) :

"Your Committee therefore considers it appropriate to restrict the extent to whch lump-sum pension distributions receive the more favorable capital gain treatment, as compared to pension income received over a period of years of retirement. Moreover, it is also desirable to tighten the tax treatment of the amounts of distribution represented by employer contributions made to purchase employer securities for the plan, as these amounts are presently accorded capital gains treatment when the securities are distributed. The cost of the employer contributions in the stock would properly be considered as deferred compensation subject to ordinary income treatment when eventually received by the employee."

The Report of the Committee on Ways and Means, leaves no doubt that Sec. 515 was aimed at the specific category of highly paid corporate employees who received large amounts of deferred compensation as corporate contributions to tax exempt employees' trusts and the favorable long term capital gains treatment on payment of distributions from such trusts. The result, however, on I.R.W.A. members, for example, will be that a long-time member of I.R.W.A. employed for 35 years at Zenith, whose hourly rate of pay may never exceed $3.00 an hour will be caught by the tax revision aimed at the corporation president who earns $200,000 a year and who has profit sharing or pension trust contributions made to his account of $50,000 a year. The $500,000 lump-sum pension distribution assumed in the example cited in the Report of the Committee on Ways and Means supporting the reason for the change effected by Sec. 515 compares overwhelmingly with the $20,000–$25,000 that might be received by the $3.00 per hour member-employee on his retirement, yet the tax treatment is identical. Not only is this inequality, but on a percentage relationship between the two employees it is confiscatory with respect to the little man. Additionally, as has been pointed out above, the little man's sole asset for retirement in all but a very few cases is his Zenith Profit Sharing distribution. This cannot be believed to be so in the case of the $200,000 per year corporate president who, it can fairly be assumed, would have income-producing investments and/or insurance annuities purchased during his high income earning years. Indeed, the Report of the Committee on Ways and Means in its example as quoted above assumes taxable income of $35,000 annually in addition to the lump-sum pension distribution.

Sec. 515 does not distinguish between those who are "getting away with murder" and those "who will be murdered." Under Sec. 515, as now written the I.R.W.A. member-employee will pay ordinary income tax on all of Zenith's contributions to his account after December 31, 1969. It will be paid him in lump-sum in the year of his retirement or termination of employment for other reason, albeit this income will be averaged on the five-year "forward" averaging method.

It is submitted that this tax treatment of the comparatively lower income group,

which includes all members of I.R.W.A., is not consistent with the stated reasons for tax reform as written by H.R. 13270. Your attention is directed to House Report No. 91–413, Part 1, supra, p. 9, where the Committee on Ways and Means states:

"The fact that present law permits a small minority of high-income individuals to escape tax on a large proportion of their income has seriously undermined the feeling of taxpayers that others are paying their fair share of the tax burden. It is essential that reform be obtained not only as a matter of justice but as a matter of taxpayer morale. Our individual and corporate income taxes, which are the mainstays of our tax system, depend upon self-assessment and the cooperation of the taxpayers. The loss of confidence on their part in the fairness of the tax system could result in a breakdown of taxpayer morale and make it far more difficult to collect the necessary revenues. For this reason alone, the tax system should be improved.

"*Tax reform is necessary* both to be sure that those with substantially the same incomes are paying substantially the same tax and also *to make sure that the graduated income tax structure is working fairly as between different income levels.* Present law, because of various tax preferences, permits a minority of high-income taxpayers to escape payment of tax on a very large proportion of their economic income by arranging to receive various kinds of tax-free income and by taking advantage of a combination of special tax deductions. As a result, many high-income individuals pay tax lower effective rates than those with relatively modest incomes." (emphasis supplied)

It is submitted that the same treatment by Sec. 515 of the highly paid corporate president and the comparatively low-paid production and maintenance employee is utterly inconsistent with the above-stated reasons for tax law revision. The I.R.W.A., therefore, submits that the Committee on Finance of the United States Senate very carefully review Sec. 515 with specific emphasis on its contention that Sec. 515, as it now stands, is not equitable. Neither the purpose for the specific revision incorporated in Sec. 515, nor the general reasons for tax reform are achieved by levying an additional income tax on those who can least afford to pay it. In fact, Sec. 515 subverts that purpose and those reasons. Accordingly, I.R.W.A. makes the following recommendation to the Committee on Finance of the United States Senate.

I.R.W.A. recommendation as to amendment of sec. 515 as proposed by H.R. 13270

I.R.W.A. respectfully recommends to the Committee on Finance of the United States Senate that Sec. 515 be amended by restricting the limitation on capital gains treatment (H.R. 13270, 91st Congress, 1st Session, p. 290, lines 14–24 incl., p. 291, lines 1–2 incl.) of distributions paid after December 31, 1969 to employees whose compensation for services to an employer computed on an annual basis exceeds $25,000 per annum or to distributions paid after December 31, 1969 which exceed $100,000 in total.

This amendment to Sec. 515 would accomplish the specific purpose, compatible with the general reasons for tax reform, expressed by the Committee on Ways and Means in House Report No. 91–413, supra. At the same time, it obviates the objection herein stated that it is not equity to penalize the little man in order to get at the big fellow. This recommendation, if adopted, would further the social and moral welfare of the nation by encouraging the vast majority of American workers to largely provide for a self-sufficient retirement through their own efforts in cooperation with their employer. There can be no question that it would enhance taxpayer morale on the part of millions of employee-participants in existing pension and profit sharing trusts.

MINNEAPOLIS, MINN., *September 11, 1969.*

Re repeal of 25 percent alternative tax on long-term capital gains for individuals (section 511—H.R. 13270) and request for treatment of "binding sales contracts" entered into prior to (but consummated after) effective date in a manner similar to "binding order" provision for investment credit repeal.

SENATE FINANCE COMMITTEE,
Washington, D.C.

DEAR SIRS:

SUMMARY

Request is made that "binding sales contracts" with respect to sale on capital assets entered into prior to (but consummated after) July 25, 1969 be acc[illegible]

same tax treatment as sales consummated by July 25, 1969. This amendment would conform to a similar provision relating to repeal of the investment credit.

For investment credit purposes a "binding order" placed before the effective repeal date will still qualify for the investment credit. This request is merely to grant similar treatment in situations where "binding contracts to sell" were entered into in reliance on the tax outcome and cannot be changed even though the law subsequently changes the tax consequences of the transaction.

STATEMENT

In examining the 1969 Tax Reform Bill as passed by the House of Representatives on August 7, 1969, an apparent oversight has occurred in situations where binding contracts to sell capital assets have been entered but the actual sale has not mechanically taken place.

Specifically, section 511(C) makes the effective date of this section July 25, 1969. Consequently, "binding sales contracts" entered into prior to that date but which were not completed until some time subsequent to that date will still nonetheless be subject to the new rules.

By imposing the provisions of section 511 on contracts which were binding at July 25, 1969, this law will cause taxpayers who entered into binding contracts to sell capital assets to be subjected to a law which was nonexistent at the time the contract became binding. The parties will be subject to results which they could not possibly have contemplated when the contract was entered into. This result seems inequitable and contrary to principles of our legal system which are intended to create certainty in our tax laws so taxpayers may rely on the law as it exists when they sign contracts.

With respect to taxpayers so circumstanced, it would also appear that this lack of certainty arises only in situations where there was no knowledge of the effective date of July 25, 1969, or where the contract by its terms could not be completed by July 25, 1969 or prior thereto. Consequently, the inequities of section 511(C) fall on those who could not prophetize the change or were unable by contractural terms to complete the contract by July 24, 1969. Anyone that could have had knowledge of the proposed amendment to the law on July 25, 1969 would have the opportunity to sell or not sell and thus could determine the tax treatment.

The House recognized a similar inequity when it inserted the "binding order" rules when it eliminated the investment credit.

It would seem necessary and equitable that a similar provision allowing taxpayers who entered into binding contracts to sell capital assets at July 25, 1969 be eligible to be accorded the same tax treatment as those taxpayers who sold capital assets prior to July 25, 1969.

Consideration should also be given to amending section 511(C) with respect to distribution by corporations who elected to liquidate in one year under section 337 of the Internal Revenue Code of 1954. Section 337 was designed to eliminate double tax (once at the corporate level and again at the shareholder level) when a corporation sells its assets and distributes the proceeds to its shareholders. In situations where corporations made the proper election and sold their assets prior to July 25, 1969, but did not distribute the proceeds until after that date, an obvious inequity occurs.

In any event, "binding contracts" to sell entered into prior to July 25, 1969, but not settled until after that date should be accorded the same tax treatment as sales of capital assets consummated prior to July 25, 1969.

Respectfully submitted.

HASKINS & SELLS, CERTIFIED PUBLIC ACCOUNTANTS,
FREDERICK W. BASSINGER, *Partner*,
KENNETH R. SWANSON, *Partner*,
DONALD R. JOHNSON, *Partner*,
BURNELL LARSON, *Partner*.

STATEMENT BY NIAGARA MOHAWK POWER CORP., SUBMITTED BY R. D. CONSTABLE, VICE PRESIDENT

On behalf of all employees of Niagara Mohawk, we urge you to modify Section 515 of the Tax Reform Bill so as to retain the present law which, under certain conditions, subjects to personal income taxation *only at capital gains* rates a

lump-sum distribution to an employee attributable to the employer's contribution. The new bill would apply *ordinary* income tax rates thereto.

Niagara Mohawk's Employee Savings Fund Plan has been in operation nearly five years and is duly qualified by the Internal Revenue Service. Attached as Appendix A is a current statement of the plan's status. It is available on a completely uniform and non-discriminatory basis to any employee with five years of service or more: 86%, or over 6,000 eligible employees, now participate. Niagara Mohawk contributes amounts equal to 50% of the employee's contribution which is limited to a maximum of 6% of his pay. Niagara Mohawk common stock is bought in the open market only by Plan trustees. Hence operation of Niagara Mohawk's plan does not involve new financing.

Niagara Mohawk's Plan permits a "one chance" opportunity for an employee to withdraw the Company's contribution at the time of vesting, which is the end of the third year after each contribution year. If not then withdrawn, the Company's contribution for such year remains in the Trust until the employee's service terminates by death, retirement or otherwise.

Niagara Mohawk's Plan is highly desirable in the interest of its employees, Niagara Mohawk and in the public interest.

It presents an opportunity for all employees, particularly "rank and file" employees to accumulate a substantial sheltered cushion of security with his employer's help, against his possible untimely death, to supplement his retirement income, to bridge possible periods of unemployment or to meet other emergency expenses such as those of high educational costs, prolonged illness and so forth under a borrowing privilege incorporated in the Plan.

It presents an opportunity for employees, again especially those in the "rank and file" category, to feel that they have an ownership interest in the business enterprise in which they are employed.

Hopefully, as participants' equities increase, there will develop a greater mutuality of interest between employer and employee through greater understanding of management problems, greater interest in the success of the enterprise and consequent lessening of tensions which may from time to time arise between labor and management.

Most importantly, the Plan is a distinct deterrent to inflation by channeling up to 6% of an employees pay into non-spendable savings represented by Niagara Mohawk stock or United States Government bonds.

Under existing tax laws, Company contributions withdrawn without termination of employment are taxed as ordinary income. Such withdrawals on death or retirement are deemed to be capital gains, a considerable inducement to participate in the Plan and accumulate savings in the Trust.

HR 13270 would change thte existing code by making the Company's contributions taxable as ordinary income whenever received by the participant. This would nullify all of the objectives of this type of plan by removing a participant's incentive to accumulate for the future. The average employee probably would withdraw his own and the Company's contribution as soon as he became vested in the latter. In such casse, the Plan would simply become a slightly deferred wage compensation program, operated at considerable expense and completely self-defeating as to the foregoing desirable features.

In fact, the Plan would probably have to be terminated.

The above change in HR 13270 is undoubtedly designed to eliminate special tax advantages in this and other areas to very highly paid employees. For a non-discriminatory plan of our type (and there are many like Niagara Mohawk's), we believe this to be illiberal, regressive legislation and not in the public interest.

Proper objectives of the Tax Reform Bill are possible without depriving the great majority of employees participating in a plan of our type of their incentive to save.

We urge that present capital gains treatment be continued if a plan is non-discriminatory as to eligibility and is subscribed to by a majority of all eligible employees.

NIAGARA MOHAWK POWER CORP., EMPLOYEE SAVINGS FUND PLAN, SUMMARY OF INVESTMENT ACTIVITY

		Number of shares purchased or face value	Average price	Amount
Stock fund:				
Balance Dec. 31, 1968		596,711		$13,000,561
Purchased:				
1st quarter 1969		46,682		1,009,681
2d quarter 1969		59,271		1,190,757
Total June 30, 1969		702,664	$21⅝	15,200,999
Amount of employee deductions and company contributions for June 1969 not invested until July 1969				128,297
Total, stock fund				15,329,296
Government fund:				
Total at beginning of quarter	104	$104,000	985	102,465
Purchased during quarter	29	29,000	986	28,599
Government securities sold during quarter	(22)	(22,000)	(1,000)	(22,000)
Total at end of quarter	111	111,000	983	109,064
Amount of employee deductions for June 1969, not invested until July 1969				657
Total, Government fund				109,721

NUMBER OF PARTICIPANTS

	Total eligible	Total subscribed: Government fund	Total subscribed: Stock fund	Total subscribed: Total	Percent of participation
Apr. 1, 1969	6,953	67	5,840	5,907	86
July 1, 1969	7,006	67	5,956	6,023	86
Increase or (decrease)	53	0	116	116	

INDUSTRIAL NUCLEONICS CORP.,
Columbus, Ohio, October 3, 1969.

Hon. RUSSELL B. LONG,
U.S. Senate, Washington, D.C.

DEAR SENATOR LONG: Most Americans are willing to pay fair and equitable taxes. Yet I don't believe anyone wants to see our American free enterprise system damaged just in order to bring a few tax offenders in line—by the rich, middle class, or otherwise.

I am greatly concerned about the impact that increased capital gains taxes (beyond the present 25 percent maximum) will have on those who own a substantial part of their business or engage in their own farming operation. Many manager-owners of small- to medium-sized businesses are locked into their companies in the sense that virtually all their assets are in the business. Higher capital gains taxes on eventual sale of long-held capital (assets or equivalent stock) amounts to a virtual confiscation of capital generated over a substantial portion of a lifetime. I would like to emphasize that I am not talking about profits from the purchase and sale of securities (stocks, bonds, etc.) held for relatively short periods of time—say—six months to one year.

Enclosed is a statement outlining the basic concern of myself and others in similar situations. Perhaps the material therein sheds a different light on capital gains tax modifications. Hopefully, it will be useful to your deliberations. I would be glad to testify to the above viewpoints and the material included in my statement.

I would hope that the Senate Finance Committee would give consideration to (1) *not* doing away with the 25 percent maximum limit on long-held capital gains and (2) proposing a graduated downward capital gains tax rate for assets generated in a business and held for *very long periods* of time (five to fifteen years).

America needs new enterprises to supply the growing needs for goods and services of our population and to maintain full employment.

Yours sincerely,

H. Roy Chope,
Executive Vice President.

Effect of Increased Capital Gains Taxes on Formation of New Businesses

INTRODUCTION

As a small businessman, I am concerned about the terrible effect that higher capital gains taxes will have on the formation of new companies. According to my understanding, the Tax Revision Bill passed by the House of Representatives (HR 13270) and now before the Senate will increase the maximum capital gains taxes paid by eliminating the "alternate calculation" (effectively eliminating the 25 percent maximum capital gains taxes). Eliminating the "25 percent maximum" works a hardship on (1) businessmen who own a good portion of their companies, (2) independent farmers, and (3) employees with an equity in their companies.

It would be my hope that these comments could become part of the record considered in the deliberations of the Congress. My statements drawn from my own experience in creating, building, and running a business. Nevertheless, many other owner-businessmen find themselves in the same situation I am in now.

THE HIGH RISK OF STARTING A BUSINESS

Part of the great American dream has involved the opportunity to start one's own company. Under the best circumstances, the *risks* of eventual personal economic success are fantastically high. According to surveys run by Dun and Bradstreet, only about *one out of ten* new businesses survives beyond ten years. Hence, the odds against "business survival" are nine to one. Other studies have shown that of those who do succeed in keeping a business alive, only between one to two out of ten earn more money doing it than they would if they had sold their services to someone else. (It usually takes a reasonably competent, hardworking indidivual to have the stamina to stay in business.) Hence, the odds against an individual doing better in his own business than in selling his services to someone else (to industry, to the government, or to universities) is one in fifty to one in one hundred.

What motivates an individual to try his hand in business? One motivation is certainly that he wants to do it and wants to make a genuine contribution to our way of life. The other motivation is clearly economic: if the individual does succeed against the heavy odds and has a substantial portion of ownership in his business, he can look forward some day to realizing part of the capital he has generated.

BUSINESS SUCCESS DOES NOT COME FAST

From time to time there have been proposals made and some enacted to encourage the starting of new businesses. Today it seems to be particularly important to encourage entrepreneurship among various racial minorities. The *Wall Street Journal* of September 23, 1969, carried an article, "Ailing Entrepreneurs—Some U.S.-Assisted Black Businesses Lag After Initial Financing." The article cites many problems for lack of initial success. One of the more important ones was not emphasized: success is as much a matter of staying power, willingness to sacrifice, and hope for an eventual long-term payoff as it is anything else. Quick incentives and short-term provisions in any tax matter would not be enough.

Citing my own case, my business is about nineteen and a half years old; but it is only within the last five years that we have really started to grow and progress. A rougn rule of thumb in much of American industry is that it takes ten years to really generate a good "take-off platform" for real growth.

One view that is very important is: *"People at the bottom have to be able to generate capital on the way up."* Capital generation is necessary to allow the business to grow from within. Capital generation is also necessary so that somewhere at the end of a long, and tortuous, and uncertain road the business manager-owner may realize and obtain part of the capital he has created.

A CASE STUDY—MY OWN BUSINESS, INDUSTRIAL NUCLEONICS CORP.

The major points I have attempted to emphasize in these remarks can be illustrated from a history of my own business.

In 1950, my brother and I formed the first industrial concern to apply atomic energy to industrial purposes. We formed a company, called Industrial Nucleonics Corporation, in Columbus, Ohio. The total capital dollars put in the company by outside investors were somewhat less than $200,000. Under the original arrangement, my brother and I were supposed to work for two years with no salary as part of our deal. Actually, as it turned out, we worked five years without appreciable salary and put in $25,000 cash we had borrowed. We naturally accumulated considerable debts over the years in order to support our families in the meantime.

As the company grew, we brought in outstanding young professional people. The main motivation and incentive for them was the promise that they too could participate in company equity and ownership. A few who were able to borrow money purchased stock then. Others had to wait until some twelve years later, at which time the company could go to our outside stockholders and get approval for a good stock option plan. This had to be based upon the fact that our people had produced exceptional results through exceptional dedication, capabilities, and hard work. Today, the majority of the company is owned by our own employees.

In my own case, the following illustrates the above:

1. I worked for five years for "zero" or negligible salary.

2. By 1962–63, I was deeply in debt (to the tune of more than $100,000). I sold stock in a "private offering" just to (a) get out of debt, (b) add on to my residence, and (c) provide a little more income for my family (which by this time included four children). But even with a substantial stock sale, by the time I had paid my capital gains taxes, had selling commissions and costs deducted, and paid off my debts, I was back to "ground zero"—out of debt, but still with the major bulk of my assets locked into my company.

WHERE ARE THE FUTURE TAX DOLLARS GOING TO COME FROM?

From external appearances, my present company, Industrial Nucleonics, is highly successful—but it has taken almost twenty years. Some 420 of our approximately 800 employees participate in ownership of the company. They, like the founders, made a contribution in extra effort and other sacrifices.

The company has during its successful history paid (or committed itself to pay) some $8 million in Federal corporation taxes. The $8 million of Federal taxes is only part of the tax story. This does not include the substantial income taxes now paid by our personnel nor the many state, county, and municipal taxes that are paid by both the corporation and individuals. An indication of the above statement that success comes slowly is the following: the largest part of my company's taxes has been incurred (and profits generated) within the last five years. On the tax side, some $5 million of taxes have been incurred during the last five years.

A major worry of myself and people like me is this: *If the incentive to go into business and prosper is blunted, what will take the place of corporate and individual taxes that might have been generated but weren't?*

A recent perusal of growth companies over the last two decades indicates that small companies do get started, create many jobs and hire people, and become substantial taxpayers. Companies such as Xerox, Polaroid, Texas Instruments, Hewlett-Packard and Litton Industries illustrate the point.

MY RECOMMENDATIONS

The above states my concern for the middle-sized and small businessmen whose capital is locked into their companies. Such capital represents the great bulk of their assets. Debilitating and ever-increasing capital gains taxes will militate against their continuing their businesses and in many cases force them to sell out and take whatever residue of their capital they can obtain.

Certainly if my name were Rockefeller, Post, or Benton, perhaps I too would not be concerned about increased capital gains taxes—as seemed to be implied in the recent *Wall Street Journal* article, titled "Tax Bill Impact—Some Wealthy Assail Plan Aimed at Them. But Others Approve." As was therein cited, the super-rich may have a base capital fortune of—say—$100 to $200 million. A some-

what higher capital gains tax on incremental appreciation beyond this base doesn't hurt too much.

I am further not talking about profits in stocks which are bought and sold after being held for a little over six months. Perhaps the holding period for "true" capital gains should be extended. In my own case, a holding period of five to ten years to establish a "true" capital gains is reasonable. I and others like me worry about the basic shrinkage of our fundamental capital assets through increased capital gains taxes. Once the breakthrough is made to tax capital gains at more than (a maximum of) 25 percent, no one could seriously contend that the rate would not go higher.

I specifically would make two recommendations. These are:

1. That the alternate capital gains tax calculation be retained (providing a 25 percent maximum rate) for truly long-term capital gains. The holding period could be one, three, or even five years.

2. That consideration be given to a lower, graduated downward capital gains tax for "generated" business capital which has been held for longer periods of time (perhaps five to fiteen years). This would allow owner-businessmen to "translate" capital from one growth organization to another (possibly to stimulate other growth companies which in time would become good taxpaying corporations).

In a recent interview in the *U.S. News & World Report*, Chairman Wilbur Mills commented—not unfavorably—upon the possibility of a lowering capital gains tax rate being made a function of the holding period.

To quote a fairy tale: "Let us not kill the goose that has laid the golden egg." Our American system of free enterprise and business has produced great benefits. These have been made possible by the initiative of many "dreamers" and "doers" who were willing to risk their time, effort, and money in creating new enterprises. A short-term fix yielding more taxes now may only come back to haunt all our economy in the future.

Statement of the Procter & Gamble Co., Submitted by James M. Ewell, Vice President—Manufacturing and Employee Relations, re Section 515

TOTAL DISTRIBUTIONS FROM QUALIFIED PENSION, ET CETERA, PLANS

This statement is presented on behalf of some 24,000 employees of Procter & Gamble who participate in the Company's retirement plans. Over 80% of them participate in profit sharing plans of the Company and its subsidiaries, and the remainder in pension plans of subsidiaries. These 24,000 employees live and work in all 50 States of the Union.

Procter & Gamble employees and thousands of employees of other firms would be adversely affected by the treatment of lump sum distributions from qualified profit sharing and pension plans provided for in Section 515 of H.R. 13270. We request, therefore, that the Senate Finance Committee eliminate Section 515 from any tax bill.

We believe the following points are important for the Committee to consider:

1. Employee profit sharing began in Procter & Gamble in 1887 and, today, after more than 80 years is the oldest continuous profit sharing program in the United States. Our Plan was initiated for hourly paid workers and clerical staff. In 1945, the Company extended profit sharing to all classes of employees and the current profit sharing plans are all qualified plans under the Internal Revenue Code.

These plans are the principal Company-based source of retirement income for all employees. Section 515 would adversely affect these people even though we believe this result was unintended.

2. Over 90% of retiring hourly workers and salaried employees request lump sum distributions from the profit sharing plans. These requests are made in spite of various other alternative methods of distribution which are available and for reasons other than tax saving.

Retiring employees request lump sum distributions for a number of reasons, including the desire for a free rein in handling their own resources, the desire to use a capital sum in purchasing a small farm, a duplex, or motel which would combine a residence with an active retirement interest, or the desire to relocate upon retirement.

We believe that the adverse effects of Section 515 would tend to discourage the average retiree from requesting a lump sum distribution in the future and this

would call for a significant change in his retirement planning which is unwarranted and undesirable.

3. Section 515 is extremely complex and will not be understood by the average retiring employee. As a result, he will be confused and may make wrong decisions that can have a serious effect on his retirement income. For example, under the proposed five year averaging provisions, most retiring employees will be called upon to overpay the tax on a lump sum distribution, and then, after five years of meticulous record keeping, file a claim for refund. Another part of the proposal would make it advantageous for people to retire early in a calendar year, and this artificial incentive can work to the disadvantage of the retiree and his employer.

4. The tax rules which have been in effect in substantially their present form since 1942 are equitable and simple. Lump sum distributions are presently taxed on a fair basis and the method is one that the average employee can understand readily. We do not believe, therefore, that it is necessary to revise these rules. Section 515 would introduce inequities and complexities which we believe would place an unrealistic burden on recipients of lump sum distributions.

In summary, we recommend that the present tax treatment of lump sum distributions be retained. It is fair and simple and should not be replaced by the alternative in Section 515 that would be both inequitable and complex and that would place added burdens upon the average retiring employee.

DISCUSSION

Over 90 percent of Procter & Gamble's employees choose lump-sum distributions for many reasons

In 1887 Procter & Gamble inaugurated what is now the oldest continuous profit sharing program in the United States. All Procter & Gamble employees participate in profit sharing plans which permit lump sum distributions, or in pension plans, most of which permit some type of lump sum distribution. These plans provide Procter & Gamble employees with their principal source of retirement income from the Company. Our plans are qualified under the Internal Revenue Code and, therefore, cover a broad spectrum of employees.

Well over 90% of all Procter & Gamble employees in profit sharing plans request and receive lump sum distributions, even though the plans permit a variety of other distribution options such as annual payments over a period of years, purchase of an annuity, or a combination of these alternatives. This clearly shows that requests for lump sum distributions come from employees at every compensation level in the organization and not just from "highly compensated" executives.

Lump sum distributions are sought by more than 90% of our participating employees for a variety of reasons. The desire to have a free rein in handling their own resources is the overriding reason in virtually every case. Some retiring employees have planned for years to buy a small farm, a duplex apartment or a motel which would combine a residence with an active retirement interest. Others plan to relocate in warmer climates, purchasing a new home and reorganizing their way of life after retirement. They obviously need the capital nestegg of a "lump sum" retirement distribution for these purposes. There are other reasons, of course, why employees prefer the control of their own resources which comes with lump sum distribution. For instance, an employee in ill health might rightly conclude that his family will be far better off financially if he takes his retirement benefits in a lump sum distribution and handles it himself rather than purchase an annuity which would yield less if he were to die in two or three years.

Included in all of these reasons is a concern over inflation which adversely affects dollar annuities. The retiring employee often prefers and needs to use his retirement income in a manner which will protect him as far as possible against shrinkage of the dollar.

In many Procter & Gamble retirement plans—and this is true of plans of other companies—lump sum distributions are mandatory in the case of death; neither the decedent's widow nor his estate has any option to receive any other type of payment.

Tax saving is seldom the primary reason for requesting a lump sum distribution. More often the lump sum distribution is requested because the employee has carefully thought out his retirement plans and sees quite clearly how he

wants to use these retirement funds to suit his own individual and family needs. In many cases, this planning has implicitly assumed that present tax rules would continue to apply to lump sum distributions.

Section 515 is inequitable and overly complex and will cause confusion for retiring employees

Section 515 substitutes ordinary income treatment, with five year forward averaging, for a portion of the capital gains treatment provided under present law. In our judgment, its provisions do not give adequate recognition to the fact that employer contributions to a profit sharing plan have been made over the many working years of an employee's career. The provisions also unjustly compress a number of years' retirement benefits into a "five-year-averaged"-ordinary-income-tax structure.

The proposed tax treatment will be a matter of concern and confusion to many employees. In our Company already many employees have expressed concern over the effect of the proposed legislation on them. Since the proposed tax treatment is extremely complex, it contains pitfalls for employees, almost all of whom are unsophisticated in tax matters.

Retiring employees, regardless of income level, would find themselves faced with complicated record keeping for the preparation of tax returns and refund claims. Requirements such as five year forward averaging with a refund look-back would compel a taxpayer to preserve all his records for a five year period to be able to prepare and file refund claims. This would be an undue burden on retiring employees particularly those who may lose or misplace necessary records in the course of relocating after retirement. Also, there are certain to be many cases where the employee may not realize, or may forget, that he is entitled to make the five-year look-back computation. In such cases, this could result in the overpayment of taxes by small taxpayers.

Finally, Section 515, even with its five year forward averaging, fails to deal appropriately with the "bunched income" problem. The progressive income tax rates will cause a lump sum distribution to be taxed in higher brackets than would normally be true if the distribution had been received over a period of years. Actuarial tables indicate that an employees retiring at age 60 has a life expectancy of 18.2 years, and one retiring at age 65 has an expectancy of 15.0 years. Normally then, if the retirement benefit is not paid in a lump sum, it would be spread over this period (in many cases, the benefit might be paid over a longer period since it might cover a joint and surviver period which includes the life of the employee's spouse). Section 515, however, would assume automatically that the lump sum payment would otherwise have been received over a five year period. This seems to us most inequitable.

The five year forward averaging provisions are also mechanically deficient. They will in most cases, automatically result in an overpayment of taxes which the government will hold for five years when it may be needed by the retiree. The portion of a lump sum distribution which would be taxed at capital gains rates under the House Bill would cause the computation of the tax on ⅕ of the ordinary income portion of the distribution to be at a high rate of tax. The capital gain would normally push the employee into a much higher tax bracket than he will maintain over the next four years after retirement. Under the five year "look-back," the employee would then be entitled to a refund but he would have been deprived of the use of this retirement money for four to five years.

We also expect that Section 515 would create artificial pressures on employees who are deciding the timing of their retirement. Section 515 would make it important for a retiring employee to take his lump sum distribution in a year when he has a minimum amount of other income. The informed retiring employee would, therefore, prefer to retire in January or February to minimize his other income. The unwary taxpayer, however, would continue to retire at whatever time seemed most appropriate in the light of his own circumstances without regard to any tax consequences attaching to the retirement date. Present law does not contain the disruptive possibilities inherent under Section 515.
Present tax rules are fair, equitable, and simple to und

Present tax rules are fair, equitable, and simple to understand

For 27 years the Internal Revenue Code has provided that a retiring employee who takes his retirement benefit from a qualified plan within one taxable year is subject to Federal Income Tax on this payment as a long-term capital gain. The retirement planning of our employees during their whole business lives have been based on the premise that these present rules will continue. This current tax

treatment is based on the very solid principle that the employee's accumulation in the plan has been built up over a working career of many years.

The new tax rules, which would change rules in effect since 1942, lack the virtues of fairness and simplicity. They will create major administrative problems for the Internal Revenue Service and for taxpayers. The present rules have worked well, and should not be changed except for very compelling reasons. We do not believe that the reasons advanced thus far for the changed rules meet this test.

Summary

Section 515 would eliminate long-standing rules covering the tax treatment of lump sum distribution from qualified retirement plans. These changes were accepted by the House of Representatives on the apparent premise that lump sum distributions are used almost exclusively by a few highly compensated executives. We do not believe the members of the House of Representatives were aware of the large number of employees who would be affected by these proposals. Many plans permit or require lump sum distributions for all employees covered by the plan regardless of salary level. In Procter & Gamble, over 90% of the participants in profit sharing plans choose lump sum distributions. These distributions serve many retirement purposes, almost all of which are wholly unrelated to taxes.

Because so many retiring employees at all income levels would be affected by the proposals, and because most of them are not tax experts, the proposals should be easy to understand. They are not. We believe the proposals are unduly complex, and are in many ways inequitable. Present law is both fair and simple to understand and, in our opinion, properly taxes the retirement income accumulated over the employee's working career.

In closing, we state once more that The Procter & Gamble Company, in the interest of its employees who participate in its retirement plans, recommends that the Senate Finance Committee give serious consideration to the continuance of the present tax treatment of lump sum distributions from qualified retirement plans.

We thank the members of the Committee for their consideration of our request.

STATEMENT OF ARNO HERZBERG, CERTIFIED PUBLIC ACCOUNTANT,[1] UNION, N.J.

Sir: In response to your request for a statement on the capital gain provisions of H.R. 13270 I submit the following comments.

ACTION ON CAPITAL GAIN PROVISIONS SHOULD BE POSTPONED

It is respectfully recommended to postpone action on the pertinent Sections 511 to 516 of the House Bill pending a thorough study of the entire capital gain structure. This study should solicit the views of authorities in this field, should extend to laws of foreign countries, and should examine the possibility to separate the capital gain taxation from income tax laws in general. The House Ways and Means Committee began such a study in 1959, but the discussions never lead to any meaningful action, simply because they were conducted in the framework of a general study of tax revision.

Other reasons that support a recommendation to postpone action on the House Bill, as far as capital gain provisions are concerned, are as follows:

1. The House bill was adopted in an emotional reaction to disclosures about tax inequities especially in the capital gain field,
2. The bill was adopted without consideration of the far-reaching economic effects of tax changes on national income, savings and investment,
3. The capital gain provisions of the bill are again patchwork, opening new inequities,
4. The bill does not show a new approach to capital gain taxation and does not change present short-comings,
5. The bill does not consider the staggering problems of enforcement that are created on top of existing problems. The preparation of a tax return with income subject to provisions of the House bill will require more recordkeeping and will be more time consuming,

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[1] Author "Saving Taxes Through Capital Gains" (Prentice-Hall).

6. The House bill continues the unfortunate trend in recent legislation to perpetuate contradictions,

7. The bill shows inconsistencies in applying the capital gain concept.

Criticism of bill (sec. 511–516(c), 461)—Recommendations

1. The proposed change in alternative capital gain tax for individuals and corporations overlooks the fact that even the present 25 per cent or 30 per cent maximum tax freezes existing investments and thereby reduces the funds that otherwise would go into new ventures. The fact remains that many authorities have recommended not a higher but a lower tax for true long-term capital gains. An increase was and is considered as very harmful by them.

The reason given for the change in the bill, i.e. that it is not appropriate to allow high-income taxpayers to reduce their effective tax rate by means of the alternative capital gain tax, is at variance with all past thinking, which was influenced by the need for capital formation and unlocking investments.

2. Capital losses of individuals were allowed as a deduction but always with the thought that it is necessary to protect the revenue. This deduction has been changed so often that new reasons must be found to change the deduction again. As reason for the proposed change the example is given that taxpayers who are able to manage their investments to realize their gains and losses in different years are able to take advantage of the 50 per cent deduction for long-term capital gains in one year, and yet obtain a full deduction for long-term losses in another year. Although I have recommended such a tax saving device in my book on capital gains, I have failed to come across of any taxpayer who would be such a successful manager of his portfolio that he could take advantage of this device. It is not necessary to further complicate the Code. The $1,000 deduction against ordinary income is a bare minimum. It has lead to administrative difficulties because the loss to be carried forward indefinitely will have to be proven every year.

It is therefore recommended not to adopt Sec. 512 of the bill, but to restore the previous provision that the $1,000 deduction against ordinary income can be carried forward for five years. Another step would be to allow capital losses only against future capital gains, but then in full. This would eliminate to a certain extent, the so called tax selling and would induce investors to hold their securities in a bear market.

3. Letters, memorandums, etc., especially in the form of collections, are typical assets. The bill, in its present form taxes gains from their sale as ordinary income, because they are similar to a literary or artistic composition which is created by the tax payer's personal efforts. No estimate of revenue gained is given. In fact, any additional revenue should be extremely small.

This is a typical case where the attempt is made to legislate details which again gives rise to doubts and controversies and makes the Code that much more complicated. Actually, there is no need for this provision. Any misuse could be dealt with on the administrative level. Since, most of the time, in such a case the question of valuation is involved, the Commissioner has ample opportunity to stop any misuse.

4. The bill proposes to extend the holding period that distinguishes long-term and short-term capital gain from six months to one year. In the list of the reasons given for such a change no mention is made of the so called locked-in problem which has been the object of many studies. These inquiries, in general, came to the conclusion that a lengthening of the holding period would impede the mobility of capital assets and compound the locked-in problem.

A table giving figures of the year 1962 is used by the report on the bill to show the higher the adjusted gross income of the taxpayer, the more he is inclined to take long-term capital gains. It seems that these figures dating back to 1962 cannot tell the story of 1969. In the first place, they explain something which seems to be natural. Taxpayers in the lower brackets are inclined to invest in mutual funds. Their long-term capital gains from these sources do not show on a tax return with a specific holding period. Even in 1962 these gains make up 13.8 per cent of all long-term capital gains. Since then we have experienced the boom of the mutual fund industry and the number of security holders has increased to 26 million. Secondly, taxpayers in the higher brackets will always be in a position to hold investments longer or they will not change them at all. Legislators have always been presented with the effects of the holding period as far as gains are concerned. Their attention has never been drawn to the fact that a short holding period can have a very stabilizing effect in a bear market. The following table shows how much of his profit of $1,000 a taxpayer can lose

in a declining market if he sells long-term instead of short-term. The higher the taxpayer's bracket, the more it pays if he waits to sell long-term instead of short-term. With a short, six months holding period such a taxpayer would not throw his stock on the market at the first sign of a decline. A 12 months holding period does not make it worthwhile to take a risk of a further decline. A long holding period would thus accelerate a decline and create a bear market much faster than a six months holding period. In a rising market a longer holding period would double or triple the required percentage of gain on any reinvestment to be made with the proceeds of sale after taxes. Up to this day, all authorities in the capital gain field have recommended a lower holding period than six months which would bring in more revenue and solve the locked-in problem.

PERCENTAGE PROFIT OF $1,000 CAN SHRINK IF SOLD LONG TERM (MARRIED, JOINT RETURN)

Taxable income up to—	Rate including surcharge	Left of $1,000 after tax if sold—		Percent profit can drop if sold long term
		Short term	Long term	
$10,000	24.2	$758	$879	13.8
$20,000	30.8	692	846	18.2
$30,000	42.9	571	786	31.5
$40,000	49.5	505	733	32.9
$50,000	55.0	450	725	37.9
$100,000	66.0	340	725	53.1
			[1] 675	[1] 49.6
$200,000	75.9	241	725	66.8
			[1] 675	[1] 64.3

[1] Proposed 1971.

5. The proposed provisions affecting pension and other plans add again to the complications that plague the Revenue Code. The revenue raised through these changes is negligible; there is no relation to this revenue and the cost of enforcement for the taxpayer and the government.

Since distributions from profit or pension plans constitute deferred compensation, they should be treated as ordinary income. The provisions for averaging income will take care of any excessive increase in tax. In addition, plans will not be forced to liquidate investments if *as a consequence of such a treatment*, distributions would be spread over more than one year.

6. The proposed provisions for sales of life estates, casualty losses and franchises are of a technical nature and clarify certain situations.

7. The repeal of the investment credit leaves one problem unsolved that has been and is an urgent question for American industry. The necessity to modernize machinery will no longer receive recognition through tax legislation. This will effect especially the small manufacturer who is under constant pressure to raise working capital. Without much loss on revenue an extension of Section 1231 should be considered. This section was originally inserted in the Code to take care of the rise in prices of used machinery during the war. This problem is still with us in an inflationary period. The incentive to buy new machinery and replace old one is being reduced by the fact that the sale of old machinery results in a tax which is higher than ever through the recapture provisions of the Code.

It is proposed to amend Section 1231 as follows:

> If assets of like or similar nature are acquired within one year of the sale of the old asset, the gain on the sale is figured as heretofore, but the gain is used to reduce the basis of the new asset. In case of a plant the one year period is to start one year before or after erection of the new one.

Such a provision would have these results:

1. Working capital for the purchase of a new asset would be freed,
2. Benefits are not dependent on profits like in the case of the investment credit,
3. Further complication of the tax structure, especially elaborate recordkeeping, is avoided,
4. The true meaning of the capital gain provision—to give recognition to the rise in the economic plateau of the country—is maintained,
5. The effect on the revenue through a decreased depreciation allowance would be negligible.

General observations

There is a relationship between capital gains and inflation. The cost of living has increased by about 25 per cent during the last ten years. An increase in the value of any asset is therefore partly a product of inflation. The question arises whether a tax that is levied on such an increase is not harmful to capital formation or still has anything to do with increased income. The bill does not make any attempt to attack this problem.

The bill wants to lower income taxes in a period of inflation. So far economists have held the opposite to be true.

The bill wants to increase the standard deduction hitting the average homeowner in favor of the apartment dweller. So far any Tax Act has favored the homeowner.

Unfortunately, the spiritual climate in the country has undergone radical changes since the last Revenue Act was passed. The air is polluted with negativism, extremism, hysteria, and demagoguery.

The question arises whether in such a climate a meaningful and durable Tax Reform Act can be enacted at all.

STATEMENT SUBMITTED BY BONNER HOFFMAN, SECRETARY, GEUDER, PAESCHKE & FREY CO., MILWAUKEE, WIS.

The law regarding distribution from qualified pension plans should not be changed. Specifically, capital gain treatment for lump sum payments upon permanent separation of employees from a company with a plan providing for lump sum distribution of benefits should remain.

1. Workers covered by pension plans are the backbone of the United States economy. They have worked hard for many years, and paid proportionately the highest taxes of any group. This tax money supported the senators while in office and paid their pensions when they retired. These taxpayers also supported relief recipients, other underprivileged people, and provided old age assistance for people who had not saved any money.

2. It is grossly unfair after a lifetime of hard work to arbitrarily reduce their life savings by taxing the company contribution at ordinary rates. Due to an annual inflation of 2% a year, which is certainly a minimal figure, in 30 years the company contribution would have declined to 40% or less of its value when contributed.

3. The feature of forwarded income averaging is too complicated to explain to pension plan participants, and even more complicated to calculate. When a person has retired, he does not wish to spend a great deal of money hiring a tax attorney to claim refunds over the following 5 years in order to recoup the excess taxes paid upon retirement.

4. While it is recognized that the government needs tax money to provide for the welfare of those who are unable to work, it should not penalize those people who are willing to sacrifice all their lives in order to provide for their own old age.

5. It is to the economy's benefit for corporations to contribute to such pension plans, as such funds become a source of capital which is invested and is used to provide jobs for the ever increasing numbers of people entering the work force. Nothing should be done to discourage this practice.

6. It is hoped that you will take these factors in consideration during your deliberations, and eliminate this confiscatory provision in House Bill H.R. 13270.

ILLINOIS TOOL WORKS, INC.,
Chicago, Ill., September 15, 1969.

Subject: Section 515 of H.R. 13270, affecting capital gains treatment of lump sum distributions from corporate pension plans.

Section 515 of H.R. 13270 (Tax Reform Act of 1969) provides that the employer contribution portion of any qualified pension or profit sharing plan shall be taxed as ordinary income at time of receipt, should a taxpayer elect to receive his benefits as a lump sum distribution. The appreciated value of the taxpayer's and employer's contributions would continue to receive capital gains treatment.

Under present law, the entire lump sum distribution (exclusive of the taxpayer's own contribution, which is taxed each year) receives capital gains treat-

ment. If a taxpayer elects to receive his pension or profit sharing benefits on an annuity basis, the installment distributions are treated as ordinary income in the year received.

The reason for the change, as outlined on page 154 of the House *Ways and Means Committee Report*, is that some wealthy taxpayers are, in effect, using employer contributions to pension plans as a form of deferred income, thus avoiding a higher tax rate during the productive earning years.

Even if the factual basis of this argument is admitted, the cure proposed in *H.R. 13270* is similar to attacking a small tooth cavity with a pneumatic hammer. While *Section 515* does cause some wealthy corporation executives to pay higher taxes, it also hits at literally thousands of smaller beneficiaries of corporate pension and profit sharing plans—and it hits them with higher taxes at a time when they can least afford them—the first year of their retirement.

Illinois Tool Works Inc. began in 1968 a Savings and Investment Plan wherein any person, after reaching the first anniversary of his employment date, can cause to have deducted from his paycheck a relatively small percentage of his income. ITW then makes a contribution based on the individual's contribution up to a current maximum of 3%. ITW's contribution and any appreciation thereto vests in the individual's account at a rate of 10% per year. At the end of ten years, the entire ITW contribution and appreciation vest in the individual's account.

This plan contemplates in most cases an individual taking a lump sum distribution from his Savings and Investment Plan account at the time of his retirement or termination from ITW. Thus, a person earning $10,000 a year, who is with ITW for forty years, could conceivably have $12,000 worth of ITW contributions in his account upon retirement.

Under present law, this person would receive capital gains treatment on this $12,000 as well as on the appreciation of his own and ITW's contributions. He would, therefore, pay taxes on $6,000 (one-half of the employer contribution). Under *Section 515*, this same individual would have to declare the entire $12,000 as ordinary income—more than doubling the tax on the employer's contribution, due to progression to a higher tax bracket.

On behalf of the members of the ITW Savings and Investment Plan, Illinois Tool Works Inc. urges the removal of *Section 515* from the proposed legislation. We see no valid reason why smaller taxpayers should be thus penalized.

Although ITW would prefer to see no change made in the present law affecting capital gains treatment of lump sum distribution from qualified pension and profit sharing plans, we do suggest the following alternative, should such changes be deemed advisable:

ALTERNATIVE PROPOSAL

If the Congress intends only to correct what the House Ways and Means Committee considers to be an unfair situation with respect to certain wealthy taxpayers, ITW believes that this can be accomplished by merely *requiring any taxpayer who receives a lump sum distribution from a qualified pension or profit sharing plan to treat as ordinary income that portion of the employer contribution thereto which exceeds $10,000 in a calendar or other tax year.* Any employer contribution under $10,000 in a calendar or other tax year would continue to receive capital gains treatment.

Elsewhere in the bill (*Section 331*), a taxpayer who defers part of his income until retirement is permitted to pay taxes on the first $10,000 annual deferred income at the time he receives it. The excess of $10,000 annual deferred income is taxed at the rate applicable during the year he earned it. Thus, a $10,000 "exception" for other forms of deferred income is already contemplated elsewhere in *HR 13270*. It would seem that applying this exception to lump sum distributions from qualified pension and profit sharing plans would fully accomplish the objectives set forth on page 154 of the Committee report. It would also save thousands of smaller taxpayers from paying higher taxes the first year of their retirement.

Therefore, Illinois Tool Works Inc. respectfully urges that no changes be made in the capital gains treatment of lump sum distributions from its Savings and Investment Plan. In the alternative, we urge the adoption of the more equitable proposal outlined above.

ARTHUR H. HAEDIKE, *Treasurer.*

STATEMENT OF JOHN K. HULSE, C.P.A., MERCHANTVILLE, N.J.

Two conditions facing the nation require prompt action through changes in the income tax law, as measures taken to remedy them through other channels have proved to be ineffective. One is the inflation that has increased the burdens of so many millions. The other is the tight money and resultant high rates of interest, which have reduced business profits, increased the financial problems of Federal and local government, and reduced the supply of mortgage money for financing present and future housing construction. At this point in time, the Committee on Finance alone can initiate the necessary action.

These two conditions were caused largely by two artificial devices in the Internal Revenue Code: (1) The investment credit and (2) the six months holding period prescribed for "long-term" capital gains. Repeal of the investment credit now appears to be favorably viewed. It is the purpose of this memorandum to urge the Committee to increase the holding period to a figure consistent with the words "long term", and to adopt other measures that would require stocks to compete for investment dollars on an equal footing with other types of investments, including mortgages, insofar as income tax treatment of current income from investments is concerned.

The specific changes urged here are:

(1) Increase the holding period to at least three years. Five would not be too long.

(2) Eliminate the dividend exclusion of $100. Subchapter "S", adopted in 1958, removed all justification for this exclusion.

(3) Eliminate the exclusion of the "nontaxable" portion of dividends based on excessive depreciation in Federal income tax returns. State laws govern the determination of earnings from which dividends may be paid.

For a number of years previous to 1965, the volume on the New York Stock Exchange was approximately 2,600,000 shares on a typical day. In August, 1965, the daily volume began a gradual climb, and for many months now the daily average has been around 10,000,000 shares.

The reduction in tax rates in the 1964 Act accounts for much of this, but much more of it is due to the opportunity to get preferential tax treatment for gains to be realized after the comparatively safe period of only six months. There could be billions of mortgage money and lower interest rates in a realistic holding period of three to five years for stocks.

The six months period is a relic of the wartime tax legislation of 1942, when the Dow-Jones average of industrial stocks stood at around 100, and war needs came first. That average has now ranged from 800 upwards for several years, and domestic needs now come first.

STATEMENT OF THE INVESTMENT BANKERS ASSOCIATION OF AMERICA, SUBMITTED BY ITS FEDERAL TAXATION COMMITTEE

The 1963 Tax Message of President Kennedy to the Congress included the following observation:

> "The present tax treatment of capital gains and losses is both inequitable and a barrier to economic growth. * * * The tax on capital gains directly affects investment decisions, the mobility and flow of risk capital from static to more dynamic situations, the ease of difficulty experienced by new ventures in obtaining capital, and thereby the strength and potential for growth of the economy. The provisions for taxation of capital gains are in need of essential changes designed to facilitate the attainment of our economic objectives."

We agree fully with these observations and believe that they suggest that any change in the capital gains tax should reduce the effective rate of taxation and shorten the holding period for long-term capital gains. Neither the 25% maximum effective tax on long-term capital gains nor the six month holding period for such gains has been changed since that time, except that the 10% surtax imposed in 1968 raises the maximum effective rate of taxation of long-term capital gains to 27½%.

The study of capital gains by the Internal Revenue Service published early in 1967, indicated that 96% of all the realized capital gains were long-term. Many capital gains are long-term simply because it takes a period of time for the value of some capital assets to appreciate in value. However, the fact that 96% of all realized capital gains in the period covered by the study were long-term is per-

suasive demonstration that both the holding period and the tax rate on the long-term capital gains are determinative factors in the decision whether and when to sell a capital asset and realize a taxable gain.

HOLDING PERIOD SHOULD NOT BE INCREASED

We recognize that, to exclude normal business and trading transactions from long-term capital gains, there must be a requirement that the asset be held some reasonable length of time. We believe that the present six month requirement serves effectively to separate such transactions and that any lengthening of the holding period would cause investors in securities to postpone the sale of securities so that they would qualify for long-term capital gain treatment. Such postponement of sales of securities would seriously reduce the liquidity of capital by putting fewer buyers and sellers in the market. It would also reduce the supply of securities available in the market as the turnover time of individual holdings lengthened. Further, such postponement would reduce venture capital because potential investors would turn elsewhere, due to the uncertainties of a longer holding period; a lower return making the risk unacceptable. In our opinion, the resulting holding of securities for longer periods of time would reduce Federal revenues from capital gains.

NONCORPORATE ALTERNATIVE TAX SHOULD NOT BE ELIMINATED AND THE CAPITAL GAINS TAX RATE SHOULD NOT BE INCREASED

Capital Gains Tax Rate should not be increased for corporations and the alternative long term capital gains tax should not be eliminated for individuals (which, in effect, increases the capital gains rate for certain individuals). Any increase in the capital gains tax would cause many investors in securities to postpone the sale of capital assets with resulting capital gains. Many investors who sell capital assets plan to reinvest the proceeds in other capital assets, so they are confronted with a determination of whether the after-tax proceeds from the sale of a currently held asset will be profitable enough to warrant its sale. We believe that any increase in the capital gains tax would tend to freeze holdings of capital assets because of a reluctance to pay a higher capital gains tax, resulting in less revenue to the Treasury. We also believe that an increase in the capital gains tax would would be a deterrent to investments which provide the needed growth in our economy. A lack of capital expansion manifests itself in jobs which seriously effects the economic impact of a community. For instance, it takes $23,000 in capital to provide one manufacturing job, $15,000 to build one new house or apartment; $300 to $400 in new capital per year to up-grade each job and home which already exists. Yet, the young, the disadvantaged and low-income people generally can supply none of the capital they have come to expect to be available. Others must be encouraged to invest in greater measure than ever before. Worldwide, the capital shortage is even more severe. Today's record interest rates of 8½% to 10% are documentation of the shortage of savings dollars.

100 PERCENT OF NET LONG-TERM CAPITAL LOSSES SHOULD BE OFFSET AGAINST INCOME UP TO THE PRESCRIBED MAXIMUM

It has been suggested that only 50% of net long-term tax losses be permitted as an offset to ordinary income, up to the present limit of $1,000 in any year with a carryover to subsequent years. The fact that only 50% of long-term capital gains are taxable is no reason for restricting credit for losses to 50%. The 50% inclusion of gains is simply a measure of the amount to be taxed. However, net long-term losses should be permitted to be offset in full against ordinary income because: (a) the taxpayer has suffered loss of the full amount from his assets and, (b) if only a portion of net losses could be offset, many investors would be less willing to incur the risks of investment in new ventures which are essential to growth in our economy.

CONCLUSION

A change in the taxation of long-term capital gains and losses is not tax reform but rather is an impediment to the free flow of capital. The resulting effect will not accomplish the avowed purposes of the proposed Tax Reform Act of 1969. Nor will these proposals increase the revenue from capital gains.

If the Committee is considering alternatives to insure additional revenue, we believe that reduction in the effective rate of tax on capital gains and shortening the holding period would increase revenues to the Treasury by increasing the frequency of securities transactions and the willingness to realize taxable gains.

LYBRAND, ROSS BROS. & MONTGOMERY,
Washington, D.C., September 30, 1969.

Re William M. Booth, Jr., Englewood, Colo.

SENATE FINANCE COMMITTEE,
New Senate Office Building,
Washington, D.C.

DEAR SIRS: This firm respectfully requests that the Senate Finance Committee consider the addition of certain relief provisions to Subtitle B, Section 511 of the Tax Reform Bill of 1969, H.R. 13270, pertaining to the alternative capital gains tax rate. We are writing to you on behalf of Mr. William M. Booth, Jr., of the above address. We believe that a description of his situation will demonstrate why equitable relief should be accorded him and others similarly situated.

FACTS

As to tender offer

On or about December 2, 1968, the boards of the directors of three Canadian companies, United Westburne Industries Limited, Commonwealth Petroleum Services Ltd. and Trimac Transportation Limited, announced that they had agreed in principle to amalgamate. The plan of amalgamation provided for a new Canadian holding company, Westburne International Industries Ltd., to acquire the stock of these three companies in exchange for a portion of its stock plus cash.

At the time of the announcement, Mr. Booth owned 25,400 shares of Commonwealth (representing about 3% of the shares outstanding) and was a director of that company.

Westburne International made a formal tender on March 31, 1969 to the shareholders of the other three companies for their shares. The offer was conditioned on the occurrence of three primary events prior to the closing date:

1. The deposit of at least 90% of the common stock of Commonwealth with the depositary in acceptance of the offer;
2. the acquisition of 100% of the shares of Trimac (automatic acquisition if 1 and 3 are met) ; and
3. the acquisition (tender) of 80% of the United Westburne stock.

The closing date was established as the earlier of July 31, 1969 or the date on which all the conditions were fulfilled.

On April 7, 1969, Mr. Booth tendered his Commonwealth shares in acceptance of the offer to the Montreal Trust Company, Calgary, Alberta, Canada, the depositary for the transaction. Under Canadian law, Mr. Booth was at that time irrevocably committed to the exchange. In an opinion letter attached thereto, Canadian counsel states, that, because of his position as a Commonwealth director, Mr. Booth could not have lawfully obtained redelivery of the tendered shares without the consent of all the other shareholders who had tendered shares in acceptance of the exchange offer. Furthermore, even if Mr. Booth had not so tendered his shares, under Canadian law he could have been compelled to surrender them to the new parent organization as soon as it had 90% of Commonwealth's outstanding shares. Westburne International actually did compel all remaining minority shareholders to surrender their Commonwealth stock under this 90% rule.

On July 31, 1969, it was announced that that date was the effective date of the closing of the amalgamation; the new shares of Westburne International and the cash consideration were then distributed to the appropriate parties, including Mr. Booth. A question may exist as to whether any shareholder who had tendered shares in acceptance of the exchange offer could have withdrawn the shares after July 25, 1969. On July 25, 1969, over 90% of the Commonwealth shares and over 80% of the United Westburne shares had been tendered to Westburne International. In order to obtain 100% of the Trimac stock, Westburne International merely had to give notice to the Trimac shareholders that the required percentages of the Commonwealth and United Westburne stock had been obtained. Consequently, the "closing date" for acquisi-

tion of the Trimac stock fell after July 25, 1969, even though this was an "automatic" acquisition, and the closing date for the Trimac shares became the closing date of the overall share exchange offer.

As to the land option

On June 26, 1969, Mr. Booth sold a 60-day option to purchase certain real estate in Calgary. By the terms of the agreement, Mr. Booth was committed to convey title to the property if the option was exercise prior to noon on August 25, 1969. If the option is so exercised, that portion of the proceeds in excess of his basis will constitute long-term capital gain to Mr. Booth.

DISCUSSION

Section 511 of the Tax Reform Bill of 1969 repeals the alternative tax computation for individuals with respect to "sales and other dispositions after July 25, 1969." Under present tax laws, we assume that the date of "sale" for both of the above transactions will fall after July 25, 1969. Consequently, under the proposed legislation, Mr. Booth will be denied use of the alternative tax computation for calendar year 1969 even though he performed all actions requisite to transferring legal title to the properties in question prior to July 26, 1969. Mr. Booth and other persons who have entered similar agreements will thus be bound by a law unknown and unforeseen at the time they chose to pursue a given course of action.

Congress has deemed it appropriate, in the past, to make exceptions to changes in the new tax laws when a segment of the population was obligated under an executary contract. For example, this has been the case with the investment credit rules where a binding contract existed prior to the effective date of the law.

We therefore believe that relief should be granted in this instance to Mr. Booth and others similarly situated when they have, with no efforts toward tax avoidance, entered contracts prior to July 25, 1969, the consummation of which are dependent upon acceptance subsequent to July 25, 1969.

RECOMMENDATION TO THE COMMITTEE

This firm recommends that Bill Section 511(c) be amended to read as follows:

(c) *Effective date.*—The amendments made by this section shall apply to sales and other dispositions after July 25, 1969, except for those made pursuant to (1) stock deposited before July 26, 1969 pursuant to a tender offer; (2) options granted before July 26, 1969 and (3) binding contracts entered into before July 26, 1969. In the case of a taxable year beginning before and ending after July 25, 1969, the alternative tax imposed by Section 1201(b) of the Internal Revenue Code of 1954 shall be computed in a manner to be prescribed by the Secretary of the Treasury or his delegate.

Respectfully submitted.

LYBRAND, ROSS BROS. & MONTGOMERY.

STATEMENT OF EASTMAN KODAK CO., SUBMITTED BY R. L. MCKNIGHT, MANAGER, TAX DEPARTMENT

Eastman Kodak Company maintains for its employees a qualified profit-sharing plan under which the company makes all contributions to the plan for the benefit of its employees It is known as the Eastman Kodak Employees' Savings and Investment Plan, and was established in 1960. Company payments to the profit-sharing plan are made in the year following the year for which they are accrued on the company's books. As of June 1, 1969, 23,722 employees of Eastman Kodak Company were active participants in the Savings and Investment Plan which had a total market value in excess of $158 million.

When the employee retires, payments under the plan may be made either in a lump sum or at the request of employees may be made in installments. From the inception of our plan in 1960 through May 31, 1969, 5,847 employees or their beneficiaries had received lump-sum distributions totaling $31,792,000—an average of only $5,437 per employee. 684 employees had elected to receive installment settlements.

The proposed change in the method of taxing lump-sum distributions from profit-sharing plans would affect all of the thousands of Kodak employees now or hereafter participating in our plan. The change in the method of taxing lump-sum distributions is, therefore, of serious concern to us.

The present method of taxing lump-sum distributions was enacted in 1942 as an equitable means of taxing the receipt of a relatively large amount in one taxable year which had accrued for the benefit of an employee over a long period of time. The method is simple and has the result of imposing a fair tax upon an amount which has become to the employee a capital accumulation in the true sense of the word. This distribution enables the employee to use funds, which, although accumulated for him, have not been available to him, for any necessary purpose at the time when he retires. The plan is an important element in assisting our people in retirement. Participation therein should not be discouraged by increased taxation. Every sociologist in the country would applaud efforts such as the Kodak plan to make elderly retirees self-sufficient.

The proposed method would require a tax on an amount equal to the employer contribution in the fund on an averaging basis after the employee retires and is vastly complicated. It will impose an additional tax on the millions of employees throughout the country who will be affected. The averaging method will surely result in many failures to claim refund with attendant tax windfalls to the Internal Revenue Service at the expense of the tax unwary.

Furthermore, the provisions will be difficult to explain so that the average employee will understand their effect on the method of taxing lump-sum distributions under the profit-sharing plan. In effect employers will have to describe two plans from now on—before and after January 1, 1970.

It would be unfortunate if, as a result of the proposed change in tax treatment of distributions under profit-sharing and pension plans, there is a reduction in the numbers of employees covered by such plans. The social benefits of having large numbers of employees participate in such plans and in having available additional funds for use after retirement we believe warrant continuing the present provisions of taxing lump-sum distributions entirely as capital gain.

We emphasize that under the revised capital gains provisions contained in the Tax Reform Bill the maximum tax on these distributions will be increased from 25% to 32½%—a sustantial increase in tax particularly on employees whose tax rates are in the maximum brackets.

We also suggest that in lieu of the complicated averaging provisions the Committee consider continuing to tax these distributions as capital gains but at rates no less than 20%, up to the maximum of 32½%. It would be preferable, however, if the present capital gains provisions were continued, having in mind the proposed increases in capital gains tax rates.

We also note that under the bill amounts subject to ordinary income tax when received in a lump-sum distribution will not be entitled to the maximum rate on earned income provided by Section 802 of the bill and Section 1348 of the Code. We recommend that if a part of the lump-sum distributions from profit-sharing plans is to be taxed as ordinary income that the 50% tax limit on earned income be made applicable to such distributions. Specifically we believe that the exception for distributions to which Section 72(n), Section 401(a)(2) or Section 403(a)(2) applies should be deleted from Section 1348(b)(1).

Thank you for your consideration of our suggestion.

ARTHUR ANDERSON & CO.,
Chicago, Ill., September 12, 1969.

Chief Counsel, Committee on Finance,
New Senate Office Building,
Washington, D.C.

DEAR SIR:

LUMP-SUM DISTRIBUTIONS UNDER PENSION AND PROFIT-SHARING PLANS

SUMMARY OF COMMENTS AND RECOMMENDATIONS

1. Alternative capital gains tax should be applicable to lump-sum distributions made before January 1, 1970.

2. The treatment of the effect of forfeitures in computing the capital gain should be clarified in a way to avoid extreme computation burdens being imposed on the employer.

BASIS FOR COMMENTS

(1) Alternative tax on 1969 distributions

The major change in taxation of lump-sum distributions applies to employer contributions made during years beginning on or after January 1, 1970 (Section 515). However, there is a substantial effect on lump-sum distributions made after July 25, 1969, since the alternative capital gains tax is eliminated (Section 511).

A number of plans may have made lump-sum distributions from July 25, 1969, to date without a knowledge that the elimination of the alternative tax may have made such a change in the recipients' tax status that other methods of payment should have been chosen. The Bill's effective date could cause substantial individual detriment without any material increase in tax revenue. It would not have been practical to communicate the proposed change to plan participants and to secure consents to changes in time for the participants to make an informed decision on the desired method of payment.

In a separate letter to your Committee, we are recommending that the alternative tax be applied to years beginning after December 31, 1969. An even more forceful argument exists for permitting the alternative tax to apply to lump-sum distributions during the current year.

(2) Treatment of forfeitures as employer contributions

Section 515(a) of the House Bill requires the employee to establish the portion of a distribution which is ot attributable to an employer's contributions after December 31, 1969. It may be necessary to put this burden on the taxpayer-recipient but as a practical matter the burden will fail on the employer since it is the only entity which can practically make the determination.

However, the problem of determining what portion of forfeitures allocated to participants after 1969 consists of post-1969 employer contributions is staggering. For example, assume 50 forfeitures in 1975 which are allocated among 1,000 participants—each of the forfeitures would have to be completely analyzed to determine the post-1969 employer contributions, an overall ratio established and then applied to the forfeiture allocated to each of the participants.

A solution would be to make it clear that only the employer's contribution would be considered and forfeitures were to be ignored.

Another solution would be to provide some phase-in of forfeitures over a perid of years to achieve the result intended by the House Bill and eliminate the cost and work which would otherwise fall on the employer. For example, forfeitures during 1970 plan years are almost certainly going to consist of pre-1970 employer contributions (plus, of course, plan income and asset appreciation which are not affected) and could be treated as pre-1970 contributions. Starting in 1971 perhaps ten percent of forfeitures could arbitrarily be considered to be employer contributions and this percentage could increase ten percent each year to a maximum of, perhaps, fifty percent. The reason for limiting the maximum to fifty percent would be to recognize that a sizable amount of all forfeitures would consist of plan income and appreciation.

SUMMARY

The foregoing comments are not intended to indicate an approval or disapproval of the remaining portions of the Act, but are only indications of technical areas which obviously need simplification. This statement is submitted as part of a series of letters, each dealing with a particular area of the proposed legislation. It is intended that the comments and suggestions contained herein be made part of the record of testimony relative to the legislative changes contemplated for lump-sum distributions under pension and profit-sharing plans. We shall be pleased to discuss these matters further with you or the Committee, either in person or by telephone. Please call us collect at 312—346-6262 if necessary.

Very truly yours,

By JOHN MENDENHALL,
Director of Taxes.

ARTHUR ANDERSON & CO.,
Chicago, Ill., Sept. 12, 1969.

Chief Counsel, Committee on Finance,
New Senate Office Building, Washington, D.C.

DEAR SIR:

CAPITAL GAINS AND LOSSES

SUMMARY OF COMMENTS AND RECOMMENDATIONS

1. Any changes regarding capital gains and losses should not be effective until taxable years beginning after December 31, 1969.
2. Franchise income which would be taxed as ordinary income should be excluded from the definition of personal holding company income.
3. The disallowance of adjusted basis of a term interest in property should not apply to interests which have the same nature in the hands of the holder as in the hands of the donor/decedent.
4. Price level—Corrective legislation should provide for price level changes in determining the adjusted basis of assets sold in order to recognize the proper amount of gain or loss.

BASIS FOR COMMENTS

(1) Effective dates

While there are at least nine effective dates relating to capital gains and losses, there are, in reality, four different dates. These are:

1. Sales or transfers after July 25, 1969 (Sections 511, 513, 516(a), 516(c)).
2. Sales after July 31, 1969 (Section 461).
3. Taxable years beginning after July 25, 1969 (Sections 512, 514, 516(b)).
4. Employer contributions to plans for years beginning on or after January 1, 1970 (Section 515).

However, the fact that there are different dates impose real burdens on the individuals preparing returns, whether they are experienced advisors or not, and on the taxpayers either in the form of increased work or increased fees to advisors.

The elimination of the alternative tax for individuals and for corporations for transactions after a mid-point in the year adds an additional degree of complexity to the proper preparation of the returns and will necessitate an additional computation schedule as well as major problems for the IRS conducting examinations.

A change in capital gains taxation midway in the year is particularly difficult to handle for purposes of preparing estimates of 1969 individual income tax by quarters to avoid penalties for possible underpayment. How do you advise a client as to what, as of September 15, 1969, his tax will be if you do not know whether the alternative tax will apply to present transactions? This is particularly so at this time where the Treasury has recommended against the changes. The answer is not to compound the complexity of the problem by amending the penalty sections but to choose a date which will be close to the date of enactment. This date would likely be sufficiently close to December 31, 1969 to adopt that as the effective date.

Supporting the above position is the fact that the capital gain and loss provisions are also closely tied into many other provisions which are applicable to years beginning after December 31, 1969. Among these are:

1. Income averaging (Section 311).
2. Limit on tax preferences (Section 301).
3. Allocation of deductions (Section 302).

(2) Exclusion of franchise income from personal holding company income

The present regulations (1.543–1(b)(3)) provide that amounts received for the privilege of using franchises are included in the term "royalties." Royalties, in turn, are considered the equivalent of dividends, interest and other forms of passive income and are considered to be personal holding company income.

Income from franchises may have been passive income in prior years but much franchising is now a completely different industry than it was years ago when the regulations were written. The intent of Section 516(c) of the House Bill seems to be to deny capital gain treatment to the sale of franchises, where the franchisors are engaged in the business of selling franchises and of exercising active operational control over the franchisee. Thus, ordinary income will result where the franchisors conduct a regular business operation.

As a corollary, ordinary income from franchises should be excluded from personal holding company income. It would seem impractical to make the exclusion depend on other mechanical tests, such as a percentage of gross income or specified amounts of expenses.

(3) *Sale of term interests*

The purpose of Section 516(a) of the House Bill seems to be to deny use of basis where the donor/decedent has divided his interest in the property on a chronological basis. However, it would appear that the full interest of the donor/decedent might fall within the definition of "term interest in property." For example, a person may own a real estate leasehold on an oil royalty or leasehold working interest. If he bequeaths this interest to his son, we question whether a sale by the son would permit the use of tax basis under the present provision.

It should be made clear that the provision in the House Bill does not apply to situations where the nature of property interest in the hands of the seller is the same as in the hands of the donor/decedent.

(4) *Price-level adjustment*

Corrective legislation should provide for price-level changes in determining the adjusted tax basis of assets sold in order to recognize the proper amount of gain or loss. We have previously recommended to Congress the recognition of price-level changes in the determination of the depreciation deduction. This recognition should be carried into the sale area and to other areas which are not appropriately covered here.

The major stated reason for the Tax Reform Bill of 1969 is to share the tax burden fairly. The failure to recognize changes in price-level is perhaps the major inequity in our tax system.

The mechanics of making the necessary adjustments are easily available in the indexes published by the U.S. Government.

Recognition of inflation has resulted in increased social security benefits, civil service pensions, automatic wage increases, etc.

The adjusted tax basis of assets held for a lengthy period of time should be indexed upward to recognize the effect of the declining value of the dollar and thus to avoid taxing what is actually a mere capital recovery rather than income.

SUMMARY

The foregoing comments are not intended to indicate an approval or disapproval of the remaining portions of the Act. This statement is submitted as part of a series of letters, each dealing with a particular area of the proposed legislation. It is intended that the comments and suggestions contained herein be made part of the record of testimony relative to the legislative changes contemplated for capital gains and losses. We shall be pleased to discuss these matters further with you or the Committee, either in person or by telephone. Please call us collect at 312–346–6262 if necessary.

Very truly yours,

JOHN MENDENHALL,
Director of Taxes.

STATEMENT OF THE NAEGELE ADVERTISING COMPANIES, INC., SUBMITTED BY WILLIAM BEGIN, TREASURER, AND ROGER A. PETERSON, SECRETARY

STATEMENT OF CONDITION GIVING RISE TO PROPOSED AMENDMENT

The changes in the taxation of capital gains adopted by the House of Representatives would be effective for all gains realized by individual taxpayers after July 25, 1969. This proposal would result in an inequitable treatment of individual taxpayers receiving distributions from corporations being liquidated under the provisions of Section 337 of the Internal Revenue Code unless appropriate amendment relating to this effective date is made.

Section 337 provides that the stockholders of a corporation may adopt a plan of liquidation and, within the following 12 month period, the corporation can sell its assets and distribute the proceeds to the shareholders without the recognition of gain from the sale of the assets at the corporate level (with the exception of depreciation and investment credit recapture. These liquidating distributions are treated as in full payment in exchange for the stock of the shareholders and the

gain is considered realized by the shareholders at the time funds are distributed to them. Thus, the actual receipt of the liquidating distributions is the taxable event to the shareholders and under the presently passed House Bill, such distributions would be taxed under the new provisions relating to capital gains if they occur after July 25, 1969, even though the actual sale of assets by the corporation may have occurred before that date. In deciding whether or not to sell a business and liquidate, the tax results to each individual shareholder are, of course, of major importance. Thus, it could well be that plans adopted and sales begun prior to the change would not have been pursued had the individual shareholders known the changes that would take place in taxing capital gains.

There are then situations where individual shareholders, making their decisions based upon the law in existence at the time, approved a plan of complete liquidation and the corporation then proceeded with the sale of its assets. Since the mechanics of actually completing a sale of an entire business enterprise are time consuming, such liquidation sales were at a point where it was impossible to change any of the decisions regarding sale and liquidations and yet actual distributions to shareholders could not be completed prior to the July 25 effective date. This results in gains actually realized from sales occurring before that date (the sale of assets by the corporation) being taxed to the shareholders as gains occurring after the effective date. This produces an inequitable result and it is, therefore, respectfully requested that an appropriate amendment to Section 511 be made as outlined below.

SUGGESTED AMENDMENT—BILL SECTION 511

(a) * * *

(b) * * *

(c) EFFECTIVE DATE.—The amendments made by this Section shall apply to sales and other dispositions (with the exception of Subsection (d)) after July 25, 1969 * * *

(d) Subsection (c) will not apply to distributions received by individuals from a corporation liquidating under the provisions of Section 337 if—

(1) The corporation adopted a plan of complete liquidation prior to July 25, 1969, and

(2) The corporation had sold (or entered into binding agreements to sell) at least 50 percent of the total fair market value of its assets at the date of adoption of the plan of liquidation before July 25, 1969.

PALM BEACH, FLA., *September 9, 1969.*

SENATE FINANCE COMMITTEE,
Washington, D.C.

GENTLEMEN: The undersigned is representing a client who will suffer substantial economic detriment if Section 511 of H.R. 13270, relating to the repeal of alternative capital gains tax for individuals, is enacted without providing transitional rules to cover those situations where a course of business action was adopted in reliance on the availability of the alternative tax.

With the exception of certain situations that are not pertinent to this statement, our system of government gives an individual the right to choose between retaining property or making a sale or disposition thereof. In making this choice, most individuals are concerned with the net amount that will be realized after the payment of all taxes incurred as a result of such transaction and not with the gross amount they may receive. It is only the after tax dollar that can be utilized for further investment or whatever purposes a particular individual might find appropriate.

Throughout the history of the many various Revenue Acts, the taxpayers of this country have been able to rely on the basic structure of then existing tax laws in making their business choices. This is true because Congress has always made transitional rules available for those who entered a transaction in reliance on those laws. In addition to being true, it is fair. The federal income tax is an integral part of substantially all contracts and the failure to provide transitional rules would violate the spirit of our form of government which prohibits the passage of a law after the execution of a contract which retrospectively changes the legal consequences of such contract. Indeed, this is recognized many times in the bill that is presently pending which, among other things, provides transitional rules for the changes applicable to the treatment of capital losses.

Some might argue that the repeal of the alternative tax is nothing more than a rate change, and that all taxpayers assume the risk of a rate change in making any executory contract. Such an argument ignores the true nature and purpose of the alternative tax. The alternative tax is a limitation on the rate structure and not a part of it and was designed for the purpose of allowing "* * * transactions to go forward without fear of a prohibitive tax." (1920) H. Rept. 350, 67th Congress, 1st Session, pgs. 10, 11. With the exception of a short period covering taxable years beginning after December 31, 1933, and before December 31, 1937, this limitation on the rate structure has been in force since its adoption in the Revenue Act of 1921. It is believed that such a history induces reliance on its continuation for the purpose of determining whether to enter an executory contract for the sale of a capital asset.

The matter involving my client is a case in point. During the year 1952, he inherited an interest in a closely held business enterprise (approximately 32.25%) having a then value of $2.9x. Primarily as the result of his efforts in managing the company, this had grown by the year 1969 to a corporation having a value of approximately $70x, and he had become the owner of approximately 94% of the outstanding common stock. In the early part of the year 1969, he was approached by a broker who advised him that he could sell substantially all of the assets owned by the corporation for such value.

Numerous computations were made, and on the basis of his understanding that the capital gains tax would not exceed 27.5% of his profit, including the applicable surtax, a decision was made to advise the broker that the corporation was willing to sell for the prices indicated. Following this decision, the company adopted a plan of complete liquidation under Section 337 of the Internal Revenue Code of 1954, and during the first week of July, 1969, actually closed transactions involving approximately 80% of its assets. Following these sales, the company, as a practical if not legal matter, was bound to complete the plan of liquidation. Unfortunately, because of the necessity of retaining assets to meet claims and to wind up the affairs of the corporation, it was not possible to distribute all of the assets prior to July 26, 1969. Presumably, under the House bill, distributions after that date would not be subject to the alternative tax even though this particular taxpayer was required to make distributions after such date without regard to the remaining tax consequences.

My client now finds himself in a situation where a law has been proposed which would retrospectively change the terms of his contract. Obviously, many other persons throughout the nation have signed executory contracts who will be similarly effected. It is submitted that such retrospective taxation is unfair to those persons who were induced to sign executory contracts by the long standing tax policy of this nation to limit the tax on capital gain by means of the alternative tax. As was noted by the Ways and Means Committee when it reinstated the alternative tax in the Revenue Act of 1938, "* * * the question of whether or not a capital gain will be realized is entirely within the discretion of the taxpayer. If the rates are too high, taxpayers will not dispose of their property." If persons subject to executory contracts on July 25, 1969, had known of the possible repeal of the alternative tax, their discretion may well have been exercised differently.

Because of the foregoing, it is respectfully requested that this Committee give consideration to providing transitional rules for the repeal of the alternative tax, and that such rules should make the alternative tax available to those persons who executed binding contracts prior to July 25, 1969, or who are receiving a capital or liquidating distribution from a corporation under a plan adopted prior to such date. In this manner, those persons qualifying under the transitional rules will receive the full benefit of their bargain.

Respectfully submitted.

ROBERT O. ROGERS.

SEPTEMBER 11, 1969.

STATEMENT ON BEHALF OF FIDUCIARY TRUST CO., OF NEW YORK, BY WALTER S. ROTHSCHILD, OF CLEARY, GOTTLIEB, STEEN & HAMILTON, NEW YORK, N.Y.

Mr. Chairman and Members of the Committee, on behalf of Fiduciary Trust Company of New York, we would like to call to the attention of the Committee the unfair and, perhaps, unintended effect of Sec. 515 of H.R. 13270, relating to the tax on lump sum distributions from qualified plans.

Under Bill Sec. 515, the portion of a lump sum distribution under a qualified pension or profit sharing plan equivalent to post-1969 employer contributions is taxed as ordinary income. This treatment parallels that proposed for deferred compensation under Bill Sec. 331. We do not endorse nor do we attack the decision to amend the law in this manner. We are concerned, however, at what we believe is the unfair effect of the operation of Bill Sec. 515 in combination with the repeal of the alternate capital gains tax (Bill Sec. 511), and the allocation of deductions to tax preference income (Bill Sec. 302).

Our client, the Fiduciary Trust Company of New York, is interested in the lump sum distribution provisions of the proposed Bill both as an employer and as a trustee of numerous pension and profit sharing trusts. Its experience has proven that many employees would prefer to have a total distribution at retirement rather than an annuity or fixed income for life. The lump sum gives the retired employee the flexibility to enjoy his retirement through the purchase of a retirement residence, or otherwise in a manner suited to his personal circumstances. It also permits him to use his investment judgment in preventing his retirement resources from being eroded by inflation. Fiduciary Trust has two qualified plans for its employees, both of which authorize lump sum payouts. Fiduciary would like to see its employees and others taxed fairly on these distributions.

Under present law, a lump sum distribution made to an employee of his entire interest in a qualified plan as a result of his separation from the service (referred to here as a retirement distribution) is treated as a long-term capital gain. Section 515 provides for the treatment of that portion of a retirement distribution under a qualified pension plan equivalent to employer contributions subsequent to December 31, 1969 as ordinary income to the recipient. The remaining amounts of the retirement distribution would continue to be treated as a long-term capital gain. Section 511 repeals the alternate capital gain rate (the 25% maximum), so that 50% of all long-term capital gains is always includible in the taxpayer's ordinary income. The side-effect of the repeal of the alternate capital gains tax is that the receipt of capital gains will always affect the rate of tax on incremental amounts of ordinary income. This side-effect creates an undesirable result when applied to the income averaging provisions under Sec. 515.

Our principal objection to Bill Sec. 515 is with the operation of the five year forward averaging provision. It computes the tax in the year the retirement distribution is received by adding to the tax otherwise payable on all other income an amount equal to five times the additional tax produced by including in income one-fifth of the ordinary income portion of the retirement distribution.

The difficulty with the changes proposed by H.R. 13270 arises from the fact that in the same year the taxpayer receives the ordinary income portion of the retirement distribution, he also receives a large amount of capital gain in the lump sum distribution. Because H.R. 13270 calls for the repeal of the provision allowing a separate computation of the tax on capital gains, the ordinary income upon which the income averaging tax is calculated is received on top of the 50% of the capital gain added to adjusted gross income. Due to the progressive rates, the rate of tax applicable to the deferred compensation being received in a lump sum distribution remains abnormally high.

It is interesting to observe that the result is different in the case of lump sum distributions from plans covering self-employed persons, after which the forward averaging provision is patterned. These distributions are all ordinary income, so that the entire distribution is subject to averaging. In that case the result is fair since the ordinary income is not taxed on top of a non-recurring capital gain attributable to the same distribution.

The refund provision provided by Sec. 515 of H.R. 13270 does alleviate some of the distortion created by the operation of the forward averaging method. Because the forward averaging method has the technical defect referred to above, the refund, or look-back method, will be the method under which virtually all recipients of retirement distributions eventually will be taxed. This fact in itself demonstrates that the forward averaging provision is technically faulty.

The refund method itself has several undesirable aspects. A taxpayer who dies in the second, third or fourth years after the year of the lump sum distribution suffers the inequities of the high tax in the first year but never receives the full five year benefits of the look-back.

The look-back provision has another defect. Under Bill Sec. 302, the capital gain portion of the retirement distribution will constitute a substantial tax preference under proposed new IRC Sec. 277. As a result, a portion of the tax-

payer's personal deductions are allocated to the non-taxed half of the capital gain. Moreover, Bill Sec. 302 appears to provide that under the five year look-back provision the tax preference income in the year the retirement distribution is received is recalculated, with only 20% of the ordinary income portion of the retirement distribution being taken into account. This increases the amount of disallowed deductions unjustifiably.

This application of the disallowance of tax preferences to retirement distributions is unfair. The Committee's Report on Sec. 302 justifies the disallowance of deductions on the grounds that the personal expenses giving rise to the deductions (interest, state and local taxes, etc.) are paid from the tax preferred income. This is unlikely to be true in the case of a retiree receiving a retirement distribution. Moreover, in most cases, tax preferred income is recurring in nature. A retirement distribution is not.

Finally, it is undesirable to burden the taxpayers and the Internal Revenue Service with large numbers of avoidable refund claims, as would be the case under Bill Sec. 515, and it is unfair to require virtually all recipients of retirement distributions to make interest free loans to the government.

The effect of Bill Sec. 515 and Bill Sec. 302 is to subject the recipient of a distributed distribution to excessive tax. Moreover, there is no indication in the Committee Reports under either Section that consideration has been given to the precise way in which a modestly situated recipient of such a distribution would be affected. We, therefore, suggest an alternative treatment, as follows:

1. Exclude both the capital gains and ordinary income portions of the retirement distribution from the effect of Sec. 302 (relating to tax allocation of deductions in tax preference income);[1]

2. In calculating the tax on the forward averaging method, the capital gain portion of the distribution should be ignored; and

3. Eliminate the look-back refund.

Our first recommendation is the exclusion of both the capital gain and ordinary income portions of the distribution from the effect of Sec. 302. A retirement distribution is by nature non-recurring and because it involves a bunching of income, does not really result in an unduly low tax burden on the recipient even with respect to its capital gain component. Therefore, to subject the distribution to additional tax through allocation of deductions is inequitable.

Our second suggestion is that the tax on the ordinary income portion of the retirement distribution be computed without regard to the portion of the retirement distribution capital gain. Thus 20% of the ordinary income would be taxed on the same basis as can be expected to be the taxpayer's normal retirement level, with the tax attributable to this 20% then multiplied by 5 to produce the five year forward averaging. In making this computation, all other income and capital gains received in the year of the retirement distribution would be taken into account. The non-recurring capital gain would then be taxed on top of this 20%, and would not distort the amount of tax on the ordinary income. Under this method, the incremental tax on which the averaging is based normally would be the approximate amount of tax payable if the distribution were received over five years.

The tax on the amount averaged will still be calculated on top of the other ordinary income that the taxpayer receives in the year of distribution, so that the separate computation will not unduly help the taxpayers with large outside incomes. The income averaging provision will aid the mass of taxpayers who must rely upon a lump sum distribution to meet their needs during retirement years.

Finally, the rationalization of the forward averaging computation would permit the administratively undesirable refund provision to be dropped or, if retained, to be available principally to serve as an equitable relief for those whose incomes drop severely in subsequent years, rather than being the principal eventual basis for tax as now is the case.

Our proposals are not intended to benefit high paid taxpayers. The Committee should consider that substantial retirement distributions may be made under qualified plans to modestly compensated taxpayers. For example, a taxpayer with average career income of $15,000 who benefits from an employer contribution of 15% of compensation for 30 years would receive ordinary income of

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[1] We also believe such distributions should be excluded from Bill Sec. 301, but this is beyond the scope of this statement which is limited to Sec. 515 and other Sections which directly affect Sec. 515.

$67,500 as part of a retirement distribution. The capital gain portion of the distribution could be in excess of $100,000 (assuming level income, 6% average annual return, no benefit from forfeitures of other employees and no contributions by the employee himself). Thus, middle income taxpayers can benefit from retirement distributions with large ordinary income components, and, therefore, be subject to excessive tax under Sec. 515 as now drafted.

Secondly, the Committee should consider that the lump sum distribution may be mandatory rather than elected by the retiree. Many plans provide automatic lump sum distributions to simplify administration, and for other reasons. Even where taxpayers have a choice in the form of distribution, moderate income taxpayers may request a lump sum without realizing the adverse tax it may have compared to an annuity. Thus, the annuity alternative may be denied to many taxpayers or they may unwisely fail to elect it. They should not be penalized, as they would be, under Bill Sec. 515 as now drafted.

We appreciate the opportunity to assist the Committee in providing a fair and equitable method of taxing retirement distributions.

ROBERTS & HOLLAND,
New York, N.Y., September 5, 1969.

SENATE FINANCE COMMITTEE,
New Senate Office Building,
Washington, D.C.

DEAR SIRS: I enclose a memorandum urging an amendment to section 511(c) of the Tax Reform Bill of 1969, the effective date provision for the elimination of the 25% alternative capital gains tax. The Tax Reform Bill of 1969 as presently written would impose a severe hardship on taxpayers who entered into a binding contract of sale before July 25, 1969, but failed to transfer the property before that date.

Very truly yours,

SIDNEY I. ROBERTS.

PROPOSED CHANGES IN SECTION 511 OF THE TAX REFORM BILL, 1969, AND ACCOMPANYING COMMENTS

PROPOSED AMENDMENT

The first sentence of Section 511(c) should be an amended to read "The amendments made by this section shall apply to sales and other dispositions made after July 25, 1969, *but not to sales and other dispositions made after July 25, 1969, pursuant to a binding written contract or a written option executed on or before July 25, 1969.*"

The recommended limitation is necessary to prevent an indefensible frustration of taxpayers' reasonable and justifiable expectations. There is ample precedent for the recommended limitation in many other sections of the bill.

COMMENTS

A. Grounds

Section 511 of the Tax Reform Bill of 1969 (H.R. 13270) provides for the repeal of the 25% alternative capital gain tax for noncorporate taxpayers. The report of the House Ways and Means Committee indicates that the repeal is one of a series of changes designed to reduce the difference between the tax rate paid on capital gains and that paid on ordinary income to taxpayers in higher tax brackets. The repeal will result in tax rates which may reach 35% for taxpayers in the highest tax bracket (not including the surcharge).

The repeal of the alternative capital gains tax is to "apply to sales and other dispositions [made] after July 25, 1969." The Bill and the relevant House Committee report are silent on the question of whether this effective date provision operates to include or exclude sales after July 25, 1969, which are made pursuant to a binding contract or an option executed on or before July 25, 1969.

It is urged that a taxpayer who has on or before July 25, 1969, entered into a binding contract or who has on or before July 25, 1969, given an option should be accorded the same treatment as those taxpayers who have completed a sale or other disposition on or before July 25, 1969. In either case, the taxpayer has relied on the long-existing treatment of capital gains. In either case the taxpayer has committed himself to an irrevocable course of action.

In many cases, taxpayers after having held property for many years have sought to realize their gain at the alternative capital gain rate. These taxpayers bargained for the sale of property which was often of great value, agreed to a fair selling price and have bound themselves to execute the terms of their agreement. The selling price was based in part on the sellers' expectations of the tax burden to be imposed upon their realization of gain. Therefore, a significant change in the effective tax rate, such as the repeal of the alternative tax which will cause high bracket taxpayers to pay a 40% greater tax on capital gains, will result in change in the terms of the originally bargained sale. To force the new net price upon them would indeed be an unjustifiable defeat of reasonable expectations.

B. Present bill precedents

Congress has on many occasions recognized the need for transitional rules for taxpayers who are confronted with a fundamental change in tax treatment while committed to or engaged in an affected transaction. For example, in the 1969 Tax Reform Bill there are numerous effective date provisions which provide for exceptions for those taxpayers who have acted pursuant to contracts and plans which preceded the effective date.

Section 321, changing the timing of the taxation of restricted property received for services, provides that the section shall not apply to property transferred (a) pursuant to a binding written contract entered into before April 22, 1969, (b) upon the exercise of an option granted before April 22, 1969 or (c) before February 1, 1970 pursuant to a written plan adopted and approved before July 1, 1969.

Section 331, dealing with a minimum tax for deferred compensation, provides for a four-year transition exception where the deferred compensation payment was made pursuant to an obligation binding on the effective date and at all times thereafter.

Section 414, limiting the deductions to a corporation on premiums paid or incurred upon the repurchase of a bond or debenture, provides that the amendments shall not apply to a bond repurchased pursuant to an obligation which was binding at the time of the effective date.

Section 421, changing the method of taxing stock dividends which alter the interests of stockholders, provides that it shall not apply with respect to stock issued pursuant to a contract binding on the distributing corporation on January 10, 1969.

Section 501, changing the treatment of mineral production payments, provides that it shall not apply to mineral production payments created prior to January 1, 1971, pursuant to a binding contract entered into before April 22, 1969.

Section 521, dealing with the repeal of double declining balance depreciation, provides an exception for binding contracts for the construction or financing of a new building existing on or before the effective date.

In each case Congress acknowledged the plight of certain taxpayers who had entered into a transaction in reliance on the existing law and adjusted the effective date to avoid inequity and hardship.

It is interesting to note that the suggested saving clause is omitted in several other provisions of the pending bill, but virtually all of those provisions are distinguishable as involving transactions which are inherently in the "loophole" category. Clearly, the 25% capital gain rate ceiling has been sufficiently established in the basic framework of the income tax to be entitled to protection against retroactive repeal.

C. Investment credit precedent

Section 703 of the 1969 Tax Reform Bill, dealing with the termination of the investment credit, provides that the investment credit will not be available with respect to property, the construction or acquisition or erection of which is begun after April 18, 1969, but provides an exception where property is constructed or required under a binding contract entered into before April 18, 1969. The report of the House Ways and Means Committee indicates that repeal of the credit required a series of special provisions providing for those cases where a facility had not yet been fully completed but where the taxpayer had made a substantial commitment and where the injury from the removal of a credit would be substantial. The legislation providing for the temporary suspension of the investment credit in 1966 also recognized the need for flexibility in situations where certain tax treatment was to be repealed or eliminated. The suspension pro-

visions provided that both the investment credit and certain depreciation provisions would not be suspended with respect to property which was constructed, reconstructed, erected or acquired pursuant to a contract that was binding on the taxpayer at the time of the effective date and at all times thereafter. The committee report of the House Ways and Means Committee (H.R. 2087–89th Cong., 2nd Sess. p. 21) stated that a contract shall be considered binding on a taxpayer even though (a) the price of the item to be acquired under the contract was to be determined at a later time; (b) the contract contains conditions the terms of which are under the control of a person not a party to the contract; and (c) the taxpayer has the right under the contract to make minor modifications as to the details of the subject matter.

Another provision in the investment credit suspension bill which was included so as not to defeat reasonable expectations at the time of commitment provided that if a taxpayer, pursuant to a plan which existed on the effective date, had constructed, reconstructed, erected or acquired a plant facility and the construction, reconstruction or erection of more than 50% of the aggregate adjusted basis of the depreciable property of such plant facility had begun by the effective date, then all qualified property would be excluded from the suspension. This exception did not allow taxpayers to add machinery and equipment with respect to buildings under construction at will, since the building and equipment were required to be a part of a specific plan in existence before the effective date and evidence of the taxpayer's intentions, in one form or another, had to be available. However, the bill provided that a specific plan could be modified after the effective date without disqualification.

The careful and detailed attempt by Congress to mitigate the impact of the complete suspension of the investment credit is an example of the kind of legislative flexibility which is required when taxpayers are confronted with a major reshaping of the tax structure. In each of the above examples, the effective date provisions were modified so that taxpayers who had committed themselves in one form or another to a particular transaction or series of transactions were treated in effect as if they had completed such transactions before the effective date.

D. 1954 code precedents

In addition to the above described special relief provisions, the Internal Revenue Code of 1954 and numerous amendments thereunder have made special exceptions, modifications and transitional rules in situations where the increased tax burden was comparable to the 40% increase in capital gain rates which may occur as a result of section 511. For example the following provisions of the 1954 Internal Revenue Code operate to except from the 1954 tax treatment those taxpayers who have suffered a change of position in reliance on the pre-existing tax law:

Section 103(c), dealing with the limitation on the exemption of interest from industrial development bonds, was not made applicable to bonds issued after the enactment of the statute if the user of the proceeds had entered into a binding contract to expend in excess of 20% of such proceeds. (There was also an exception for the issuance of an obligation which has been authorized or approved by the governing body or by the voters prior to the end of the taxable year following the adoption of the statute.)

Section 391, relating to the effective date of Subchapter C of the Code, was not made applicable to "an acquisition of stock described in section 306 which occurred on or after June 22, 1954 and on or before December 31, 1958 pursuant to a contract entered into before June 22, 1954."

Section 393(b), dealing with the adoption of a plan of reorganization under the 1954 Code, provides that corporations who were parties to a plan of reorganization adopted before June 22, 1954, may elect to have the reorganization treated under the 1939 Code.

Section 402(d), dealing with the taxation of contributions by an employer to a trust which acquires annuity contracts, provides that it shall not apply to contributions made pursuant to a written agreement entered into prior to October 21, 1942.

Section 424(c), dealing with the limination of restricted stock options and their replacement by qualified stock options, provides that an option granted after December 31, 1963, will continue to meet the restricted option rules if granted pursuant to a binding written contract entered into before January 1, 1964.

Section 425(h)(2)(B), dealing with the modification of an employee's stock purchase plan or a restricted stock option, provides that it shall not be applicable with respect to a modification, extension or renewal made pursuant to a binding written contract entered into before January 1, 1964.

Section 614(b)(3)(C), dealing with the change in the pooling rules for operating mineral interests, exempts pooling agreements which were entered into in any taxable year beginning before January 1, 1964.

Section 864(c)(4)(B)(iii), taxing income from the sale of property outside the United States where there is no office or other fixed place of business outside of the United States that materially participated in such sale, provides that it shall not apply with respect to a binding contract entered into on or before February 24, 1966.

E. Conclusion

It is urged that the policy goal of reducing the advantages of the preferential capital gain treatment will be maintained if the effective date provisions are modified as suggested above. It is only fair that an individual who entered into a contract for the sale of his property should be entitled to rely on the tax rate which he knew to be applicable when he bound himself to complete the sale. Such a taxpayer should be subject to the same tax as is a taxpayer who completed his sale before the cutoff date.

The purpose of the cutoff was to prevent precipitate selling for fear of statutory change. But, this objective can be achieved, with adequate safeguards to the revenue, without retroactively penalizing taxpayers who committed themselves to ordinary business transactions in complete and justifiable reliance upon existing law.

Statement of Mitchell Rogovin, in Behalf of Samuel Hamburger

I. Summary

My name is Mitchell Rogovin and I am a partner in the law firm of Arnold & Porter in Washington, D.C. The purpose of this statement is to express the position of this firm on behalf of its client regarding the inequitable effective date provision in section 511(c) of H.R. 13270 dealing with the repeal of the alternative capital gains tax for individuals.

II

Section 511 of the House Bill eliminates the alternative tax rate for net long-term capital gains for individuals, applicable to "sales and other dispositions after July 25, 1969."

Without reference to the relative merits of the proposed repeal of the alternative tax, we believe that if the Committee recommends the repeal or a modification of the alternative tax, it would be wholly unjustified and totally inequitable to apply any modification or repeal to binding contracts in existence on or before July 25, 1969.[1]

Congress has historically attempted to avoid retroactive tax legislation because it tends to undermine the public's confidence in our self-assessment system of taxation.[2] The present bill fails to recognize that as of the effective date of the provision, July 25, 1969, literally thousands of taxpayers were bound by contract to the sale of assets, the actual sale or other disposition of which would take place at a later date. These taxpayers, in good faith and without notice of the possible repeal of the alternative tax,[3] entered into binding contracts based on

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[1] Although the Treasury is opposed to the complete elimination of the alternative tax, its counterproposal does not speak to the problem raised herein. Statement of David M. Kennedy, Secretary of the Treasury, on Tax Reform Act of 1969, H.R. 13270, Before the Senate Finance Committee (Comm. Print), Sept. 4, 1969, p. 76.

[2] For a review of the cases dealing with the constitutionality of retroactive tax legislation see, Memorandum of the General Counsel of the Treasury re the validity of the effective date of H.R. 8000, Hearings Before the Committee on Finance on H.R. 8000 (Interest Equalization Tax Act), 88th Cong., 2d Sess., at 89 (1964).

[3] The Ways and Means Committee issued a complete outline of the subjects to be covered during the hearings which began on February 18, 1969. Item X dealt with capital gains and indicated testimony would be received regarding: "1. As to whether the categories of items which presently receive capital gains treatment should be revised. 2. As to whether the length of the holding period for long-term capital gain should be revised. 3. As to other suggestions related to this topic." No notice was given regarding possible repeal of the alternative tax. Revised Press Release Concerning Public Hearings, Committee on Ways and Means (Comm. Print), 91st Cong., 1st Sess. (1969).

an alternative tax rate on capital gains of 25 percent. Now they are incapable of recasting their contracts to reflect a 40 percent increase in the effective tax rates for individuals. The net after-tax effect of the bill, unless relief is granted, is to drastically reduce the terms of the contract.

In order for this provision or any modification of the alternative tax rate on capital gains to achieve a real measure of fairness and equity among taxpayers, an exemption must be provided as to the effective date so as to give relief to those taxpayers who, on or before July 25, 1969, entered into a binding contract of sale.

Ample precedent for such an approach is to be found in the suspension of the investment credit legislation in 1966 [4] and the proposed repeal of the investment credit in the current bill.[5] Indeed, at the time the suspension of the investment credit was debated on the floor of the House, the Chairman of the Ways and Means Committee explained the purpose of the "binding contract" provision:

"We recognize that it would be unfair to deny the investment credit . . . to items which the taxpayer was committed to purchase or construct before he knew about the possibility that these tax incentives would be suspended. That is why we exempt such items from the impact of this bill." [6]

In defining the phrase "binding contract," the Committee Reports, dealing with both the suspension and repeal of the investment credit provision, stated:

"A contract may be considered binding on a taxpayer even though (a) the item to be acquired under the contract is to be determined at a later date, (b) the contract contains conditions, the occurrence of which are under the control of a person not a party to the contract, or (c) the taxpayer has the right under the contract to make minor modifications as to the details of the subject matter of the contract." [7]

This definition of a binding contract, along with the examples which follow in the Committee Reports, should be adopted with respect to this proposed amendment to the effective date of section 511.

III

It is urged that the bill before your Committee be amended to eliminate this apparently unintended retroactive feature. It is recommended that section 511(c) of the bill be amended to provide:

"Section 511. Repeal of Alternative Capital Gains Tax for Individuals.

* * * * * * * *

(c) Effective Date—The amendments made by this section shall apply to sales and other dispositions after July 25, 1969. *For the purpose of this section, the term 'sales and other dispositions' excludes sales and other dispositions pursuant to a contract which was prior to July 25, 1969, and at all times thereafter, binding on the taxpayer.* In the case of a taxable year beginning before and ending after July 25, 1969, the alternative tax imposed by section 1201(b) of the Internal Revenue Code of 1954 shall be computed in a manner to be prescribed by the Secretary of the Treasury or his delegate." (Underlined portion added).

STATEMENT OF HAROLD M. SHAPERO, ESQ., DETROIT, MICH.

My purpose in requesting appearance before the Committee was to seek a clarification of the language of Section 511(c) so that it will unambiguously state that Section 511 eliminating long term capital gain alternative tax will not apply to transactions made pursuant to a binding contract of sale or disposition entered into on or before July 25, 1969 rather than the present ambiguous provision making it applicable to "sales or dispositions made after July 25, 1969". Since the Committee was unable to grant my request for appearance, this statement is being submitted instead as suggested by the staff.

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[4] Section 48(h), I.R.C. 1954, P.L. 89–800, 80 Stat. 1508. The concept of relief where a "binding contract" existed was in the original bill. H.R. 17606, 89th Cong., 2d Sess., as introduced by Mr. Mills on Sept. 8, 1966.

[5] Section 511, H.R. 13270 and H. Rpt. No. 91–413 (Part I), p. 183, 91st Cong., 1st sess. (1969).

[6] Cong. Rec., Sept. 30, 1966, p. 23583.

[7] Suspension of Investment Credit and Accelerated Depreciation, H. Rpt. No. 2087, 89th Cong., 2d Sess., at 21 (1966), and H. Rpt. No. 91–413 (pt. I), 91st Cong., 1st Sess., p. 183 (1969), dealing with the repeal of the investment credit.

I am an attorney-at-law, a member of the firm of Shapero, Shapero & Cohn, with offices at 2525 Cadillac Tower, Detroit, Michigan, 48226, WOodward 2-8164. I have actively practiced law for forty-eight years and have done considerable corporation, real estate and tax work during that period. This is the first time I ever requested an appearance or submitted a statement to a Congressional Committee. I am confining my remarks to the provision of Section 511(c) of such Bill.

It seems apparent this effective date provision was intended to prevent large number of persons from entering into transactions after July 25, 1969, when the proposal to eliminate such alternative tax was first released by the House Ways and Means Committee to the public and thereby obtaining preferential alternative tax treatment. However, the language of the Bill is ambiguous and could possibly be held to apply to transactions made before July 25, 1969 but actually closed after that date, if a technical and narrow construction is given to the words "sale or disposition".

I have several clients in the category of taxpayers who entered into binding contracts of sale before July 25, 1969, but such sales were or will be closed after July 25, 1969. Since the transaction was bargained for and the obligation to sell became firm at the signing of the contract of sale, the change of position by the taxpayer occurred at that time and not later when the sale was actually closed. The act of closing does not substantially change the taxpayer's position from what it was before the closing, since the closing only is the act of performing what the taxpayer had already obligated himself to do. The decisive economic change occurred when the contract was entered into obligating the taxpayer to sell, and fixing the consideration to be received by the taxpayer as well as the terms of the sale.

I am sure that the House Ways and Means Committee intended that the provisions of Section 511 would not apply to a transaction entered into by a written contract binding on the taxpayer before July 25, 1969 notwithstanding that the actual closing took place after that date. In fact, I have been so advised by a member of that Committee. However, unfortunately the language used may be ambiguous, and if not changed will undoubtedly lead to litigation under the claim that the words "sale and disposition" should include a sale closed by actual instruments of transfer after the critical date even if the taxpayer had irrevocably bound himself to the transaction before the critical date. To avoid this litigation and its attendant injustice if determined adversely to the taxpayer, the effective date provision should be modified so as to make its provisions inapplicable to transactions entered into under a written contract binding on taxpayer before July 25, 1969, irrespective of whether or not it was actually closed before such date.

Analogously, Section 703 of the Tax Reform Bill repealing the Section 38 Investment Credit, provides, in a new Section, being Section 703(a), that the elimination of the Investment Credit shall not apply to property "acquired pursuant to a *contract* which was on April 18, 1969, and at all times thereafter binding on the taxpayer." The reasons for the effective date provisions of Section 703 to protect taxpayers who have in good faith bound themselves before the critical date from being thwarted in his reasonable tax expectations ex post facto, are exactly the same as such reasons for effective date contained in Section 511.

I strongly urge that Section 511(c) of the House Bill be amended by inserting after the words "sales and other dispositions after July 25, 1969" the words "but not to sales made pursuant to written contracts binding on the taxpayer on such date."

SOUTHERN NATURAL GAS CO.,
Birmingham, Ala., September 10, 1969.

Re denial of capital gains treatment to certain distributions from qualified plans—section 515—H.R. 13270.

Hon. RUSSELL B. LONG,
Chairman, Committee on Finance,
U.S. Senate, Washington, D.C.

DEAR SIR: Section 515 of H.R. 13270 will abolish existing total capital gains treatment which is normally only available to distributions from certain plans (including stock-bonus purchase plans) occurring entirely within one taxable year and will substitute therefor a "five-year averaging" effect. We are opposed

to Section 515 because while it purports to be a tax relief measure, it actually will be less fair than existing capital gains treatment.

Under present law capital gains treatment is applicable to the total gain resulting from a distribution from a qualified employee plan which is made entirely within one tax year by reason of termination of employment or death. The capital gains treatment is presently available both to the employer's contribution and to any appreciation in such contribution. One beneficial result of the present capital gains treatment is that the thrift habits of corporate employees are enhanced. In many plans the contribution of the employer matches or is in direct proportion to the employee's participation and the employee is encouraged to save more by increased participation in his company's plan. Section 515, on the other hand, will effectively remove the capital gains treatment on the portion or the distribution attributable to the employer's contribution and the employee will pay tax on such contribution as ordinary income.

The five-year averaging proposed by Section 515 recognizes the inequity of income bunching but is completely inadequate as an equitable tax relief measure. Many times, income bunching occurs in the higher earning years of a person—this being especially true in our inflationary economy and due to the normal earning progress usually made during the working years of an individual. For this reason, the averaging features of H.R. 13270 do not meet the problem as fairly as does the capital gains treatment.

Enactment of the proposed law will result also in an unfair additional tax burden on millions of taxpayers who, for a number of working years, have projected and planned child education and family retirement funds without unreasonable taxation caused by the pyramiding of taxable income into one year. Therefore, we respectfully urge that the existing capital gains treatment remain applicable to the one-year distribution from qualified plans. However, should any alteration of capital gains be made, we urge that a sliding scale relief provision be drafted which is logically related to the usual earning period of the tax-paying citizen, because the proposed five-year period is not so related and is not adequate or equitable.

Respectfully submitted.

PETER G. SMITH,
Vice President, General Counsel and Secretary.

STATEMENT OF WALTER N. TRENERRY, ST. PAUL, MINN.

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*) Sell appreciated stock from time to time;
(*b*) Make charitable gifts in appreciated common stocks;
(*c*) Own and operate a racing farm and racing stable;
(*d*) Buy and/or build business buildings from time to time.

SUMMARY OF ARGUMENT

The Capital Gain and Loss proposals of H.R. 13270 impose high capital levies along with checks on replacing capital.

They result in extorting money now without concern about their effect on saving, or investing, or accumulating new capital.

SUBTITLES A AND B OF TITLE II, SUBTITLE A OF TITLE III, AND SUBTITLES B AND C OF TITLE V OF THE TAX REFORM BILL OF 1969 (H.R. 13270)

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 A and B of Title II, Subtitle A of Title III, and Subtitles B and C of Title V, which he mentions specifically here.

Your relator does object formally to the following as abrupt reversals of policy unsuited to their contemporary setting:

Title II. Subtitle A:

Sec. 201 (a). limits on Charitable Deductions in Appreciated Property (Proposed Secs. 170(b) (1) (C), 170(b) (1) (J), and 170(c) of the Code)

Sec. 201(c). Sale or Exchange Treatment of Charitable Gift of Appreciated Property (Proposed Sec. 83 of the Code)

Title II. Subtitle B:

Sec. 211(a). Excess Deductions Account (Proposed Secs. 1251(a) and 1251(c) of the Code)

Sec. 211(a). Aggregating all farm businesses (Proposed Sec. 1251(e) (4) (B) of the Code)

Sec. 212(a). Recapture of livestock depreciation (Proposed Sec. 1245(a) (2) (C) of the Code)

Sec. 212(b). Lengthened holding period for depreciable livestock (Proposed Sec. 1231 (b) (3) of the Code)

Title III. Subtitle A:

Sec. 301(a). Tax preference income (Proposed Sec. 84(c) (1) (E) of the Code)

Sec. 302(a). Disallowance of personal deductions (Proposed Sec. 277 of the Code)

Title V. Subtitle A:

Sec. 511(a). Repeal of alternative capital gains tax (Proposed repeal of Sec. 1201(b) of the Code)

Sec. 512(a). Limit on capital loss deduction (Proposed Sec. 1211(b) of the Code)

Sec. 514(a). Extending the holding period (Proposed Sec. 1222 of the Code)

Title V. Subtitle C:

Sec. 521(b). Recapture of excess real property depreciation (Proposed Sec. 1250(a) of the Code)

I. THINK BEFORE TAXING CAPITAL

In the years 1765–1775 numbers of sturdy farmers, fishers, and merchants living along the Eastern seaboard became alarmed about new taxes a remote legislative body insisted on enacting and trying to collect.

Their alarm brought about the social explosion known as the American Revolution.

While these men shouted. "No Taxation Without Representation!" historians of 1969 feel that the protesters really worried more about substance. Specifically, they worried about their property. If Parliament could tax it for George III's benefit, Parliament could take it away.

In other words concern about capital—that is, property accumulated beyond needs of the day—was at the center of American life from the beginning.

Capital is the womb that brings forth increase. In economic life it deserves the same hymnodic praise as a reproductive force that Venus does as the Alma Genetrix of mankind in Lucretius' poem.

In capitalist society, lawmakers and managers have a duty to help perpetuate the race, economically speaking, by guarding the generative center.

For a time now the good-humored American public has put up with levies on capital. This has become a fact of economic life; but a fact limited in effect to 25% of growth as the highest capital exaction.

Now the Congress plans a drastic and abrupt change in the rules of the game, and the *only excuse* is that Uncle Sam wants more money.

Uncle Sam can *stop spending* Joe Taxpayer's money.

In the 16th and 17th Centuries the sovereigns then annointed by the Lord to rule America also wanted more of their subjects' money; to buy Cloth of Gold, or dungeans, or ships, or painted ladies. Henry VIII, Edward VI, Mary, Elizabeth, James I and Charles I bustled with sweating forced loans, ship money, aids, relief, and benevolences from Lords, Commons, and Clergy, as levies on capital.

By 1969 the unwisdom and backward economic effect of those acts are clear.

If Joe Taxpayer has no encouragement to amass capital, and if his capital gets no protection, he is going to get some fun out of his money by squandering it. *Apres lui, le deluge.*

While it is easy to disable something, repairing or rebuilding it is tougher.

II. CAPITAL MAKES MORE TAXPAYERS

In handling Capital Gains the Congress baldly states that it wants more money, without other justification or excuse.

In other words the Congress coldly penalizes Joe Taxpayer for his shrewdness in picking up land and securities that climbed in value, without rewarding him for taking risks that added real wealth to the country.

When Joe bought assets, he put money into circulation. By good luck this money went into channels which added value to the assets bought with it. Joe might have lost it all.

Joe is not the only gainer. His money may have financed a new process, or a new product, or a whole new plant. It obviously added value to the economic picture generally; it brought forth something that was not there before.

At some point new value creates new businesses and new payrolls; and, as a melancholy concomitant to the Welfare Century, new taxpayers.

Before striking at Joe by simply squeezing him harder, the Congress might take a few minutes to see how much more Uncle Sam will get from new taxpayers getting incomes as a result of Joe and Judy's risk capital.

III. THESE PROPOSALS DO NOT FIT THE SCENE

The Congress is not reworking Income Tax laws in the stillness of a vacuum but against the shrill sounds of contemporary America in the contemporary world.

In this contemporary setting the following happenings suggest tiptoeing softly when levying upon capital:

1. *War.*—So long as Uncle Sam wants to fight in the Far East, Joe Taxpayer's son, the soldier, has to have arms, ammunition, and equipment that only a gigantic and growing industrial plant can give him.

2. *Inflation.*—As labor costs climb to $5, $6, $7, and $8 an hour, and metals to $5, $6, $7 and $8 a pound, Joe Taxpayer finds that he cannot afford to add that new wing to his wheel factory.

3. *Drouth.*—Uncle Sam's policy of "cooling the economy" without controlling wages and prices leaves Joe Taxpayer with no place to borrow the capital he needs for his factory addition, unless he is willing to give Shylock his pound of flesh.

4. *Erosion.*—Falling stock and bond prices hit Joe Taxpayer at the same time he tries to fight uncontrolled inflationary price surges in labor and materials. Steady, daily capital erosion, apparently not a matter of worry to Uncle Sam, wipes out Joe Taxpayer's usual alternative to borrowing: selling securities to the public.

5. *Rebuilding America.*—Uncle Sam's busy assistants daily proclaim in cheerful tones the clean rebuilt American countryside of tomorrow, rebuilt, apparently, from capital they expect to spring from the ground.

6. *Lack of confidence.*—Years of bumbling and bubbletalk have made Joe Taxpayer wary of promises from Uncle Sam; particularly wary of risking capital in any of Uncle Sam's projects. Joe has seen his friends collect the normal reward of Uncle's nephews: heavier taxes and shrieking denunciations as rich evil-doers whom the public has a positive duty to rob.

IV. SPECIFIC SHORT-SIGHTED MEASURES

Your relator believes that Congressional tinkering in all these Capital Gain and Loss provisions is short-sighted because in effect it sacrifices the present and future national economy in exchange for a revenue grab for today.

Each proposal affecting Capital Gain and Loss looks almost bearable standing alone; but all of them together launch a formidable attack on capital.

A. *Capital gain, capital loss, holding period.*—(Secs. 511(a), 512(a), and 514(a) of the Bill, proposed repeal of Sec. 1201(b), proposed amended Sec. 1211(b), and proposed amended Sec. 1222 of the Code)

These proposals lengthen the holding period of a capital asset from 6 to 12 months, remove the former 25% ceiling on capital gains tax, and limit capital loss deductions to one-half the amount of loss.

At this point Joe Taxpayer finds he has to hold an asset twice as long as before, or pay an ordinary income tax on all his gain; and also finds that if he does hold the asset a whole year he now has to pay an income tax on half his gain at ordinary individual rates which legislative moves have pushed as high as 91% in the recent past.

At the same time he sees that if he loses this longheld asset, he can only recover half of it as an offset to profit in selling something else.

Although he may wince, Joe Taxpayer can understand higher extortions based on half his profit, but will find it hard to see how an asset lost is really only half an asset lost.

By fiat Uncle Sam can grab 70% of half the gain when Joe Taxpayer sells his business Jetstar at a profit. No fiat could convince him that he only lost half his capital if it crashed.

To stay in business, to stay a taxpayer, Joe has to recapture all his loss. He should not be thwarted. The easiest way to let him recoup is go on letting him offset his capital gains with 100% of his capital losses.

B. *Farm Losses, livestock.*—(Secs. 211(a), 212(a), and 212(b) of the Act, proposed new Secs. 1245(a), 1251(a), and 1251(c), and proposed amended 1231(b) of the Code)

Uncle Sam now throws several new lassos at Joe Taxpayer's OK Corral and at Old Paint who lives in it.

If Joe Taxpayer keeps the old corral in business, the Congress now makes him keep a new set of books for it called an Excess Deductions Account.

Here Joe has to enter all his business expenses above a figure the Congress thinks it proper for him to spend. Even if he spends every cent paying a salary to old Frank Farmer, who is not much help but needs the income and pays a tax on it, Joe Taxpayer is stuck with ordinary income tax on this taxpaid salary if he sells the OK Corral at a profit.

This is not all. If Joe owns the Purple Peachtree Orchard as well as the OK Corral, he has to lump these both together for his EDA purposes.

This is still not all. If Old Paint is a valuable stud, Joe Taxpayer has to own him at least two years before Joe can depreciate the bangtail as a business asset; and then, if Joe can sell Old Paint at a profit, he must pay an ordinary income tax on so much of the profit as equals past depreciation.

In the farm and livestock field, accordingly, the Congress is again boxing capital and making investments in this field less and less attractive. Depreciation or expense recapture at ordinary income tax rates meets Congress's scheme of capital levy today, and the devil take tomorrow.

The history of agricultural progress, from Jethro Tull and his machine drill and Thomas Jefferson and his moldboard plow in the Eighteenth Century, to the present, shows that it takes rich men to bring about improvements.

They can and will take the risks. They can and will swallow the payrolls (taxable in this Welfare Century) needed for experiments.

Obviously, H.R. 13270 makes it very simple and attractive for them to put their money elsewhere.

C. *Real property depreciation recapture.*—(Section 521(a) of the Bill, proposed amended Sec. 1250(a) of the Code)

While the country needs more plant and office buildings, H.R. 13270 applies to this kind of capital the depreciation recapture rules formerly applying only to short-lived business equipment.

If Joe Taxpayer sells a factory some 40 years from now, he will have to pay ordinary income tax, at rates in force in 2009, upon so much of his profit as applies to depreciation taken in the past.

If Joe Taxpayer sells a factory some 40 years from now, he will have to pay up with in the year 2009?

While the Congress may cook up an analogy between short-lived personal property and long-lived buildings, the two are not alike. Depreciation rates on personal property are relatively short; Joe Taxpayer can see what will hit him reasonably soon; but depreciation on new buildings runs to 40 or 50 years.

The Congress appears indifferent so long as it grabs tax money for now. Here again, H.R. 13270 creates an almost irresistible urge to put money somewhere else where the return of capital will not be taxed at ordinary income rates.

D. *Tax preferences and allocated personal deductions.*—(Secs. 301(a) and 302(a) of the Bill, proposed new Secs. 84 and 277 of the Code)

After boxing capital in, levying on it, and penalizing its recovery and growth, H.R. 13270 takes another bite out of it; and then goes on to make it a factor in raising Joe Taxpayer's income tax bill by limiting his deductions.

The Bill's main capital levy comes in making Joe pay ordinary income tax, at top rates, on half his gain. After that the Tax Preference formula gets at the other half by throwing ordinary income tax, at top rates, at that other half if it goes over a certain percentage of Joe's income.

To top it all, that other half also shows up in the "Sec. 277 fraction" which shears off part of Joe Taxpayer's personal deductions, such as state taxes, interest, contributions, and the like.

These proposals, with the others, simply discourage Joe from selling anything, and are certainly not incentives to putting out risk capital.

E. *Charitable gifts in appreciated property.*—(Secs. 201(a) and 201(c) of the Bill, proposed amended Secs. 170(b) and 170(e), and proposed new Sec. 83 of the Code)

Your relator has covered these topics in Part 1 of this statement, but would comment that they combine with the other Gain and Loss proposals to discourage using capital or investing in disposable capital.

CONCLUSION

The Capital Gain and Loss proposals of H.R. 13270 show a concerted plan by the Congress to make a capital levy, now, for the pressures of today regardless of what this will mean for the future.

The effect will be to discourage the sale, use, or accumulation of capital, and to encourage following Uncle Sam's example of spending all and living for the moment.

Respectfully,

WALTER N. TRENERRY.

(This part 2 of four parts prepared by Walter N. Trenerry, attorney-at-law, Charles J. Hess, accountant, Robert W. Powell, accountant.)

BAY MINETTE, ALA., *August 23, 1969.*

Hon. JOHN SPARKMAN
New Senate Office Building,
Washington, D.C.

DEAR SIR: I would appreciate very much if you would contact Mr. Tom Vail, Chief Counsel, Senate Finance Committee, prior to August 26 and ask him to consider this written testimony (this letter) prior to the Senate Finance Committee hearings.

The 1969 Tax Reform Bill (HR 13270) is too severe. I have been in accounting practice since 1947 and this bill, if passed, will do more to wreck professionally planned ideas and projects than any other tax measure I have ever seen. There is a need for tax reform, I will admit, but make the effective date some time in the future, not retroactively. I would like to go on record as strenuously opposing *any* retroactively effective tax date change.

The Tax Reform Bill coincides with a decline in general business profits, high cost money and a stock market that has been sliding since January 1, 1969. What this country urgently needs right now are business *incentives*, encouragement and perhaps some type of relief from the very high interest rates prevalent today. I believe, if allowed to remain as high as they are, that interest rates will severely depress the construction industry and businesses related thereto (building supplies, etc.).

I believe that the changes in Bill Section 511 removing the 25% capital gains tax ceiling will spell trouble for the stock market of America and the millions of investors. With interest on savings accounts earning over 5% now, what incentive will an investor have to risk his capital in the uncertain stock market? If the market goes up and he sells, he is slapped with a big tax on his gain. If it goes down and he loses, his capital loss has a limitation. If people do not buy stock in American companies, how will they finance their operations?

The investment credit for small businesses should be retained. They need all the help they can get just to exist!

May I suggest another law? Make it illegal to require depositary receipt-type payments for personal income taxes. This would be an unworkable, unwieldy monstrosity if ever allowed to become law.

Very truly yours,

CLIFFORD M. WOOD.

STATEMENT OF E. S. WEISE, JEWELL, IOWA

It is indeed a very special privilege to present a statement before this committee and appreciate the opportunity to be heard on this extremely urgent matter.

I am E. S. Weise, Jewell, Iowa. We are just dirt farmers actively engaged in the production of corn, beans, hay, cattle, hogs and turkeys; first as tenant-farmers, owner-operators and absentee landlords, which indicates we are not only straddling both sides of the fence but riding the middle as well. Agriculture is at the bottom of the "Economic Totem Pole". As for the "Tenant-Farmer", one must dig a hole to get to his level, so from this position I would like to share a few observations with you while I plug this guy.

At an alarming rate the economic bulldozer is shoving the tenant-farmer off the land into the large industrial centers. They settle in the blighted places vacated by those of our affluent society that have escaped to the suburbs and wind up in the hair of the metropolitan city fathers with various new problems including ever increasing demand on the cities bare coffers. You are being called upon to support these people in one way or another, the tenant-farmer poses a three-pronged problem each of which constitutes a drain on the U.S. Treasury. Why not reverse it and make it pay off instead? I believe we can do just that, first expound the problems then look at the options.

AMERICAN AGRICULTURE NEEDS YOUNG FARMERS

Farm operators are going to seed fast, U.S. Census reveals that the *average* farm-operator is in the late fifties, this indicates there must be a large segment in the seventies. Time is running out. Where are the youth that are going to jump into our shoes? Go to any agricultural gathering, present might be a few teenagers and under, others from thirty-five and up, but in between are the missing ones. They are absent because we have failed to give them an opportunity with a goal. Today a constant transfusion of young blood infuses the industrial giants, but agriculture is anemic in this respect.

All industry is subject to change, agriculture is no exception, practices and methods shift from area to area. However great the change the more it basically remains the same, namely, the production of food and fiber, every living thing must eat and does. Youth can adapt but age hesitates, where youth innovates, age is satisfied.

THE AMERICAN AGRICULTURE SYSTEM IS THE ENVY OF THE WHOLE WORLD—WHY?

The built-in incentive promises the individual he will reap the rewards in direct proportion of his ability to, and application in, his hands to the soil. Any ambitious emigrant without a dime could climb the agricultural ladder at his own pace and together with thrift, in the course of time, enjoy the full ownership of the land he toiled. Today the ladder is broken, the lower rungs are missing, no longer can youth progressively become a hired man, tenant-farmer, contract-owner and then full owner. "By this method in the past ten years only .07% have reached the contract goal, 71.1% of all farm transfers were on the woman's side of the family"—Timmons.[2] They hold title to most of the rented lands and live in the rural towns surrounded by these farms, (prominently evident wherever the terrain is adaptable to large row crop equipment and predominantly operated by tenant-farmers).

Does not this indicate we are drifting into the old feudal system where ownership was through marriage or inheritance? We are now accelerating a modernized feudal system where again ownership is through marriage and succession to a dynasty is by birthright. Are we not establishing an absolute "closed shop landed aristocracy" via economic measures? Upon this premises we might ask, by what "Divine right" are we instituting and, or advocating land reform in foreign countries if we create here the very conditions we are foreign aiding to correct elsewhere?

WHY ARE YOUNG TENANT-FARMERS LEAVING THE LAND?

(*a*) Most tenant-farmers of retirement age cannot live on the minimum Social Security.

(*b*) There is no job in his small town to supplement his retirement check.

(*c*) Age and insurance make him unemployable in the nearby city, so he hangs on.

Although the young tenant-farmer may have the skills, aptitude, ambition and drive, they are of little value to him if he cannot obtain the capital to buy and equip a farm. Today he will be dead before he can accumulate the down payment by saving (by contrast his brother who works in industry can buy a $30,000.00 house with next to nothing down). Previously most rented farms were

See footnotes at end of statement, p. 2448.

on a year to year basis (March to March) and we saw a lot of moving here and there and back again, not so much today because more and more leases are on a crop to crop basis. Many tenants have leases on several farms; it also happens that several tenants may have different crop leases on the same farm. This operation calls for a lot of equipment and a show of machinery is necessary to obtain more crop leases or have those renewed he is already operating. Resulting in most young farmers being overcapitalized in iron, they are strangled by short term loans at high interest rates which relegate the borrower into some type of perpetual-poverty.

The crop leases makes for grain operation heavily dependent on Price Supports, because generally he has no permanent base for a livestock operation. There is a constant struggle to adjust their cropping operations to meet their obligations, live off the depreciation and get the leases renewed for next year. They are the most optomistic gamblers in all the world, but the forgotten man in USA, should he lose his leases the bank must sell him out, liquidate to the last pitch fork, in a year or two he might rent another farm. It is doubtful if the same bank will refinance him in his new venture from scratch, and FHA will give him the fisheye unless he has a term of years contract, so he is out. He needs a permanent base where he can set up a livestock operation, expand with one arm or retrench with the other without going out of business, this will enhance his credit at the local bank, The majority of young farmers seem to have no credit to buy land save for FHA and that is like being on the old OPA. Ratioing List. Rural youth is versital, adaptable and aggressive, he will take any job to gain experience regardless of pay, this robs those rooted in the area of jobs. However he wises up fast too, my contention is you are going to support him and his displacement one way or another, the city Mayors are already crying for Federal Funds because of him. Why not utilize this guy's drive while he still has it, right where he is, with his enthusiastic and positive attitude toward farming? All they ask is "tools" to help themselves, there are "Billions of Private Capital" ready and willing to help them if Congress will set up the guide lines, so where do we go from here?

OPTION NO. 1

Well there is the Factory Corporation Farm.—The concentration of more and more land into fewer hands bid for this type of operation. It has certain advantages in a vertical integrated structure, but until we have climate control plus reversal of the present cost-price squeeze, it will collapse of its own weight, providing it cannot write off farm losses against other income. Throughout the feed grain area climatic conditions imperatively dictate daily decisions must be made by the manager on the spot and he must have his hands in the dirt, computers notwithstanding.

Personally I don't fear the factory corporation farm concept in the least. It will be overburdened with problems that do not exist on the[1] family farm, today's most efficient producer of food in the world. *To know anything well one must live with it.* You might be surprised what revelations one can get from a month's "livein" with relatives and they from you, than by twenty years association.

We can pass all the laws curbing factory corporation farming you can print, but if we fail to provide opportunity and tools for the young fellow to start in farming we will dump the whole shebang into the corporation's lap by default. The grim reaper will take care of us old bald and grey heads, together with the bulldozer's piled up displaced rural people creating a vacuum for the corporation to move right in, *that will be the end of cheap food.* Remember time is on the corporation side, it pays no death taxes to survive, versus farms carrying the burden of periodic liquidation of the capital invested in them. Then we have in the works;

OPTION NO. 2

Bipartisan Senate File 1567.—"Young Farmers Investment Act" It cuts FHA's bands tied with too little and too late, they have an accomplished record in spite of the restrictions. We simply cannot continue to function without young blood, new ideas, new enthusiasm and drive toward ownership. It will prevent fate from strangling those young men now boxed in, starting a career in agriculture and move them out of the poverty segment by providing them with a permanent base of operations. The question naturally arises, where are we going to get the money? Congress will be very reluctant, especially at this time to appropriate money to fund this project.

How can we get young tenant-farmers into the owner-operator bracket and keep them solvent? Most landlords are primarily interested in three things; income, security and taxes. Six things prevent the sale of farm lands to tenant-farmers.

Seller's position:

(a) Taxes: Even capital gains takes a big bite out of the sale price.

(b) Restricted: Ever larger down payments limits the number of tenant-farmers as buyers.

(c) Funds: Problem of investing realized cash in a new field.

Tenant's position:

(a) Age: Everyone wants to protect youth from taking risks in appreciating investments but have no compunctions whatsoever from getting them into debt up to their eye brows on expendables.

(b) Cash: Actuarial statistics prove he will be dead before he can accumulate the asking down payment by saving.

(c) Credit: No private lending agency is interested in extending credit to these individuals, while "Government Aid" set up for this purpose in FSA now Farmers Home Administration functioning these thirty odd years has been extremely limited in this direction.

OPTION NO. 3

Try this:

1. Authorize Farmers Home Administration to act as a credit depository.
2. The Federal Government guarantee the contract sale between seller and purchaser.
3. Cancel Capital Gains Tax on farms sold to tenant-operators, and then only if the entire transaction is approved by Farmers Home Administration (prevents collusion). This is not a "Steal Deal" to take advantage of the "no tax sale" the seller must do two things to qualify:

Seller agrees:

(a) Accepts nominal down payment from purchaser, balance in form of a "guaranteed credit deposit" with Farmers Home Administration in lieu of cash.

(b) Accepts a low interest rate the first five years then in graduates upward in five year intervals in exchange for "no tax sale" thus becoming a "Lendlord."

Tenant purchaser agrees:

(a) Insured loan, not transfer farm for period of five years because of profit motives.

(b) Variable payments equivalent to rentals on a crop share basis be mandatory.

HERE ARE THE MECHANICS—(SIMILAR TO BANK CHECKING ACCOUNT)

Owner sells to qualified tenant for whatever price they agree (FHA approval), seller takes Government guaranteed deposit account with FHA in lieu of money in exchange for no income taxes on the real estate transaction; however, if the seller withdraws from this account an amount in excess of the principal payments made by the tenant-purchaser, such excess amount be subject to capital gains tax, interest earnings from this account be taxed at the regular rate. This shall in no way effect the interest payments made by the purchaser nor shall the seller be forced to withdraw any specified sum but can leave all on deposit to accumulate interest at the lowest rate. No purchaser shall be able to sell or transfer for a period of five years any farm financed under any FHA plan because of profit motives. Set up on an amortized long term basis, nominal down payment, graduated interest rates, purchaser to make variable payments equivalent to rentals.

It may be argued we are subsidizing retirement by forgiving the capital gains tax however, unless and until there is a sale, no taxes are due, also if the owner elects to parcel it out while he is living "Uncle" will not collect inheritance taxes either.

Tax revenue:

1. Presently the income from tenant operated farms (cornbelt) as divided on a fifty-fifty basis and the tax proportioned subject to the deductions of the indi-

viduals effected. Under the above plan the new owner-operator will receive 100% of the income and pay taxes accordingly.

2. The former owner (Landlord) previously received fifty percent of the income from the farm and paid the tax thereon, now however he is a Lendlord under FHA and receives interest income on the unpaid balance of the farm sold to the tenant-operator. In effect this is a contract sale and would minimize the Capital Gains Tax over the long pull anyway.

3. (a) The Treasury will receive taxes from the total production of the farm same as under the preseent regulations, plus: (b) The Treasury will receive taxes from interest income on the unpaid balance.

This is all voluntary, in fact it will deter the inflationary spiral of land prices, most tenant-operators would jump at this opportunity. Landlords would also take advantage of it because they are primarily interested in (a) income (b) security, if FHA guarantees the contract how much security do we want?? Within a relative short time FHA will have so much money in this account they will move it around via bulldozer.

No supplementary income in excess of 15% shall escape taxes through this provision.[3]

"The Question may be raised why have any tenancy, particularly if 100% loans are workable? In other words, what are the advantages and disadvantages of substituting "LENDLORDS" for landlords? If a significant proportion of farms continue to be tenant operated, what is the function of the landlord? In earlier years the landlord furnished both credit and management to young farmers. With large number of urban farm owners and woman landlords resulting from the operation of the laws of descent, has not the function of landlords changed materially?"—Timmons.[2]

The ultimate alternative: Megaton Depression, Bust everybody, Youth will return to the land, but who wants it??

CONCLUSION

Our argument is valid, the request reasonable, the idea sound.

There are secondary benefits to others too.

It will influence stabilization of family farms and communities.

Enables a Tenant-Purchaser to avail himself of long range planning and cuts waste.

Accelerates use of Farmers Home Administration already functioning.

Inflation proof, makes no "raid" on the Treasury. Pays its own way.

A program of this type is essential if rural youth are to have the opportunity to farm. We can no longer delay, action is of essence, your support in helping organize such a program is a must in view of the world food needs.

Thank you.

MERRILL, LYNCH, PIERCE, FENNER & SMITH, INC.,
New York, N.Y., August 26, 1969.

Hon. RUSSELL B. LONG,
Chairman, Senate Finance Committee,
Senate Office Building, Washington, D.C.

DEAR MR. CHAIRMAN: Since the Senate Finance Committee will commence hearings next month on H.R. 13270, a bill to reform the income tax laws, I want to take this opportunity to comment on two sections of the bill as passed by the House of Representatives.

As you know, the securities industry is vitally interested in the tax reform bill currently before the Senate, and in particular, we are concerned with the sections dealing with the tax treatment of capital gains and the holding period

[1] Family Farm—The size depends on the locality, the crops produced in that area and what the family can profitably operate with a minimum of hired help during peak load seasons.

[2] "Farm Ownership in the United States" by Dr. J. G. Timmons, Iowa State University, Ames, Iowa.

[3] From statement to House Committee on Agriculture, Washington, D.C., March 1, 1956:

"Tighten up income tax laws so no one who does not depend upon agriculture for 85% of his income may use profits made in other business to cover farm losses—Tomatoes are one of our crops, when prices remain around the 3¢ to 4¢ level, farmers have no outside competition, but if prices rise as this year to 12¢ and 15¢ then next season we have bankers, lawyers, doctors, barbers, merchants all in the tomato business from a few acres on up. They have all to gain and nothing to lose as Uncle Sam pays their losses taxwise." (By Mr. J. Perrin Willis, Agricultural Economist and Radio Farm Director, KTLU, Rusk, Texas.)

of capital assets, Subtitle B, Sections 511 and 514. We earnestly hope that before this bill is enacted, proper consideration will be given to the economic consequences of any revisions of the existing laws.

It is my view—one shared by many in the securities industry—that the bill that emerged from the House is not supported by sufficient research into alternative approaches to capital gains taxation. While I wholeheartedly welcome constructive changes in the nation's tax laws, I am disturbed by the prospect of ill-advised legislation drafted in the name of reform.

Specifically, I question the wisdom of eliminating the alternative long-term capital gains tax for individuals and lenthening the holding period to one year. I have serious doubts that the arguments in favor of these proposals will stand up under objective examination. At the very least, a study should be made of the potential impact of these proposals before they are acted upon by the Senate.

The holding-period provision of the House bill appears to be based entirely on an Internal Revenue Service study of income statistics for 1962, which was hardly a typical year for the securities industry. The House Ways and Means Committee report on H.R. 13270 conceded that "no hard-and-fast distinction can be made between speculative and investment gains on the basis of the holding period involved . . ." Then it proceeds to recommend a one-year holding period on the ground that the I.R.S. study "offers evidence that almost 90 percent of all capital gains on corporate stock in 1962 arose from sales occurring after one year of possession."

The report fails to mention that 1962 was the year of the worst break in stock prices since 1929. Naturally, gains were taken on stocks held for every conceivable period. (A lot of capital losses were taken, too.) Short-term transactions accounted for 5.4 percent of the gains, stocks held for six months to twelve months were responsible for 6 percent of the gains, and stocks held one to two years were the basis for 8.2 percent of the gains. There was an equally even distribution of gains from sales of stocks held for longer periods (two to three years, 6.8 percent; three to four years, 6.5 percent; four to five years, 5 percent). Stocks held five years or more accounted for another 48.8 percent of the realized gains, and 13.3 percent of the gains could not be assigned to any specific holding period.

The Ways and Means Committee report cites the 1.6 percent of gains attributable to disposition of stock held between six and seven months as evidence of a "very sharp increase in sales", presumably for tax purposes. This is not a very persuasive statement in view of the fact that 4.4 percent of the gains was accounted for by stock held for seven to twelve months, and, as stated earlier, 8.2 percent resulted from the sale of stock held one to two years.

In reviewing the report, I am unable to discern a pattern that suggests a better legal distinction between short-term and long-term capital gains than we have now. If such a line is to be drawn, I respectfully submit that more than one year's experience should be studied in arriving at a recommendation for legislation.

Aside from what seems to me to be meager data supporting the House bill, there is inherent in it an intent to narrow the distinction between capital and income. Historically, our tax laws have preserved this distinction on the theory that capital investment should be encouraged as a means of stimulating the growth of our free-enterprise system.

The Ways and Means Committee report seems to challenge this precedent in stating that the effect of the alternative capital gains tax is "at variance with our progressive tax rate structure . . ." The implication seems to be that thrift, on which the accumulation of capital depends, should not be rewarded.

In the dissenting words of Representative James B. Utt of the Ways and Means Committee, "The Committee failed to distinguish between an increment to a capital asset that often accrues—largely due to inflation—over a long period of time and income that is generated on an annual basis."

It is illustory to assume that a substantial rise in the dollar value of a capital asset necessarily represents an increase in real value that should be taxed at progressive rates. In the thirties, consumer prices were about 40 prcent of today's prices. In other words, the dollar would buy two-and-one-half times more than it does now. Hence a $10,000 investment made in 1935 that is worth $25,000 today has not appreciated at all in terms of true value.

I believe that the present 25 percent statutory limitation on the taxation of a long-term capital gains should be maintained. Of course, inroads have already been made into this limitation by the 10 percent federal surcharge and by increasing

state and local income taxes, all of which apply to long-term capital gains. Realistic tax reform should reflect these developments as well as inflation.

It is likely that the House bill, if enacted, would impair the liquidity of otherwise marketable securities and thus reduce the availability of risk capital at a time when high interest rates have already taken their toll on the money markets.

As the Congress and the Administration strive to reduce the burden of taxes on millions of low- and middle-income Americans, proven sources of revenue should not be jeopardized. The arguments that repeal of the alternative tax and extension of the holding period would increase tax revenue are utterly unconvincing, nor are they documented in the Ways and Means Committee report.

If, for example, investors were to hold their securities longer than they do now, there would be less—not more—income to the federal government as a consequence. If our country hopes to pay for large defense outlays and much-needed social and tax-sharing programs and still have a sizable surplus, we need all the revenue we can get. Let's not dry up one reliable source of tax income in the false hope that a better one might somehow be developed.

Obviously, the Ways and Means Committee has labored long and hard to write the many tax-reform measures that will soon be considered by the Senate Finance Committee. As a citizen and a member of the securities industry, I salute much of the work that has been produced by the Ways and Means Committee, but the capital gains tax is not a loophole and needs no reform. I am also opposed to the drafting of tax legislation affecting the investments of more than 100 million Americans without giving them an opportunity to react to the Committee's proposals.

According to Representative Sam M. Gibbons, a member of the Ways and Means Committee, "it was not until the 28th of July, six days before the writing of these views, that the committee had the first opportunity to view any of the more than 360 pages of this very complicated legislation. Moreover, the general public, who must pay the taxes imposed by this legislation, has never had an opportunity to see this legislation, to examine it, to criticize it, or even to offer suggestions about this specific draft, or, in fact, any draft thereof".

I trust that as the House bill is taken up by the Senate Finance Committee it will receive the thorough examination it deserves—and that the public will be kept fully informed of your deliberations.

Sincerely,

DONALD T. REGAN,
President.

BAKER & MCKENZIE, ATTORNEYS AT LAW,
Washington, D.C., September 9, 1969.

Re H.R. 13270—Section 516(c)—Omission of rules regarding deductibility of certain franchise acquisition costs.

Hon. RUSSELL B. LONG,
Chairman, Committee on Finance,
U.S. Senate, Washington, D.C.

DEAR MR. CHAIRMAN: The purpose of this statement is to direct the Committee's attention to a problem connected with section 516(c) of H.R. 13270, the new provision in the bill dealing with the sale of franchises and other intangible business assets. In short, the House bill has introduced specific statutory rules dealing with the tax treatment of the seller of such assets but is completely silent with respect to the treatment of the purchaser.

It is of great importance that the purchasers of these assets, the large majority of whom are small businessmen, know what tax effects attach to the payments they make for acquiring franchises, trademarks, trade names and similar intangible assets vital to the operation of their businesses. It would appear that in the development of the House bill the purchaser's problems were either simply overlooked or there was insufficient time to draft the necessary statutory language. Now, however, it seems most appropriate that the Senate complete the picture and provide rules for the deductibility of the payments made by the purchasers.

The analysis of the present law and the new problems which may arise by reason of the enactment of H.R. 13270, set forth below, is made to assist the Committee in formulating a policy and developing a set of rules covering the purchase of intangibles. It should be kept in mind that the basic situation with which this statement is concerned is the tax treatment to be afforded to the annual, recurring payments made by the purchaser to the seller of a franchise,

trademark, trade name or other similar business asset, which payment is measured by the year's use of the asset or by the annual income produced thereby, and is essential to the purchaser's continued ownership and utilization of the asset. In other words, this statement should not be confused with another basic proposition, i.e., the tax treatment to be afforded the payment of a lump sum for the acquisition of an intangible asset with an indeterminate useful life. That is an entirely different problem and it is completely unnecessary to deal with it in order to take care of the very common and important situation at which this statement is directed.

Thus a significant item of tax reform can be effected by the Tax Reform Act of 1969 if the area of law under discussion is clarified.[1]
to permit the current deduction of franchise, trademark, trade name, etc., payments which are determined by reference to the income derived from, or the utilization of, the franchise or other intangible. As developed more fully below, this is not a novel concept; it has been applied by both the courts and the Internal Revenue Service in a sufficient number of analogous situations to have become known as the "flow of income" method of depreciation.

The significance of the tax reform recommended in this statement is heightened by the fact that franchising is a method of doing business whose importance is constantly increasing. Of even greater importance in the context of the current tax reform program, which has become so deeply concerned with providing more equality for the smaller taxpayer, is the fact that franchising is probably the single largest economic phenomenon whereby small businesses are being established and developed in the United States today. By removing the doubts surrounding the tax treatment of the cost of acquiring a franchise the proposal advanced herein will help to further stimulate the growth of franchise operations.

The Problem—An Illustrative Case

FACTS

Assume that Mr. and Mrs. John Public, a retired but still vigorous couple who have accumulated a sum of money by diligent saving, respond to an advertisement in a financial journal stating that "a food franchising business with good income potential is available for a modest capital investment." They are contacted by the franchisor who shows Mr. and Mrs. Public the standard franchise agreement (which, in fact, is essentially like many existing franchise arrangements) pursuant to which they would be granted the exclusive right to prepare and sell spareribs under the trade name "Super Ribs" in a defined geographical area. Mr. and Mrs. Public's rights would continue as long as they maintained a certain quality standard and made an annual payment of 25 cents per pound of spareribs sold.

Mr. and Mrs. Public sign the agreement and in 1968 they sell 100,000 pounds of spareribs at $1.00 per pound. They pay the franchisor $25,000 and incur additional costs and expenses of $63,000 in 1968. Accordingly, Mr. and Mrs. Public report $12,000 ($100,000 less total costs of operation, $88,000) on their 1968 return as income from the operation of the franchise business.

Mr. and Mrs. Public's 1968 return is audited and the revenue agent disallows the deducation taken for the $25,000 franchise payment on the ground that the franchise agreement granted Mr. and Mrs. Public "all substantial rights" to the trade name "Super Ribs" in the specified territory. The agent maintains that such rights represent a capital asset having an indeterminate useful life and that, accordingly, the franchise payment of $25,000 represents a non-deductible capital outlay.

THE DECISION IN "DUNN V. UNITED STATES"

In September 1968 the Court of Appeals for the Tenth Circuit in *Dunn* v. *United States*, 400 F.2d 679, affirming, 259 F. Supp. 828 (D.C. Okla. 1966), a case involving payments of 28 cents per gallon of Dairy Queen mix used by a franchisee, upheld the Internal Revenue Service position. The gallonage payments were disallowed as a depreciation deduction with respect to the cost of the asset purchased thereby, viz., the franchise right to market under the Dairy Queen name, solely because the life of the Franchise was of an unascertainable length (it

[1] Significantly, the new rules regarding the taxation of transferors contained in section 516(c) of the bill have been characterized as being simply a clarification of the existing case law. H. Rep. No. 91-431 (Part 1), p. 164. This clarifying process should properly be extended to encompass transferees.

could be ended by the franchisee by non-payment of the gallonage charges or by a voluntary surrender of the franchise, or by the franchisor upon violation of the terms of the agreement by the franchisee).

THE DISASTROUS ECONOMIC CONSEQUENCES OF THE "DUNN" DECISION

Let us examine the intolerable economic situation into which Mr. and Mrs. Public have been placed by the *Dunn* decision. Now their taxable income for 1968 has been increased to $37,000. Twenty-five thousand dollars of this $37,000 ordinary income represents an "investment" in an asset which has little or no resale value.[2] The remaining $12,000 earned by Mr. and Mrs. Public from the operation of their franchise will probably be barely sufficient to cover the income tax due on this alleged $37,000 income.[3] If the audit occurs in 1972 the situation is even more drastic since Mr. and Mrs. Public would be faced with having three taxable years in issue with a substantial interest payment to boot. It is not unlikely that this tax situation will force Mr. and Mrs. Public to abandon their franchise—and another small business will have departed from the U.S. scene.

"DUNN" RULE ILLOGICAL AND BAD POLICY

Not only is the *Dunn* case intolerable from the viewpoint of small business economics, it is wrong as a matter of law.

DEPRECIATION DEDUCTIONS ARE DESIGNED TO CLEARLY REFLECT INCOME

The Supreme Court has said that the "primary purpose of depreciation accounting [is] to further the integrity of periodic income statements by making a meaningful allocation of the cost entailed in the use of the asset to the period to which it contributes."[4] The Court of Appeals in the *Dunn* case failed to follow this dictate of the Supreme Court. Indeed, the conclusion in *Dunn* does violence to the integrity of periodic income statements by causing the deduction of the periodic production payments for franchise rights to be deferred in most cases until the termination of the franchise. The practical result of this is to deprive the taxpayer-franchisee of any deductions for the payments made to acquire the franchise because in the year of franchise termination there is apt to be little or no income against which the loss represented by the aggregated payments can be offset. Such a result can only be characterized as a patent distortion of income for tax purposes (as the Service itself expressly recognized in Rev. Rul. 67-136, discussed below).

Conversely, permitting a franchise payment based on production, use or sale to be deducted in the year of such production, use or sale results in the clear reflection of income which it is the function of section 167 to insure. This is so because there is a direct relationship between the income generated by the taxpayer's use of the asset during the period and the amount of the taxpayer's obligation to pay during that period arising under the franchise agreement. Furthermore, the right to continue such use is directly dependent upon such payment because the usual franchise agreement terminates, and the right reverts to the seller, in the event of a default in payment. Accordingly, the franchisee cannot acquire by such payments any residual rights in the asset. Moreover, the usual franchise agreement also precludes a transfer or assignment without the consent of the franchisor, even if there is no default in payment.

DUNN DECISION CONTRARY TO CASES

The taxpayer-franchisee's position that franchise acquisition costs geared to income generation are currently deductible is supported by court decisions as well as Internal Revenue Service rulings involving intangible assets, other than franchise rights, having indefinite or unascertainable useful lives. Thus, in cases involving unpatented inventions[5] and patent applications,[6] neither of which have a definitely measurable life, the Tax Court has held that if production payments

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[2] It is difficult to imagine that anyone would be willing to pay the franchisee his cost basis for the franchise and, in addition, assume the burden of continuing the production payments to the original franchisor with no tax benefit in the form of a current deduction for any of the payments.

[3] The increase in state income taxes must also be taken into account.

[4] Massey Motors v. United States, 364 U.S. at p. 104.

[5] [illegible] Co., 10 TCM [illegible] (1951).

[6] [illegible] Manufacturing Co., 18 TCM 450 (1959).

"are to be regarded as part of the cost of the [asset] then it seems reasonable to allow a corresponding deduction for each year because the payments are measured by the profitable use of the [asset] in each year and will continue to be so measured during any year in which the payments are made."[7]

The case of *Associated Patentees, Inc.*, 4 T. C. 979 (1945) is most helpful because of the force and clarity of its reasoning. The *Associated Patentees* case is all the more meaningful because it involves patents. The validity of the taxpayer's position is thus very dramatically illustrated since the court rejected the statutory lives of the patents as a basis for depreciation, for which the Government was contending, and held that the flow of income method of depreciation, for which the instant taxpayers are contending, should be used because it produced a deduction which resulted in a more clear reflection of annual income for tax purposes.

In *Associated Patentees* the taxpayer acquired patents of varying lives. The sellers were to receive as consideration 80 percent of taxpayer's annual income from any license agreements covering the patents which it negotiated. The taxpayer claimed a depreciation deduction in the amount of such royalties it paid to the sellers in the taxable year. The Commissioner disallowed the deduction contending that only a proportionate part of the royalty payment should be allowed currently with the balance prorated over the remaining lives of the patents. In each succeeding year, the taxpayer would be allowed a deduction for a proportionate part of the payment in that year plus the amount allocated to such year from prior payments. Although the Commissioner used the definitely ascertainable life of the patent as the basis for his depreciation computation, his determination was rejected by the Tax Court with the following statement:

> It will readily be seen that although this method of computation will give to the petitioner aggregate theoretical deductions for depreciation equalling the total ultimate cost, its practical result will be an entirely inadequate allowance for depreciation at the beginning of the terms and excessive allowances for depreciation at the end. Actually, in the later years, the depreciation allowances would largely exceed income from the patients. Under such a method of computation the petitioner might not, in fact, recover its cost from income.

The court then went on to prescribe the method of depreciation for which taxpayer is contending in this request for legislative relief—the most rational method of depreciating an intangible asset with an indeterminate useful life being purchased by contingent payments because the deduction varies in direct relationship to the economic exploitation of the acquired asset. The court said:

> Petitioner's contention is that the cost payment made each year is subject to depreciation in its full amount because it is a cost pertaining to that year alone and measured by income over that period. It is argued that, with an allowance so made, at the close of the lives of the patents the petitioner will have recovered the amount of their cost prorated equitably over their lives.
>
> Section 23(1) provides for "a reasonable allowance" for depreciation. It provides no specific method for its computation. Respondent's regulations recognize the fact that there is no fixed rule, but that the cost should be apportioned over the useful life in such ratable amount as may reasonably be considered necessary to recover during the remaining useful life of the property the unrecovered cost or other basis. The situation here is unusual. But we think that the method for computing depreciation for which petitioner argues gives it a reasonable, and not more than a reasonable, allowance, whereas the method urged by respondent might deny petitioner the recovery of its cost and would unquestionably result in a distortion of income.

It is respectfully submitted that the reasoning of *Associated Patentees* is unquestionably sound and applies to the instant situation with equal force.

DUNN DECISION ALSO CONTRARY TO IRS RULINGS

It is significant to note that the Treasury Department has *required* taxpayers to use the "flow of income" method of depreciation in situations completely analogous to franchise acquisitions for the very reason that such a method assures a minimum distortion of income. In Rev. Rul. 60-358, 1960-2 C.B. 68, the Service ruled that the proper method for depreciating leased or rented television films, property with an unascertainable useful life, was by reference to the income generated by the films. In pertinent part the ruling states:

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[7] M. E. Cunningham Co., 10 TCM at p. 278.

. . . the usefulness of such assets in the taxpayer's trade or business is measurable over the income it produces and cannot be adequately measured by the puassage of time alone. Therefore, *in order to avoid distortion*, depreciation *must* follow the "flow of income." (Emphasis added.)

In Rev. Rul. 67-136, 1967-1 C.B. 58, the Internal Revenue Service again approved the "flow of income" method of depreciation where inventions covered by patent applications were purchased for a continuing purchase price based upon income produced by the exploitation of the inventions:

. . . by the terms of the contract in the instant case, the price of the assets is tied to the benefits the taxpayer derives from them; as the assets produce income their cost or basis increases and their period of usefulness to the taxpayer is proven. The use of the amounts which the taxpayer in this case is contractually obligated to pay on the price as the measure of the allowance for depreciation *assures minimum distortion of income. The contrary would be the case if the taxpayer were required to delay recapturing his capital investment in the assets until their total price is established.* (Emphasis added.)

In the light of the logical reasoning expressed in Rev. Rul. 67-136, how can the Service on one hand allow a deduction for annual payments where a patent application is involved and deny the deduction where a franchise is involved? In either case it is impossible to determine with any degree of certainty what the life of the asset will be. The uncertainty surrounding the life of a franchise right contingent upon exploitation has been outlined above. Similarly, it is impossible to determine with any degree of certainty when (if at all) a patent will issue after an application has been submitted to the Patent Office. Although the majority of applications are processed in three to four years, it is not unusual for an application to be pending as long as five or six years—and in some cases the period has exceeded ten years or more.

It is respectfully submitted that there is no difference in principle between the situations involved in the foregoing cases and rulings and that involved where a franchise is purchased on a basis geared to the production of income.

IRS ERROR: TREATING LUMP SUM AND PRODUCTION-BASED ACQUISITION PAYMENTS IN A LIKE MANNER

The error in the Internal Revenue Service position (unfortunately now embedded in the law by decisions of a District Court and a Circuit Court of Appeals) stems from a failure to distinguish, for purposes of income tax depreciation, the fundamental difference between a lump sum payment to purchase a franchise right and a purchase price consisting of periodic payments contingent upon the income derived from, or other indicia of exploitation of, the franchise. That this failure to distinguish between these two types of acquisition payments is not due to oversight or inadvertence, but is quite deliberate, is highlighted by the following language of the District Court:

The great weight of authority appears to hold that intangible property with an unascertainable useful life is not subject to amortization or depreciation. This rule would clearly be applicable, if, for instance, the corporation herein paid a fixed sum at the start for the franchise. This payment would have to be capitalized and recovered when the business was ultimately sold. *The fact that the parties here negotiated a different sale price, that is 28¢ per gallon forever, rather than a fixed figure, should make no difference in the legal conclusion which must be reached herein.* (Emphasis added.)

It should be noted that neither the District nor the Circuit Court in *Dunn* ever explained why the foregoing cases and rulings did not require a "difference in the legal conclusion" where a production payment purchase price rather than a lump sum cost is being depreciated. In other words, the courts in *Dunn* failed to recognize that all the cases on which they relied involved acquisitions in which the purchase price was entirely or in substantial part paid by a lump sum; simultaneously they ignored the authority of the cases and rulings dealing with non-lump sum purchases. As a result they misapplied the rule in the regulations to the effect that "An intangible asset, the useful life of which is not limited, is not subject to the allowance for depreciation." [8]

When that regulatory rule is applied to a lump sum payment for an intangible asset having an unascertainable useful life, the result reached makes sense under section 167. In other words, since the total cost of the intangible asset

[8] Treasury Regulation § 1.167(a)-3.

extends for a number of years—a number which is not limited, i.e., unascertainable, there is no basis on which a deduction can be permitted which would assure that income would be clearly reflected. Certainly to permit the entire amount to be deducted in the year of expenditure would result in a distortion of income. Similarly, although the distortion would be less, there would be no rational basis for spreading the cost over a number of years. Accordingly, where a lump sum acquisition is involved, the regulations, and the courts, have reached a logical result in the light of the present statute.[9]

However, slavish adherence to the literal language of the regulations in the case of non-lump sum purchases contravenes the cases and Service rulings cited above and results in a manifest perversion of section 167.

A FALSE ISSUE—PARALLEL TREATMENT OF SELLER AND PURCHASER

The *Dunn* case and the second paragraph of item 10 in the tentative modification of the tax treatment of capital gains and losses set forth in the July 25, 1969 press release[10] of the Ways and Means Committee are some indication that the tax treatment received by the seller may affect the manner in which the purchaser is treated. Apparently it is felt by some that if the seller makes a sale at capital gains rates the purchaser should be precluded from depreciating the cost of acquiring the franchise or other intangible asset purchased. There is no basis in law, logic, or equity for such a position.

Apparently a cause for some of the thinking along this vein arises from analogizing the periodic purchase payments in question to rental or royalty payments. However, it is submitted that the character of the payment *from the viewpoint of the franchise* is no different where the transaction is an installment *sale*, a lease or a royalty arrangement. If, under the new standards of section 516(c) of H.R. 13270, the transferor of a franchise has not retained any significant power, right or continuing interest with respect to the subject matter of the franchise (or if amounts are attributable to the transfer of all substantial rights to a patent, trademark or trade name) why should the transferee automatically be precluded from deducting the cost of acquiring the franchise, patent, trademark or trade name? The question of deductibility does not hinge upon what happens to the transferor tax-wise. We must look to the nature of the item in the hands of the transferee and apply the pertinent rules of deductibility to him as a separate taxpayer.

Looking at the transaction from the viewpoint of the purchaser the threshold proposition is that there is no inherent prohibition in our tax laws against deducting the cost of assets used in the trade or business. Indeed, depreciation deductions are the classic example of such deductions. Certainly no one has suggested that depreciation deductions should be denied if the seller of the depreciable property realized capital gain on the sale rather than ordinary income. Moreover, no one would suggest that depreciation deductions should not be allowed simply because the capital gain sale was made on an installment basis. The same reasoning applies to the instant situation.[11]

FAILURE TO CLARIFY DEDUCTION RULES MAY PLACE FRANCHISEES IN WORSE POSITION

One final observation may be worthwhile. If H.R. 13270 is not clarified along the lines suggested in this letter, franchisees and purchasers of other intangibles may be worse off after the bill's enactment than under existing law. The above-referred to item in the July 25 press release of the Ways and Means Committee may be regarded as lending support to the "parallel treatment" approach of the

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[9] This is not to say that the Code is perfect in this respect. To defer deduction of the lump sum cost of a purchased intangible until it is abandoned often results, for the same reasons as discussed above with respect to periodic production payments, in the loss of the deduction. A reasonable compromise might be to permit an amortization of such cost over some arbitrary period such as 120 months. However, such legislative fiat is not required to solve the instant problem created by the IRS position and the *Dunn* cases. The solution of the instant problem lies simply in a Congressional reaffirmation of the correctness of the flow of income method of depreciation. Thus, the legislation sought does not require the adoption of a novel untested concept but is merely clarifying in nature, simply applying a rule which has been endorsed by both the courts and the Internal Revenue Service.

[10] This press release item also indicates that the problem of deductions by the purchaser was an inherent aspect of intangible asset transfers. Thus, it seems most appropriate that the Finance Committee complete the job by spelling out such deduction rules.

[11] It is significant to note that in the above discussed cases and rulings permitting the purchaser current deductions under the principle of flow of income depreciation the tax treatment of the transferor played no part in determining whether the transferee should get such deductions.

Dunn case. In other words, one might argue that the *Dunn* case doctrine, if not expressly codified, has at least received implicit Congressional approval. Thus, if the *Dunn* error is not rectified by statutory rules expressly permitting the deduction of contingent annual payments, the franchisee, invariably a small businessman who needs tax assistance rather than tax burdens, is saddled with a real penalty. If required to capitalize the annual payments he will get a deduction only when he abandons or disposes of the franchise. This will usually be a large capital loss which in most cases will be of little use to him. (The utility of capital losses will be further minimized when section 512 of the bill becomes effective.) The net result will be an extreme distortion of taxable income in the case of a class of taxpayers the law usually tries to help rather than hinder.

Therefore, not only the correct application of depreciation principles, but policy considerations based on equity as well, require that contingent annual payments for franchises and other intangible assets be made deductible by express statutory provisions.

CONCLUSION AND SUGGESTED SOLUTION

The IRS position on the deduction of franchise costs represents a fundamental departure from the logic of section 167. The significance of this erroneous position has been compounded by its endorsement by a circuit court of appeals. If taxpayers are required to resort to continued litigation of the issue, hoping for a conflict in the circuits, and eventual resolution of the problem by the Supreme Court, it is apparent as a practical matter that many small business taxpayers will be deprived of deductions to which they are rightfully entitled. Accordingly, it is appropriate that the problem be resolved by legislation—which can proceed with promptness and precision, particularly now that Congress has specially dealt with the seller's side of the transaction.

One possible legislative solution would be to add a new subsection to section 167 as follows:

"(k) A 'reasonable allowance' as used in subsection (a) in the case of a purchased intangible asset—

(1) having an unascertainable useful life, and

(2) the ownership of which is acquired by, and contingent upon, continuing purchase payments which are based upon a constant percentage of the income derived by the purchaser from the use, sale or other exploitation of such asset

shall be the amount of such purchase price paid or incurred in the taxable year."

Respectfully submitted,

BAKER & MCKENZIE.
By MICHAEL WARIS, Jr.

THE ZISCHKE ORGANIZATION, INC.,
San Francisco, Calif., September 25, 1969.

Re objections to provisions of tax reform act of 1969 affecting pension and profit sharing plans.

Hon. RUSSELL B. LONG,
U.S. Senate,
Senate Office Building,
Washington, D.C.

DEAR SENATOR LONG: As actuaries, consultants, and administrators for more than seven hundred qualified pension and profit sharing plans, we are seriously concerned with those portions of the proposed Tax Reform Act of 1969 which would affect qualified plans.

In particular, we are concerned with the proposed change in the taxation of lump sum distributions under such plans (Section 515 of the Bill).

The plans of at least one half of our clients would be adversely affected by this proposed change. Our analysis indicates that the tax penalty inherent in the proposed change in the taxation of lump sum distributions would have its greatest impact on the benefits payable to lower paid (and lower tax bracket) employees who participate under these plans.

I am enclosing a copy of our Staff Memorandum which summarizes our objections to the proposed tax changes affecting qualified plans.

It is my hope, of course, that you and your Committee can be instrumental in removing these objectionable changes from the provisions of any final tax bill.

Respectfully yours,

JAMES B. ZISCHKE.

BIOGRAPHICAL SKETCH—JAMES B. ZISCHKE

Position.—Chairman and Senior Consultant, The Zischke Organization, Inc., San Francisco—Actuaries, Consultants and Administrators for Employee Pension, Profit Sharing, and Deferred Compensation Programs.

Educational Background.—B.A. (1943)—Yale University; M.A. (1947), and Ph. D. (1950)—Stanford University.

Professional Activities.—Staff Member, Annual Pension and Profit Sharing Institute, Purdue University (since 1955); Extension Instructor, Pension and Deferred Profit Sharing Plan, University of California, Business Administration Extension, San Francisco (since 1958); Panelist and Speaker, California Continuing Education of the Bar, Self-Employed Retirement Plans Program (1968); Professional Corporations Program (1969); Member, Organizing Committee of Western Pension Conference and former President of the San Francisco Chapter; Speaker at National programs and former Chairman of Northern California Chapter of the Council of Profit Sharing Industries; Member, Committee on Pension and Profit Sharing Terminology, The Wharton School, University of Pennsylvania; and Has spoken on Pension, Profit Sharing and Employee Benefit Plan topics before numerous business and professional groups and special institutes (including Tulane Tax Institute, and C.L.U. Institutes at the Universities of California, Colorado and Wisconsin)

Publications.—Monographs.

"Tax Factors and Related Business Considerations in Establishing Profit-Sharing Plans"—Prentice-Hall Tax Ideas Service, 1955; Revised Edition, 1963.

"Pension and Profit Sharing Benefits Formulas: Their Service and Compensation Basis; Integration With Social Security; Collateral Benefit Relationships; Formula Combinations"—in *Taxation of Deferred Employee and Executive Compensation*—Henry Sellin, Editor: Prentice-Hall, 1960.

"The Use of Qualified Pension and Profit Sharing Plans for the Benefit of Small Businesses and Their Owners"—*Proceedings of the Tenth Annual Tulane Tax Institute*; Bobbs-Merrill. 1961.

Articles have also appeared in Trusts and Estates, Pension & Welfare News, Profit Sharing, and other publications.

Home.—Piedmont, California.

STAFF MEMORANDUM

SEPTEMBER 10, 1969.

COMMENTS ON TAX REFORM ACT OF 1969, AS IT WOULD APPLY TO QUALIFIED PENSION AND PROFIT SHARING PLANS

Introduction

The attached outline summarizes the main provisions of the House-passed Tax Reform Act of 1969, which affect qualified pension and profit sharing plans.

Senate Finance Committee hearings on the Act commenced last week and will probably continue through September and into October. It is presently anticipated that the full Senate will consider the Bill in late October. Thus, there is still plenty of time for persons and companies to register complaints with Congressional representatives regarding any provisions of the proposed Act which are felt to be objectionable.

From the standpoint of qualified pension and profit sharing plans, the most objectionable proposed change appears to be the one which would provide a complicated new system for taxing "lump sum" distributions to terminating employees.

We also feel that the proposed changes affecting plans of subchapter S corporations could create undesirable tax precedents for all qualified plans.

The following sections of this Staff Memorandum summarize our objections to each of these proposed changes.

Objections to proposed change in tax treatment of lump sum distributions under qualified plans

As closely as we can determine, about one-half of our clients with pension plans and almost all of those who have profit sharing plans, and a large portion of the employees covered by these plans, would be adversely affected by this proposed change in the tax treatment of lump sum distributions.

The main objections to this proposed revision, as we see them, are as follows:

1. The proposed revision would, after 1969, require double recordkeeping of all plans under which lump sum distributions may be made (in order for the plans to

be able to identify that portion of an employee's post-1969 allocation which would be subject to ordinary income tax, as differentiated from that portion which would continue to be entitled to capital gain treatment). While this double recordkeeping, in most instances, would not be difficult it will obviously result in increased internal administrative expenses for most affected plans.

2. The proposed revisions would create a complex tax computation for any employee receiving a lump sum distribution.

Instead of the present relatively simple capital gain computation, the terminating employee would first be required to make a capital gain computation; then he would be required to make a complicated ordinary income tax computation under the so-called 1/5th forward averaging rule; and finally an even more complex computation four years later (involving 5 years' tax returns) to determine his tax refund.

> *NOTE.*—We estimate that this final 4th year tax refund computation would be required in almost all lump sum distribution situations, since the capital gain portion of the initial distribution will create an artificial "bulge" in the employee's taxable income in the year of distribution. Thus, his initially-computed ordinary income tax under the 1/5th forward averaging computation will be abnormally high. This, in turn, will result in an entitlement to a tax refund when the computation of actual applicable taxes is made on the basis of normal income in the 4-year period following distribution.

3. The House Ways and Means Committee Report estimates that this proposed change would bring in $5,000,000 of additional tax revenue in 1970, increasing to $50,000,000 of additional annual revenue by 1979.

We estimate that approximately 100,000 qualified plans would initially be affected by this amendment. By 1979, a conservative projection indicates that at least 200,000 and possibly as many as 300,000 plans could be affected.

Assuming that increased administrative costs for recordkeeping and participant tax computations initially average $150 per affected plan per year, and that this figure increases to an average of $400 per year by 1979 (when the volume of computations and complexity will have grown substantially), this provision would result in increased non-productive expenses to the American taxpayers of some fifteen million dollars in 1970, and somewhere between eighty million and one hundred twenty million dollars by 1979. If only half of this additional taxpayer expense qualifies as an allowable income tax deduction, it is apparent that the proposed revision will actually result in substantial revenue losses to the government.

4. The proposed revision would unfairly penalize hundreds of thousands of lower-paid employees.

While the House Ways and Means Committee Report purports to show that this proposed change would primarily affect taxpayers earning above $50,000, anyone familiar with the actual operation of qualified pension and profit sharing plans can testify that the vast majority of lump sum distributions are in the $5,000 and under category and are made primarily to shorter-service employees (most of whom are in lower income brackets).

Such smaller amount lump sum distributions are made by Plans primarily to "clear" their books and avoid having to carry records on smaller vested interests. Such smaller amount lump sum distributions also avoid the proportionately higher administrative expenses which are involved in making a series of small amount installment distributions to employees who leave before they have accumulated any substantial benefits under a program.

The mathematics of the proposed ordinary income tax computation for the post-1969 employer-contributed portion of any lump sum distribution are such that the 1/5th averaging provision will give little or no relief to a lower-paid taxpayer. As a result, lower-paid employees would in most instances end up paying twice the tax they now pay on the distribution of amounts which the employer has contributed for their benefit. In many cases this tax on the "bunched" receipt of post-1969 employer contributions allocated for the benefit of lower-paid employees will be greater than the tax these employees would have paid had these same amounts been distributed to them on a current basis during each year of their participation under the plan.

5. The present law's capital gain treatment of lump sum distributions was originally enacted in 1942 to provide relief from the so-called "bunched income" problem (i.e., the receipt for tax purposes in a single year of a large amount of

income which had been accumulated over a substantial number of years). The proposed revision would, over a period of years, reestablish this problem as a major tax inequity. For example, consider the employee retiring in the year 2000, receiving a lump sum distribution representing 30 years of employer payments on his behalf, and finding that, at best, this distribution of employer contributions will be treated for tax purposes as though it had all been paid to him in a 5-year period.

6. Tax policy has, since 1942, consistently favored the growth and expansion of private retirement plans. Every change since that date has been in the direction of liberalizing the tax treatment of legitimate plans.

Private qualified pension and profit sharing plans represent the largest single block of capital savings in the United States. More than 30,000,000 workers have a direct stake in these capital accumulations and, as a result, have become an integral part of the capitalistic system.

The proposed revision, if enacted, would from a tax standpoint be the first backward step in 24 years in the policy of encouraging the formulation and growth of a sound nationwide system of private retirement plans (and, in particular, profit sharing programs).

Objections to proposed changes in tax treatment of qualified plans of small business corporations which have elected under subchapter S

The proposed changes in the treatment of qualified plans of small business corporations which have elected to be taxed under subchapter S obviously affects only a group of plans.

The House Ways and Means Committee Report on this proposed revision does not pretend to justify it either on the basis of correcting a tax inequity or as a measure intended to produce additional revenue. Rather, the proposed revision is advocated as a measure designed to limit the tax benefits available to employee-owners of small businesses.

Without attempting to argue the merits or demerits of subchapter S, or the social justification of penalizing the small businessman who has elected to be taxed under it, it is apparent that the proposed change in the tax treatment of subchapter S corporation plans will not penalize the owners of these small businesses but, rather, will penalize their employees.

Under the qualified plans of almost all small businesses, the benefits of employees are in direct proportion to those provided for the owners. If an owner's benefits under the plan are to be restricted, it is obvious that he is going to make similar cutbacks in the amount expended for his employees' benefits. Thus, while the owner's benefits may be limited, he will recapture most, if not all (or more) of the loss through reducing contributions on account of his employees.

One has only to examine the formulas being used and the very limited benefits being provided for regular employees under the Keogh Act plans of self-employed professionals (which are currently subject to restrictions similar to those proposed for subchapter S corporations) to know the truth of the foregoing statement.

It would appear that this proposed subchapter S revision was actually inserted in the Tax Reform Act as part of the Treasury Department's rear guard action against professional corporations. If so, we feel it should have been labeled as such and should have been limited to such professional corporations as do elect under subchapter S.

In its present form, the proposed revision would backfire against the benefits of thousands of regular employees of small business corporations who are presently covered under existing approved non-discriminatory qualified pension and profit sharing plans. Furthermore, it could create a precedent that might well be used as a justification for imposing a highly restrictive ceiling on the amounts which could be contributed for an employee's benefit under any private retirement plan.

JAMES B. ZISCHKE.

TAX REFORM ACT OF 1969

(As passed by the House of Representatives)

SUMMARY OF MAJOR CHANGES AFFECTING QUALIFIED PENSION AND PROFIT SHARING PLANS

PROPOSED CHANGES DIRECTLY AFFECTING QUALIFIED PLANS

I. *TAX TREATMENT OF "LUMP SUM" DISTRIBUTIONS* (Sec. 515 of the Bill and Secs. 402(a), 403(a) and 72(n) of the Internal Revenue Code)

Present law.—A distribution of an employee's entire Account under a qualified plan, to the extent exceeding any amounts actually contributed by the employee, if made within a single taxable year and as the result of the employee's separation from service or his death after separation, is treated as a long-term capital gain (i.e., one-half the distribution is taxed as ordinary income, subject to an overall maximum tax of 25%).

Proposed Law.—Under the proposed law, such "lump sum" distributions to the extent exceeding an employee's own contributions would be divided into two parts for tax purposes:

1. PART ONE—That portion of the distribution representing benefits accrued in plan years beginning prior to 1970, plus that portion in excess of the amounts of employer contributions made on the employee's account in plan year's beginning after 1969 would continue to be treated as a long-term capital gain (but without benefit of the maximum 25% "ceiling" on the overall tax, which, as noted later in this summary, would be removed under the proposed law).

2. PART TWO—That portion of the distribution representing employer contributions made for the employee's benefit in plan years beginning after 1969 would be subject to "special" ordinary income tax treatment under the following rules. (For purposes of these rules any forfeitures which had been reallocated to an employee in plan years beginning after 1969 would be considered to be employer contributions.)

(a) If the employee had participated in the Plan for less than 5 years at the date of distribution, the entire PART TWO amount would be ordinary income in the year of distribution.

(b) If the employee had participated in the Plan for 5 years or more at the date of distribution, the PART TWO amount would be taxed as follows:

(1) There would be an initial tax computed under the ⅕th averaging rule which presently applies to self-employed persons under H.R. 10 Plans (Keogh Act Plans). Under this rule, the employee would first compute the additional tax resulting from the addition of 20% of the PART TWO amount to his other taxable income in the year of distribution. The resulting additional tax would then be multiplied by 5 to determine the total tax payable in the year of distribution.

(2) At the end of the 4th year following the year of distribution, the employee would recompute the actual additional taxes he would have paid had 20% of the PART TWO amount been added to his other taxable income in the year of distribution and in each of the succeeding 4 years. If this tax proved to be less than the amount actually paid, the employee would be entitled to a refund in the amount of the difference. (A similar recomputation would be made in event of the employee's death within the 4-year period following the year of distribution.)

II. *SPECIAL REQUIREMENTS FOR QUALIFIED PLANS OF SUBCHAPTER S CORPORATIONS* (Sec. 541 of the Bill and Sec. 1379 of the Internal Revenue Code)

Present Law.—Under present law, no distinction is made between the qualified plans of small business corporations which have elected to be taxed under subchapter S and plans of other corporations.

Proposed Law.—Qualified Plans of small business corporations which for taxable years beginning after 1969 had elected to be taxed under subchapter S would be subject to the following special limitations:

1. Any employee participant who was also an owner directly or indirectly of 5% or more of the subchapter S corporation's stock would be required to report as current income that portion of any contributions to the Plan for his benefit which exceeded the lesser of 10% of his compensation from the corporation or $2,500.

2. Forfeitures under a stock bonus or profit sharing plan in any year during which a subchapter S election was in effect could not be used for the benefit of such shareholder employees.

3. A subchapter S corporation would not be permitted to utilize the 404(a)(3)(A) carry-forward for unused profit sharing deductions from a year in which a subchapter S election was in effect to a year in which such election had been terminated.

PROPOSED CHANGES INDIRECTLY AFFECTING QUALIFIED PLANS

1. Removal of 25% "ceiling" on capital gains tax for individuals.

Effect.—Would result in a higher tax on that portion of a "lump sum" distribution taxable as a capital gain in cases where an individual's top tax bracket exceeded 50%. Provision would apply to distributions made after July 25, 1969.

2. Allocable reduction in allowable deductions where tax preference income exceeds $10,000.

Effect.—The untaxed one-half of that portion of a "lump sum" distribution taxable as a capital gain would be considered tax preference income. While this would not result in any increase in tax on the amount distributed, to the extent that total tax preference income in a year exceeds $10,000, a portion of the employee's otherwise allowable income tax deductions would be disallowed. Thus, indirectly, a "lump sum" distribution would result in an increase in taxes to the extent of any disallowed deductions allocable to the distribution.

3. Minimum "throwback" tax on non-qualified plan deferred compensation payment exceeding $10,000 in any year.

Effect.—The potential increase in eventual taxes payable on that portion of any "non-qualified" deferred compensation in excess of $10,000 annually which was "earned" after 1969 would make deferred compensation accrued under qualified pension and profit sharing plans comparatively more attractive from a tax standpoint.

4. Fifty percent maximum tax rate on earned income.

Effect.—The proposed maximum 50% tax rate that would be applicable after 1969 to earned income means that highly-paid employees would pay a maximum tax of 50¢ on each $1.00 of compensation falling into brackets above 50% (instead of paying as much as 77¢ on the dollar under present tax rates, including surtax). Under the proposed reduced tax rate schedules, taxable earned income exceeding $76,000 annually (joint return) would benefit from this provision. While this change would, for highly-paid employees, reduce or eliminate the relative tax advantages of most forms of unqualified deferred compensation, it does not appear that it would, except in unusual circumstances, have any effect on the tax attractiveness of qualified plans.

PARSONS, TENNENT & ZEIDMAN,
Washington, D.C., October 7, 1969.

Re H.R. 13270—Section 516(c): Statement of position of International Franchise Association and request for clarification of deductibility of franchise fee by franchisee.

Hon. RUSSELL B. LONG,
Chairman, Committee on Finance,
U.S. Senate, Washington, D.C.

DEAR MR. CHAIRMAN: This firm and the firm of Rudnick and Wolfe of Chicago, Illinois, represent the International Franchise Association ("IFA"). The IFA is the trade association for the franchise industry. Its membership, which includes substantially every major company engaged in franchising, consists of approximately 250 members. A membership list is attached.[1]

The purpose of this letter is to state the position of the IFA with respect to Section 516(c) of H.R. 13270 (which adds Section 1252 to the I.R.C.) relating to transfers of franchises, and to request a clarification of the effect of proposed I.R.C. Section 1252 on the deductibility by a franchisee of the franchise fee which is required to be treated as ordinary income by the transferor of the franchise.

It is the opinion of the International Franchise Association that Section 516(c) is a sound addition to the Internal Revenue Code. In the overwhelming number of cases the transfer of a franchise by a franchisor to a franchisee contains more elements of a licensing relationship than of a sales relationship. Under prevailing doctrines of statutory and decisional trademark law, as well as for practical business considerations, franchisors must both retain control over and actually supervise the quality of the goods and services sold under the trademarks which they have licensed. A second threshold determination in ascribing the proper tax treatment to the transfer of franchises is whether the franchises are held for transfer in the ordinary course of the franchisor's business. While

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[1] The membership list was made a part of the official files of the committee.

the courts have not explored this question thoroughly, it is the judgment of IFA counsel that in most instances this question would be answered in the affirmative. Finally, in the opinion of IFA counsel, most franchisors (probably the overwhelming majority) have long recognized that the initial franchise fee paid by a franchisee does not represent gain on the sale of a capital asset and have accordingly treated such payments as ordinary income.

While Section 516(c) constitutes a sound clarification of the tax effect of the transfer of a franchise to the transferor, it is deficient insofar as it fails to clarify the tax effect to the transferee. Since the rules embodied in Section 516(c) have been characterized as simply a clarification of prevailing law (H. Rep. No. 91-431, Part 1, Page 164), it would seem appropriate that such clarification include the transferee of a franchise.

The House Committee on Ways and Means issued a press release on July 25, 1969 outlining the substance of certain of its tentative decisions on the subject of tax reform. With respect to the transfer of franchises, the Committee's press release stated (with emphasis added):

> "(10) It was tentatively decided that the transfer of a franchise (whether a lump sum or contingent payment) would be treated as giving rise to ordinary income (but subject to averaging in the case of lump-sum payments to individuals) unless the transferor of the franchise does not retain powers, rights or a continuing interest in the franchise. This rule would not be applicable to that part of the amount received as a result of a transfer of a franchise which is attributable to the sale of a patent (to which Section 1252 applies) or to the sale of trademarks or trade names, if these amounts are separately stated and identified and are reasonable in amount.
>
> "*In addition, it was tentatively decided that the person to whom the franchise is transferred (the franchisee) would be allowed to deduct the payments he makes for the franchise, where the amount received by the franchisor is treated as ordinary income under the tentative decision discussed above.*"

Section 516(c) is silent on the tax treatment to be afforded to the transferee of the franchise. Under a prevailing Revenue ruling (Rev. Rul. 66-140; 1966—1 C.B. 45) and case law (e.g. *Lawless*, TCM 1966-12) a fee paid for a franchise which does not have a readily ascertainable useful life is treated as a non-depreciable capital asset the cost of which must be recovered, if at all, upon subsequent transfer of the franchise. A franchise is regarded as not having a readily ascertainable useful life if it is perpetual or likely to be renewed. This doctrine has been applied whether the consideration for the franchise is a lump sum initial payment or a contingent payment determined by some measure of future usage (see letter of Michael Waris, Jr., to Honorable Russell B. Long, dated September 9, 1969 at page 231 of testimony received on September 16, 1969—hereinafter "Waris letter"). A recent case (*Hampton Pontiac*, U.S. District Court for South Carolina 1/10/69) illustrates a minor exception to this rule. In the *Hampton Pontiac* case the court permitted the franchise fee to be amortized over the life expectancy of the franchisee based on the fact that the franchise terminated at his death. Since a desirable franchise relationship affords the franchisee an opportunity to build a transferable equity in his business, the rule of *Hampton Pontiac* will be of little benefit to franchisees.

The rule presently applied by the Internal Revenue Service to transferees of franchises is in the judgment of the IFA both unrealistic and unfair. The rule requires that the franchise be treated as a nondepreciable capital expenditure. The only tax benefit that a franchisee can realize under this rule is an increased basis at the time he sells his business. It is clear that the franchise fee is a necessary cost of doing business and it is both unrealistic and unfair to treat it differently than other necessary costs. In the Waris letter, the writer points out the unsoundness of the rule as applied to a franchise fee in the form of contingent payment based on usage. This unsoundness applies equally to a lump sum initial fee. A variety of factors including cancellation or nonrenewal of the franchise may cause the franchise to decline in value, effectively converting a necessary expense of conducting business into a loss at a time when the franchisee has no offsetting income (a highly unfair result only partially offset by the loss carry back and carry forward rules). If the franchisee sells his business at a profit, the rule at issue serves merely to reduce his capital gain, whereas other necessary expenses of doing business have offset and reduced ordinary income during the period in which it was earned. The inherent unfairness of the rule

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comes into sharp focus when the rule is applied even where the franchise carries a definite term, if in the opinion of the Internal Revenue Service renewal is likely.

While parallel treatment of the transferor and transferee of a particular type of payment does not always occur under the Internal Revenue Code, it would seem that such treatment in this case does adequately protect the revenue. The IFA respectfully submits that fairness requires parallel tax treatment of the consideration paid for the transfer of a franchise.

In the Waris letter the writer suggests that lump sum initial payment for a franchise without a readily ascertainable life can be treated differently than a contingent payment based on future usage. However, in a footnote to his letter, Mr. Waris states:

"* * * This is not to say that the Code is perfect in this respect. To defer deduction of the lump sum cost of a purchased intangible until it is abandoned often results, for the same reasons as discussed above with respect to periodic production payments, in the loss of the deduction. A reasonable compromise might be to permit an amortization of such cost over some arbitrary period such as 120 months * * *."

Depreciation practice under the Internal Revenue Code is replete with instances in which capital goods are depreciated at a rate which bears little resemblance to the actual expiration of its useful life or its decline in value to the user. It would not therefore strain current tax practice to permit he amortization of a franchise fee over its initial term (irrespective of probability of renewal) if the initial term has a minimum life (say 60 months) or over an arbitrary period (say 60 months) where the franchise has a shorter duration or does not have an ascertainable term.

In summary, we urge that, in considering the tax treatment of the franchisor under Section 516(c), the Committee clarify the tax treatment of the franchisee consistent with the tentative decision of the Ways and Means Committee. Alternatively, a provision permitting amortization over the initial term or over a specified period would alleviate inequitable tax burdens. The broad and "grass roots" need for such clarification must be recognized. Franchising is rapidly becoming a marketing "way of life" in the United States. It affects a broad cross-section of the American small business community. Relief through parallel treatment or amortization is of paramount importance.

Respectfully submitted.

PARSONS, TENNENT & ZEIDMAN,
By PHILIP F. ZEIDMAN,
Washington Counsel, International Franchise Association.

HENRY H. FOWLER,
New York, N.Y., August 28, 1969.

Hon. RUSSELL LONG,
Chairman, Senate Finance Committee,
U.S. Senate, Washington, D.C.

DEAR CHAIRMAN LONG: I am submitting this letter as a Statement for inclusion in the record of the deliberations of the Senate Finance Committee on the proposed Tax Reform Act of 1969.

You and your colleagues have the highly important responsibility of reviewing and revising this bill as it passed the House of Representatives and working out any differences in Conference.

I have assessed my own responsibilities to comment as a private citizen (now a General Partner in the investment baking firm of Goldman, Sachs & Co.) and as the Undersecretary and Secretary of the Treasury from early 1961 through December 20th, 1968.

This letter is the result. My views as a private citizen on the subjects to be discussed are parallel to the views on these subjects I expressed as Undersecretary and Secretary of the Treasury as a review of my public statements during that period will attest.

There are a large number of provisions in the bill. *Many* of them reflect in whole or in part the Tax Reform Studies and Proposals of the U.S. Treasury Department, prepared during my term as Secretary by the Treasury Tax Policy Staff under the direction of Assistant Secretary Stanley Surrey, and published earlier this year (February 5th) for information only as a Joint Publication of the House Ways and Means Committee and the Senate Finance Com-

mittee. *Other* provisions have been added on the recommendation of the new Administration or on the initiative of the House Ways and Means Committee.

On all save *three* specific provisions I shall follow the course I did in the House proceedings; namely, refrain from comment, technical and otherwise, preferring to stand on my general Statement on the Tax Reform Program of the Treasury Department, dated December 11th, 1968, which appears in full on pages 3 through 9 of Part 1 of the published report referred to.

But I do feel impelled to speak out on three specific provisions of the proposed bill which (a) were not included as needed reforms in the old Treasury report referred to, and, (b) taken together, would reverse and undo salient features of a tax policy of vital importance to a viable economic system based on free private enterprise which tax policy was confirmed in the early sixties by the Congress on the recommendations of President Kennedy and President Johnson.

That policy, developed by the Treasury Department of those years in association with other parts of the Executive and Congress, was designed to safeguard and promote adequate private investment—as an essential ingredient in sustaining economic growth, increasing job opportunities in private enterprise in sufficient number and ever improving quality, providing a steadily rising standard of living, and keeping the U.S. economy competitive.

The three provisions referred to should be deleted because they are incompatible with the maintenance of a dynamic private sector in a free enterprise economy so long as the present and projected high tax rates on individual and corporate income persist. Moreover, they undo recently won advances toward a tax policy geared to sustained and non-inflationary economic growth and reasonably full employment in the private sector.

They would reverse a national policy as old as the nation and the federal tax system and as recent as the last major revision of our permanent tax structure in the 1960s—the placing of a high tax premium on the risk investment of savings or borrowed capital.

I refer to the provisions of the proposed bill which would (a) repeal the investment tax credit, (b) increase the rate of capital gains taxation by removing the maximum or alternative rate and (c) extend the period in which any investment must be held to qualify profits or losses therefrom as capital gains or losses.

In most of the advanced industrial countries in the Free World capital gains are not taxed. In these countries investment tax credits and special allowances are established features of their tax systems. They are considered fundamental to the national pursuit of non-inflationary growth and progress via increased production and productivity.

These policies, contrary to the proposed changes above, are supported in economies far more mixed than our own and far less dependent on private enterprise and investment. It would be ironic to downgrade or give a low order of priority to policies specifically designed to preserve the role of free private enterprise in a nation that has hitherto been an example of the success of that system.

Past Congresses have sought by these very features of the tax law now under attack to make our tax system compatible with a high rate of private investment. They should be preserved as long as that system is characterized by high tax rates on individual and corporate income.

The underlying policy common to these provisions under attack is simple—to maintain the vitality of a free private enterprise system dependent on large and continuing outlays of private capital.

Our national concern with the economy and the tax systems—except in periods of war—and as recently as the early sixties—has been the inadequacy of the tax system in preserving the opportunity and incentive for private investment.

A re-reading of the Tax and Economic Messages of the late President Kennedy in 1961–3 would raise seriously doubts concerning the wisdom of tax proposals admittedly designed to diminish the premium and pace of risk investment.

A primary thrust of these Messages, confirmed as national policy in the Revenue Acts of 1962 and 1964, was the promotion of adequate private investment—the freer and fuller flow of capital into productive effort.

In his last Tax Message of January 24th, 1963, President Kennedy provided the policy basis for the Tax Reduction Act of 1964 in these words:

> Despite the improvements resulting from last year's depreciation reform and investment credit—which I pledged two years ago would be only a first step—our tax system still siphons out of the private economy too large a share of personal and business purchasing power and reduces the

incentive for risk, investment and effort—thereby aborting our recoveries and stifling our national growth rate.

It seems unlikely that developments in the last few years of war, inflation, and rapidly expanding public expenditures have changed the truth and relevance of these words in his accompanying Economic Message of 1963:

> To raise the nation's capacity to produce—to expand the quantity, quality and variety of our output—we must not merely replace but continually expand, improve, modernize and rebuild our productive capital. That is, we must invest, and we must grow.

The meaning of these words is clear and unequivocal.

The nation does not need less capital and less private risk investment—it needs more.

It needs more private risk investment to provide more and better jobs which, in turn, increase total production and productivity, new products and services.

It needs more private risk investment to provide opportunities for all our citizens and to increase the standard of living for all.

What is the applicability of President Kennedy's pronouncement to the three provisions of the present bill?

Simply, that it would be a serious mistake to change our tax laws so as to discourage individual savers and corporations from investing for profit in private enterprise. By putting their savings and capital to work through risk investment, these individuals and corporations make our system a viable one.

We should never, in logic or by inference, subscribe to the proposition that a substantial tax premium for risking hard earned savings or borrowed capital in useful enterprise is a tax loophole or inequity.

This discussion is not addressed to policies that were formulated decades ago and have outlived their usefulness.

In 1962 Congress solemnly adopted as a permanent structural change in our economic and tax system a principle that was the investment tax credit. It provided that all those who invested earnings, borrowed money or equity capital in new machinery and equipment for business use should receive an investment tax credit for a percentage of that investment.

A vast majority of the members of the U.S. Senate voted for that proposal in late 1962.

Were they wrong?

They did not think so in 1964 when they voted to strengthen and improve the original provision.

They did not think so in 1967 when another overwhelming majority voted to restore the investment credit which had been temporarily suspended to cool down an excessive capital goods boom.

Why did these Senators, most of whom are still members of the body, vote for the investment tax credit?

It was designed, adopted and has proven effective:

For encouraging the development of new and better quality job opportunities, new products, new services, and new processes for improving old ones.

For promoting competitive efficiency in our productive machinery on a scale practiced by the nations competing in our markets at home and abroad.

For increasing national productivity.

For enabling business to ffset, in some measure, the rising costs that would otherwise engulf the economy in a more serious cost push inflation than the one we now have.

An examination of the reasoning advanced for repealing the investment tax credit reveals only considerations of short term expediency. The rationale for the change is that the purposes the investment tax credit has served and is serving so well are not very important now and are not likely to become so again. So it is to be permanently revoked.

The role that the investment tax credit and a vigorous capital formation played in the U.S. economy the last six years and its potential for the long term future should not be so lightly dismissed.

Sober second thoughts should lead to a better answer to any of our current fiscal and monetary dilemmas than the permanent revocation of a device that has served the nation so well in the past and is sure to be needed more often than not in the future.

Now, to add a few comments on the other two proposals affecting capital gains directly.

The nation and the Congress have long recognized that realized increases in capital risked for at least six months should be taxed at only one half the rate on ordinary income, and, in no event, should exceed 25 percent for any taxpayer (except in wartime).

Can anyone doubt that the end result of combining in one bill provisions eliminating this ceiling on capital gains and doubling the holding period will be *less* private capital put at risk and *less* mobility of risk capital and its unrealized gains from relatively safe untaxed shelters to the new or dynamic enterprises that do not have established credit or earnings?

Are new and small businesses *more* or *less* likely to find equity financing that provides an opportunity for growth with these changes in the law?

Could so-called black capitalism thrive or flourish in the environment these new provisions would create except on the basis of government hand-out?

It is a striking paradox that the House bill *puts a ceiling* of 50 percent on the top marginal rate on earned income (a commendable action), while *eliminating the ceiling on* capital gains.

The two actions taken together are said to reduce the pressure to use tax shelters to convert ordinary income to capital gains from a 45 percent differential to 17½ percent.

Is it necessary to "throw out the baby with the bath"?

The way to prevent ordinary income from being converted to capital gains is to resist changes in law that have this effect. The other stated reason for eliminating the present ceiling on the taxation of capital gains is the variance with the progressive tax rate structure on ordinary income, permitting taxpayers with top marginal rates in excess of 50 percent in effect to include less than 50 percent of their capital gains into ordinary income.

In 1963 when President Kennedy sought to remedy this situation he sought a structural change that would do so but would *also* facilitate "our economic objectives". He recommended as the right approach to both objectives a *decrease* in the percentage of capital gains taxable for all taxpayers. The effect of this approach is to give the same character of progressivity to the taxation of capital gains as to ordinary income by *increasing* rather than decreasing the premium for risk investment.

President Kennedy recommended that the inclusion rate of capital gains into ordinary income be reduced from 50 percent to 30 percent which would have more than accomplished the restoration of progressivity to the taxation of capital gains.

In so doing he noted that:

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

It should be observed that at the same time President Kennedy sought a significant *reduction* in the tax rate on capital gains he also recommended extending the holding period to one year, some definitional changes to minimize the treatment of ordinary income as capital gains and the taxation of capital gains accruing at the time of gift or death.

But the important fact that he stressed was the interrelationship of liberalization of the tax treatment of true capital gains with equitable adjustments, saying:

> I, therefore, recommend the following changes, the *nature* of which *require* their consideration *as a unified package*, coupling *liberalization* of treatment with more sensible and equitable limitations.. (Emphasis ours.)

A bill which includes only a harsher treatment of capital gains in both the rate of taxation and the holding period is neither consonant with our "economic objectives" nor adequate as a tax reform measure in the capital gains area.

The wise course is to remove those provisions from the House bill unless and until a formula can be devised that "couples liberalization of treatment" of capital gains "with more sensible and equitable limitations."

In closing, may I stress the fact that the responsibility of the United States Senate and its Finance Committee to review and revise the bill before it is far greater than that which attended its deliberations on the Revenue Acts of 1962 and 1964. In those bills the objective was structural change to provide *both* a sound but dynamic long term growth economy and equity between taxpayers. In its generally commendable, indeed necessary, effort to make our tax system more equitable, the House bill, at least in the three particular sections noted, seems to sacrifice tax policies established to provide a sound but dynamic growth economy to considerations of equity which are non-existent or marginal.

The issue is simple.

Is the Senate and its Finance Committee sure that the policies these three provisions would destroy, so painfully forged in the past, have outlived their usefulness for the 1970s?

Has some miracle been forged in the fires of war in South Vietnam that has so altered our economic system as to solve permanently the problem diagnosed by President Kennedy as recently as 1963?

Are the words he uttered then already obsolete—not only for the years of war and its accompanying inflation but for the years of peace ahead?

> The chief problem confronting the economy in 1963 is its unrealized potential—slow growth, underinvestment, unused capacity and persistent unemployment. The result is lagging wage, salary and profit income, smaller take-home pay, insufficient productivity gains, inadequate federal revenues and persistent budget deficits.

Are all those risks so far behind us that we can jettison the tools and techniques we used to overcome them?

It would seem the better part of wisdom to answer these questions in the context of a more normal peacetime economy than at present.

Long range tax policies designed to safeguard long term private investment in a tax structure still characterized by high rates on income should be maintained unless the most compelling reasons of equity require that they be abandoned.

To determine now that they are no longer useful or desirable—at a time of oncoming reconversion from a sizeable military effort when a rigorous program of fiscal and monetary restraint has already lowered the trajectory of real growth from excess demand half-way to a recession is to compound cyclical with structural risks.

It is for these reasons and against this background I would hope that the Committee and the Senate will insist upon the deletion from the Tax Reform bill of the three provisions singled out for this discussion.

Respectfully yours,

HENRY H. FOWLER.

TESTIMONY OF HARRY V. LAMON, JR., ESQ., ATLANTA, GA.

SUMMARY

My testimony is limited to Sections 515 and 541 of H.R. 13270.

I. Section 515 of the Bill is based on a misinterpretation of the legislative history of the statutory predecessor of Code Section 402(a)(2). Mr. Isidore Goodman, Chief of the Internal Revenue Service Pension Trust Branch, makes this clear. Secondly, this approach had been previously suggested and rejected in 1942 and again in 1962 by the Congress. Thirdly, the rationale of this "reform" is based on errors of fact. Finally, the 27 years of capital gains treatment has caused thousands of employees to rely upon such favorable treatment upon retirement.

II. The Treasury has already requested this Committee to delete Section 541 of the House Bill. I urge the Committee to grant this request.

CREDENTIALS

Harry V. Lamon, Jr., a partner in the Atlanta law firm of Hansell, Post, Brandon & Dorsey is a member of the State Bar of Georgia and of the Atlanta, Federal and American Bar Associations, the Lawyers Club of Atlanta and the Atlanta Estate Planning Council. He is also a member of the Bar of the District of Columbia and of the Supreme Court of the United States. He is now serving as Chairman of the Section of Taxation of the State Bar of Georgia. He is an active member of the Continuing Legal Education and the Employee Benefits Committee of the Tax Section of the American Bar Association and is Chairman of the Sub-Committee on Professional Corporations of that A.B.A. Committee. He is also currently serving as a member of the Board of Trustees of the Southern Federal Tax Institute and the Emory Law School Alumni Association. He is a member of the Legal and Legislative Committee of the National Council of Profit-Sharing Industries and the Attorneys Committee of the National Foundation of Health, Welfare and Pension Plans.

Since January, 1960, he has been a Lecturer-in-law at the Emory University School of Law, teaching in the fields of corporation law, taxation, and business planning. He has also served as a frequent speaker for the Institute of Chartered

Life Underwriters of America, The National Foundation of Health, Welfare, and Pension Plans, The Institute of Continuing Legal Education in Georgia, the Georgia Society of Certified Public Accountants and many Estate Planning Councils throughout the country. He is the author of articles for *The Tax Lawyer*, *The Journal of Taxation*, the *Georgia State Bar Journal*, and *Taxation for Accountants*, on the subject of employee benefit plans.

TESTIMONY

Mr. Chairman, I want to thank you and the members of the Committee for the opportunity of presenting my views on the Tax Reform Bill of 1969, as passed by the House and which is now under review by this Committee.

I. On July 9, 1969, the Staff of the Joint Committee on Internal Revenue made its report to the House Ways and Means Committee. I will address myself to this Report because, in my opinion, it is the true "legislative" history behind the Bill passed by the House. I believe that any consideration of the House Bill without a detailed study of the Staff Report would, of necessity, be incomplete. It is my hope that by presenting my analysis of the Report may enable the Committee to draft tax reform legislation based on the insight and knowledge that can only come from having heard the other side of the argument on two crucial items of tax law.

The first item I will discuss is the suggestion of the Report that the Committee abolish the capital gains treatment of lump-sum distributions from qualified employee benefit plans. When an employee retires from the service of an employer who has instituted a qualified retirement plan which so permits, the employee may elect to receive a lump-sum distribution of his account. Under present law, such lump-sum distributions are taxed at long term capital gains rates.

The Staff of the Joint Committee in its Report maintains that such capital gains treatment is "an exception" to the general rule of taxation; and, secondly, that "the reason for this treatment is unclear." The thrust of both of these statements is to leave the impression that capital gains treatment was an aberration—a flaw in the system which should now be corrected. The Report goes on to cite "one authority" and a number of "commentators" allegedly supporting the Treasury position. Though the statements of these "commentators" are cited as authoritative, neither the identity nor the credentials of these "commentators" are presented in the Report.

I submit that the position of the Staff Report is both erroneous and misleading. Without a doubt the highest authority for the Internal Revenue Service and perhaps for the nation as a whole, on the issue of employee retirement plans is Mr. Isidore Goodman, Chief of the Pension Trust Branch of the National Office of the Internal Revenue Service. Though his official title is that of a Branch Chief, I would like to point out that his expertise is so highly respected in this field that he is the *only* representative of the Internal Revenue Service whose every word on qualified retirement plans is published by Prentice-Hall, Commerce Clearing House and every other significant income tax reporting service throughout the nation. Every specialist working in this field owns and relies on his copy of "Goodman On Qualified Pension And Profit-Sharing Plans" which is published in book form by Prentice-Hall.

Inside and outside the Internal Revenue Service, Mr. Goodman is *the* expert on qualified employee benefit plans. In a speech delivered at the semi-annual forum sponsored by the Federal Tax Institute of New England in Boston, Massachusetts, on April 24, 1965, he stated that:

> Pensions are usually limited replacements after retirement for compensation during an employee's working span. Profit-Sharing and stock bonus plans, however, provide for lump-sum payments. A total distribution in one taxable year, based on an accumulation over many years, would subject the distribution to a much higher rate than would apply if such distribution were included in gross income ratably over the years involved. *Hence, provision was made for an averaging device in the form of the capital gains treatment.* (emphasis supplied).

I have been in personal attendance at several appearances at which Mr. Goodman re-emphasized the above quoted statement. On one occasion, Mr. Goodman amplified upon that statement by explaining that when the capital gains treatment was first contemplated in 1942, there had been long and serious deliberation as to every other possible method of averaging income in order to avoid an inequitable "bunching of taxation" at the time of distribution. He clearly in-

dicated that the Internal Revenue Service's decision in 1942 *to support* the predecessor of present Section 402(a)(2) of the Internal Revenue Code of 1954 was based solely upon the deliberate and thoroughly reasoned conclusion that capital gains treatment was the *only* equitable manner of taxing lump-sum distributions. Rarely do we have the benefit of such an expert historical account as Mr. Goodman has supplied on this point.

As the Staff Report admits, capital gains treatment of lump-sum distributions has been sanctioned and relied upon for over 27 years. During all that time, Mr. Goodman has been the chief expert of the Internal Revenue Service and the nation on qualified retirement plans. For the 27 years since the capital gains tax treatment of lump-sum distributions was first established the taxation of lump-sum distributions was considered only fair and equitable. For 27 years, there was no question in the mind of any responsible official of the Internal Revenue Service but that this method of taxing lump-sum distributions represented proper taxation of deferred income. Now, without the benefit and scrutiny of public hearings in the House Committee action and without the opportunity of our Representatives' thorough examination of this Treasury proposal, the Treasury, through the medium of the Staff Report and the House Bill, is attempting to reverse its course and maintain that the original position was an aberration.

There is no question in my mind but that the elimination of the capital gains treatment of lump-sum distributions will be disastrous to the growth of pension and profit-sharing plans throughout the Nation. The averaging method suggested by the Staff Report had been pondered and rejected 27 years ago, in favor of the present system of capital gains treatment. Thousands of plans and tens of thousands of employees have relied upon the promise of capital gains treatment for distributions at age 65. Gentlemen, how do you look a retiree in the face and tell him that he must give up close to 40% of his pension in taxes? There is no sound reason of economics or revenue which requires this sudden change.

On the contrary, the Staff Report specifically sets out its purpose as something totally foreign to economics and revenue. Prentice-Hall reports that the Staff Report includes language such as the following:

> Another problem under present law is the difference in tax treatment between lump-sum distributions received under plans established for owner-employees . . . and from corporate pension and profit-sharing plans. Lump-sum distributions made available under an HR-10 Plan are presently subject to a five-year averaging provision. *This averaging provision . . . plus the fact that lump-sum distributions payable under the corporate plan are treated as a capital gain may be viewed as artificially encouraging professional employees to incorporate so as to receive the special corporate employee pension treatment.* (emphasis supplied)

In order to discourage a comparative handful of professional employees from incorporating (a right which professional employees have now won from the Treasury after 34 years of litigation) the Treasury is recommending denial of favorable tax treatment to the vast majority of non-professional employees. I submit to this Committee that such a reason for recommending legislation of this type has no basis in either economics or revenue. Clearly, as the language of the Report indicates, the *sole* purpose of this aspect of the House Bill is to "discourage" and discriminate against professional service corporations.

Undoubtedly you are aware of the fact that the professional service organization litigation has been going on since 1935. At first the Treasury sought to tax professional groups as corporations, even though they declared themselves to be partnerships. Then in 1954 with the *Kintner* case, "the cat peeped out of the fog" and professional groups began to desire to incorporate in order to establish centralized management, continuity of life, limited liability, and free transferability of interest. However, at this point the Treasury totally reversed its course and began to oppose the incorporation of professional groups.

Since 1954 and the *Kintner* case, the Treasury has lost each and every judicial test of its attempt to tax as partnerships all professional groups which adopted articles of incorporation or association under 47 state laws which have now been enacted. Now that the Treasury has finally conceded the field of battle on this front, through T.I.R. 1019, dated August 8, 1969, it is attempting by the strategem of this Bill, to achieve by legislation the result it could not achieve through and was denied by the courts.

Though it is certainly within the power and duty of the Treasury to recommend necessary legislative proposals to Congress, I do not believe that legislation

should be proposed *solely* to create, and in this instance to continue, illegal discrimination against professional groups forming corporations or associations under the proper state law. The Staff Report quite candidly admits that this is its aim. And in order to accomplish its goal it is not only misinterpreting and misleading the legislative and administrative history underlying the establishment of the capital gains treatment of lump-sum distributions for qualified plans, but is also willing to deny any favorable tax treatment to non-professional, rank and file employees as well.

In 1962 when H.R. 10 was actively before the Congress, a Senate amendment proposed exactly the same package of restrictive proposals to be tacked on to the Self-Employed Individual Tax Retirement Act of 1962. At that time, we brought to the attention of Senator Talmadge and Senator Smathers, as members of this Committee, the devastation which would be wrought in the employee benefit field if some positive benefits could not be assured to the owner-employees of these businesses. Both Senator Talmadge and Senator Smathers worked actively on this matter and were successful in removing these restrictions from the act and the HR–10 Legislation was passed in November of 1962 without these appendages.

Former Commissioner of Internal Revenue, Mortimer M. Caplan, in an article reprinted in The Readers Digest of this month, September, 1969, offers his suggestions for meaningful tax reform. It is significant to note that almost every item indicated by the former Commissioner as being a meaningful tax reform is already included in the Tax Reform Bill as passed by the House. It is even more significant to note that the two items to which I am addressing myself today were not considered as being "meaningful" tax reform items by the former Commissioner. These items are: capital gains treatment for lump-sum distributions from qualified plans and the restrictive provisions of Subchapter "S" small business corporation as applicable to qualified employee benefit plans. Though Mr. Caplan is no longer a spokesman for either the Service or the Treasury, he was without a doubt one of the authors of the Treasury proposals which eventually became the Bill passed by the House. And, in his analysis of "meaningful" tax reform, neither of these two items is considered a meaningful reform. I could not ask for a more "meaningful" endorsement of my testimony.

There has been a suggestion that the rationale for the elimination of the capital gains treatment on lump-sum distributions from qualified plans goes something like this: Since capital gains treatment only favors the employees in the higher tax bracket and since it is only elected by employees in the higher tax brackets and since the employees in the higher tax brackets are usually the stockholders or officers of the corporation, therefore the use of the capital gains treatment on lump-sum distributions is another "loop hole" in the tax laws which must be plugged.

The errors in this reasoning are all errors of fact, not errors of logic. First, it is a fact that most, if not all, highly compensated employees, officers, and shareholders of significant amounts of stock in the corporation, who have adequate tax counsel to advise them, will refuse to take a lump-sum distribution from the qualified plan because they truly appreciate the significance of leaving their money in tax shelter. It is the lower and middle income employee who has never seen more than maybe $5,000 or $6,000 at one time who is enticed by the promise of capital gains to withdraw his $15,000 or $20,000 pension in one lump-sum and either go into business for himself or purchase the retirement house of his dreams with his 20 or more years of contributions. The Bill's provision is obviously aimed at the first group of employees, but as a matter of fact will affect only the second—the lower and middle income employees who actually do elect lump-sum distributions.

Finally, I would also like to point out that no one, not even the Internal Revenue Service, can tell this Committee how many profit-sharing plans are in existence today which permit *only* a lump-sum distribution. Yet, there is no provision in the House Bill which would deal with the inequitable position the enactment of this provision would bring about.

Mr. Chairman, members of the Committee, I respectfully request that you give very serious consideration to the errors in fact upon which are based both the Staff Report and the House Bill and that as a result of this consideration you will decide to recommend to the Congress that the 27 year history of capital gains on lump-sum distributions from qualified plans should not be disturbed.

II. The second crucial item of tax law to which I wish to address myself is the alleged "relaxation and simplification of the rules affecting Subchapter 'S' small business corporations" in the area of employee profit plans.

In this regard, I would like to draw the attention of the Committee to a report of the Prentice-Hall Tax Service dated September 12 and September 18, 1969 in which that Service indicates that:

> The Treasury has indicated it doesn't want Congress to place any additional limitations on Subchapter S 'without making . . . liberalizing changes . . .' As we told you last week, the Assistant Secretary of the Treasury for Tax Policy asked the Senate Finance Committee to delete from the tax reform bill the proposed limitation on Subchapter S retirement plans.

Unfortunately, I have been unable to obtain a copy of the text of the statement of the Assistant Secretary to this Committee. I sincerely hope that the report of the Prentice-Hall Service is accurate and that this Committee has decided or will decide to honor this request. However, in the event that my testimony can be of any assistance to this Committee and also to acquaint the Committee with the discrimination being practiced by the Treasury against small business corporations by these proposals, I ask your indulgence and permission to present the following statements.

In both the introduction and the body of the Treasury proposals the goal is stated as being the "relaxation and simplification of the rules affecting Subcapter 'S' small business corporations." I fail to see how the proposals enunciated in Part XV relating to Employee Benefit Plans either relax or simplify the existing rules affecting Subchapter "S" small business corporations.

Paragraph (i) of Item 6.B entitled "Pensions" would apply the detailed and complex stock attribution rules of Secton 318(a)(1) of the Code in determining whether a person participating under a qualified Pension Plan owns 10% or more of the outstanding stock of the Company. None of the various Code Stock attribution Sections, much less the most complex of all, Section 318 has ever been applied in the area of qualified plans established under Section 401 of the Code. In fact though the Treasury at one time had a published ruling which enunciated some form of stock attribution rules, this old ruling has been reserved by the Treasury itself and superseded in I.T. 4020 (1950-2 C.B. 61). The application of such a rule could hardly be interpreted as "relaxing" the rules affecting Subchapter "S" small business corporations.

This same paragraph requires that if an employee, by means of attribution owns 10% of the outstanding stock of his company the amount of any contribution on his behalf exceeding "the lesser of 10% or $2,500.00 of his earned income" is includable in the employee's gross income for the year in which the contribution is made. At present, there is no such limitation for corporate employees. The adoption of this proposal would severaly restrict the amounts which could be contributed on behalf of such employees and consequently reduce the benefits available to such employees upon their retirement. I would like to point out that a similar restriction in HR-10 succeeded in limiting the amount the employer actually contributed to his plan on behalf of all his other employees. Thus, if an owner-employee because of his high income contributed no more than 5% or 6% of his salary into an HR-10 Plan he almost always limited his maximum contribution on behalf of his other employees to this low amount. Whereas an employer may have been willing to contribute up to 15% of compensation for all of his employees where he could also have this benefit, *because* his contribution was limited to less than 10% of his compensation, he automatically decreased the amount he otherwise would have contributed for his employees.

This requirement is an attempt to begin to apply the present HR-10 Regulations to corporate employees of a Subchapter "S" small business corporation. No specific statement is made as to whether such an "excess contribution" would be deductible to the corporation. There is no question but that the regulations and procedures under HR-10 are much more stringent and complex than those under regular corporate type plans. Therefore, I submit that the application of HR-10 rules and regulations to corporate employees of Subchapter "S" corporations does not "relax and simplify" the rules affecting Subchapter "S" small business corporations, but makes these rules much more complex and stringent.

The House proposals also call for a definite contribution formula for all profit-sharing plans established by such Subchapter "S" corporations. As you well remember, this was the original position of the Internal Revenue Service back in the 1940's and the early 1950's. In the 1950's Treasury reversed its course and publicly announced that indefinite contribution formula profit-sharing plans were well within the meaning of Section 401 of the Code. The present proposals again reverse this position and require the much stricter definite contribution formula which is required under the HR-10 regulations. This is another example

of the encroachment of HR-10 regulations on corporate plan benefits and clearly a tightening of the statute rather than a relaxation of it.

The proposals also call for a provision that forfeitures must reduce employer contributions even though a profit-sharing plan is involved. This is in direct contradiction to the published position of the Service in Revenue Ruling 69-421 which specifies that forfeitures may be reallocated in any manner that is nondiscriminatory. It is extremely significant to note that on the one hand the Treasury is arguing that the forfeitures must reduce employer contributions and is requesting legislation to that effect and yet *after* these Treasury proposals have been submitted to the House, the Internal Revenue Service publishes Revenue Ruling 69-421 which specifies that there is nothing inherently discriminatory in a reallocation of forfeitures among plan participants. Such a requirement by the Treasury would again reverse its previous position. The adoption of this proposal would eliminate any application of forfeitures other than the method provided in the statute. However, this is hardly a relaxation of the present rules affecting Subchapter "S" small business corporations since at present the employer has great flexibility and liberal methods of reallocation of forfeitures under Revenue Ruling 69-421.

The Treasury proposal defines the term "Earned Income" in a manner that is different from the present technical definition of this term in Section 401(c)(2) of the Code. The adoption of this proposal would lead to two technical meanings being applied to the same term. The only result of such a measure would be total confusion in this already hyper-technical area.

The Code under Section 404 specifically provides for credit carry-overs under plans covering corporate employees. The Treasury proposal would allow larger corporations to make use of such carry-overs but would remove these credit carry-overs and deny the Subchapter "S" small business corporation the same benefits.

The above sentence clearly summarizes my main objection to these Treasury proposals, namely, that these proposals are an attempt by the Treasury to discriminate between corporations solely on the basis of their size. In fact, as I see it, the entire proposal can be boiled down to the maxim that "bigness is goodness". I, for one, cannot subscribe to this type of discrimination. The size of the corporation should make no difference in the tax treatment of a bona fide corporation and in the benefits available to all corporations under the Code. In my view, to allow the larger corporations all the benefits accruing to a qualified corporate plan under Section 401 of the Code and to deny these same benefits applying the more stringent and restrictive rules of HR-10 to corporate employees of Subchapter "S" small business corporations is nothing short of discrimination based on the size of the corporate entity involved.

In conclusion on this point, I would respectfully request the Committee to grant the Treasury's request that it delete from the House Bill the proposed limitation on Subchapter "S" Retirement Plans.

Gentlemen, I wish to thank you again for providing me with this opportunity and giving me so much of your valuable time. I only hope that some of the comments I have made can be of assistance to you in the difficult task of drafting the necessary but yet equitable tax reform legislation.

KRUGLIAK, WILKINS, GRIFFITHS & DOUGHERTY,
Canton, Ohio, August 29, 1969.

Hon. WILLIAM B. SAXBE,
New Senate Office Building,
Washington, D.C.

DEAR BILL: Your Administrative Assistant, William Hoiles and I recently discussed on the telephone in some detail, the "Tax Reform Bill of 1969" which recently passed the House and will be considered by the Senate in the near future. Bill felt that it would be best if I were to explain my view of the problem, created by the language of the bill as proposed, in a letter addressed to you. This would allow you, if you concur, to bring this matter to the attention of those legislative committees of the Senate which will be considering this bill.

The problem we discussed arises out of Section 511 of the proposed bill, which is entitled "Repeal of Alternative Capital Gains Tax For Individuals." As you know at the present time there is a 25% limitation on the tax rate with respect to net long term capital gains of taxpayers other than corporations. The Tax Reform Bill seeks to repeal this 25% limit so that a non-corporate taxpayer's net

long term capital gains will be subject to tax at a rate which is one-half of his marginal tax rate. In most cases this will exceed 25% and in the case I refer to below it will reach 35% plus the 10% surcharge. I do not happen to agree with the "soak the rich" tenor of the whole bill nor with the tentative elimination of the 25% limitation on the capital gains.

When one sells all the stock of a company, the agreed price contains an element which corresponds to cost of reproduction of the fixed assets of the company. If the price therefore exceeds the original cost of a building it does not represent a gain to the seller but the recognition of the fact that the seller would have to spend this much money to obtain an asset of the same value as he just sold. To this extent the capital "gain" tax therefore does not tax any gain but part of the capital itself away which was not the intent of the law. However, I do not want to belabor this point. It will probably be decided on the strength of broad social, economic and fiscal policy, and I am perfectly willing to leave that to your sound judgment.

I do want to address myself to the precipitous haste in which this section would become effective and the unwarranted hardships an indiscriminating use of such an early date would create. In the form in which the Legislation passed the House it is proposed that this amendment apply to sales and other dispositions after July 25, 1969. This narrower problem of implementation of the law is one of legislative propriety and fairness. We are to operate according to the law of the land, make our decisions based on these laws and are not to be subjected to retroactive laws. I assume that the use of this effective date was based on the fact that Chairman Mills of the House Committee issued a press release on July 25, 1969 announcing for the first time, the intention of the committee with respect to this provision. The committee wanted to avoid by the choice of this date a wave of selling of shares on the stock exchanges which would have rocked the already wobbly market substantially and would have allowed alert speculators to escape the intended higher tax rate.

The broad sweep of the language however goes far beyond this intent and as presently written it could be used by the Treasury in an effort to cover a transaction in which we were recently involved.

In this case the stock which was sold was all the stock of a closely held corporation, which was not being traded on any exchange. The written agreement to sell all of the stock the company was entered into on July 8, 1969, and contained a sales price fixed by the stockholders to yield an after tax return for the efforts of many years of hard work in building this enterprise. The fixed sales figure was set on the basis of the tax rates in effect at the time of the agreement. This written agreement included the usual provisions in this type of a transaction involving closely held stock wherein the seller had to provide certain schedules and other information to the buyer by a given date to support the accuracy of representations made and the buyer had the opportunity to check the information submitted. All representations by the stockholders were properly satisfied by this date: July 15, 1969. The official closing of the transaction was set for July 31, 1969 and actually took place on that date. As far as the sellers were concerned they had effectively sold all of their stock on the date on which the agreement was signed, July 8. The sellers were contractually compelled to turn over their shares for a set price which could not be raised in the least on the basis of a very respectible profit report which the company issued in the interim, nor changed upward to compensate for a loss to the seller if a portion of a proposed Tax Reform Bill suggested in a press release of the Chairman of the House Ways and Means Committee, became law.

If the sellers could not gain from any profit of their company shown in the period between July 8, the date of the signing of the agreement, and July 31, the official closing date, they should not be put in jeopardy by a law passed later on August 2nd by the House, and made effective retroactively to July 25th.

The present language would penalize unfairly those whose "capital gains" were the result of years of industry and growth, gains of the type that the capital gains provisions were originally intended to foster.

To allow the new law to apply to such transactions would be contrary both to proper legislative practice and to reasonable legislative intent. The choice of the July 25th date was to avoid wild speculation, not to trap people engaged in long range binding commitments. This would be in contravention of basic principles of legislative action which stress the prospective nature of enactments and abhor "expost facto" law. To prevent this type of application would be to chip away at the certainty and predictability upon which a sound legal system must be based.

My request is that in the consideration of this legislation, if the Senate should see fit to repeal the alternative capital gains tax, it should provide for equitable treatment in the case of sales of closely held stock so that the effect of the legislation will not be retroactive.

It would be difficult to prune away away this unintended excess while leaving the basic scheme untouched. A provision analogous to the "binding contracts" clause limiting the suspension of the investment credit could be drafted so that individuals who had entered into a binding contract to sell before July 25 might honor their contracts without penalty.

A simpler and perhaps fairer solution is also possible, although its desirability might depend on a factual determination. If it were felt that the original House provision had had the "in terrorem" effect intended (so that the shrewd speculators did not rush to sell in order to benefit from the last traces of the alternative tax), the effective date of the exchange could be moved up to correspond either to final Congressional approval or to the next taxable year, thus protecting those who sold after July 25 as a result of necessity.

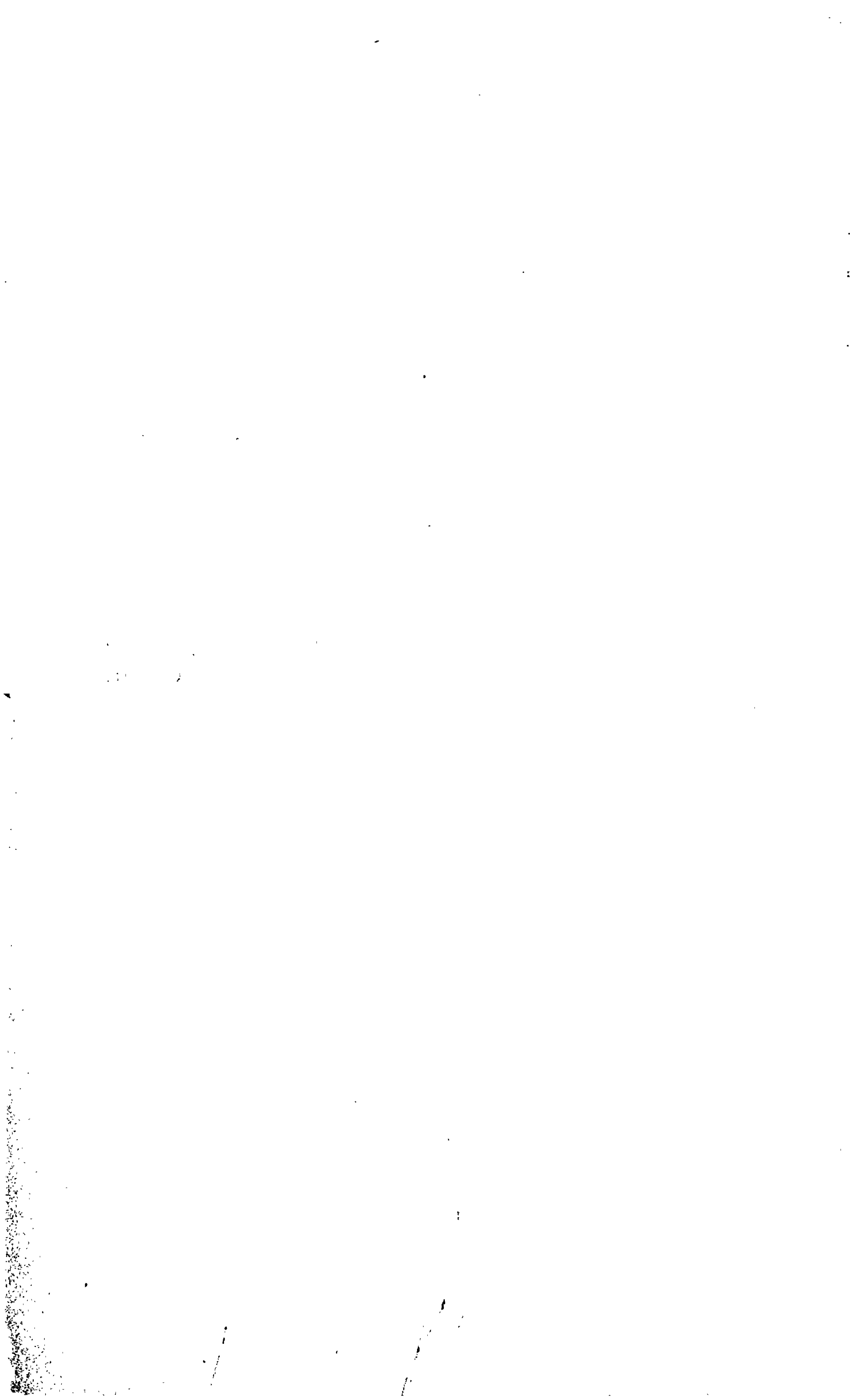
I discussed this matter in some great detail with Bill Hoiles and he probably will fill you in on our discussions. I will be glad to give you any further information you might want in this respect and I will appreciate hearing from you at your convenience.

Very truly yours,

SAMUEL KRUGLIAK.

APPENDIX C

WRITTEN TESTIMONY RECEIVED BY THE COMMITTEE EXPRESSING AN INTEREST IN THE SUBJECT OF RESTRICTED STOCK



Written Testimony Received by the Committee Expressing an Interest in the Subject of Restricted Stock

SOUTHERN NATURAL GAS COMPANY,
Birmingham, Ala., September 10, 1969.

Re section I(10) (restricted stock) of press release concerning public hearings on the subject of tax reform.

Hon. RUSSELL B. LONG,
Chairman, Committee on Finance,
U. S. Senate,
Washington, D.C.

DEAR SIR: This written statement is submitted by Southern Natural Gas Company ("Southern") of Birmingham, Alabama, on the question of whether the present tax treatment of restricted stock plans should be modified.

I. STATEMENT OF SOUTHERN'S POSITION

We believe that there are many sound reasons, of significance to Southern and to other industries in the South and the nation, for the preservation of the tax consequences and benefits of restricted stock plans under which a company can permit its employees to purchase its stock subject to reasonable restrictions. Therefore, we support the present tax treatment afforded by existing Regulations to our restricted stock plan whereby only our own common stock is distributed to our employees. We oppose the modification of such tax treatment as proposed in H.R. 13270.

If, however, the Committee sees fit to adopt such proposals or any similar changes, we respectfully urge that such amendments should not apply to plans adopted, approved and put into effect prior to the date such amendments were originally proposed. We are opposed to a cut-off date of Februtry 1, 1970, as proposed in H.R. 13270, and urge that the phase-out period for restricted stock plans permit all prior plans to continue for a reasonable phase-out period such as, in Southern's case, four more years.

II. SUMMARY SHEET

I. Statement of Southern's position.
II. Summary sheet.
III. Analysis of Southern's plan.
- A. Brief description of Southern.
- B. Brief description of Southern's restricted stock plan.
- C. The Internal Revenue Service issued a private ruling in favor of Southern's plan.
- D. Southern's Plan serves a genuinely useful economic and social purpose.

IV. The committee should find that changes in the present tax treatment of restricted stock plans are not justified.
- A. Under existing law, the amount of tax involved is clearly related to the taxable event.
- B. Comparison of restricted stock plans to nonexempt trusts is misleading.
- C. Modification of present tax treatment will not result in increased tax revenues to the Government.
- D. Southern's employees should not be penalized or punished for any abuses resulting from the plans of others.

V. Southern supports the present tax treatment of its plan and opposes modification of such tax treatment.
- A. Present tax treatment should be continued.
- B. The effects of changes as proposed in H.R. 13270 are undesirable.

VI. Adoption of any modifications should not be made retroactive.
VII. Conclusion.

III. Analysis of Southern's Plan

A. Brief description of Southern

Southern is a publicly-held natural gas company engaged in the production and purchase of natural gas and in the operation of an interstate natural gas pipeline system throughout the Southeast.

B. Brief description of Southern's restricted stock plan

Pursuant to, and in strict accordance with, existing Regulations 1.61–2(d)(5) and 1.421–6(d)(2) of the Treasury Department, Southern on May 1, 1968, by action of its stockholders, has adopted a restricted stock plan under which certain employees of Southern have purchased, and employees designated from time to time during the next four years by the Board of Directors may purchase, Southern's stock subject to restrictions provided in the Plan.

Under Southern's Plan, the Company's Board of Directors may issue, to employees designated by the Board, the right to be exercised *within 60 days* after the date of grant, to *purchase* stock subject to restrictions which prevent the employee from selling, transferring or otherwise disposing of it and which under certain circumstances require the employee to resell the stock to Southern at the purchase price.

Such restrictions remain fully in effect for one year after the employee purchases the stock, and then gradually lapse over the ensuing eight years. Thus, in effect, Southern's Plan is not an "option" plan in the usual sense.

C. *The Internal Revenue Service issued a private ruling in favor of Southern's plan*

So that Southern's Board of Directors, stockholders, management and optionees would be completely secure in their understanding of the tax status of Southern's Plan, Southern's attorneys requested a ruling from the Internal Revenue Service concerning the tax consequences to Southern and its participating employees under its Plan.

On April 29, 1968, the Service issued a Private Ruling to Southern stating, in pertinent part, that:

"*After carefully considering the plan presented, we conclude that* if the stock is transferred strictly in accordance with the provisions of the plan:

"1. *An employee will realize compensation at the time the restrictions on the shares lapse* or the shares are disposed of by the employee in an arm's length transaction (whichever event occurs first), *in an amount equal to the lesser of:*

"(i) *The difference between the purchase price and the fair market value* of the shares (determined without regard to the restrictions) *at the time of purchase* by the employee, *or,*

> "(i) *The difference between the purchase price and the fair market value* of the shares (determined without regard tothe restrictions) *at the time of purchase* by the employee, *or,*
>
> "(ii) *the difference between the purchase price and the fair market value* of the shares (determined without regard to the restrictions) *at the time the restrictions lapse* or, in the case of earlier disposition, the consideration received on disposition." (Emphasis added.)

On the basis of and in reliance on such Ruling, Southern put its Plan into effect and represented to its employees that such Plan would continue until 1973.

D. Southern's plan serves a genuinely useful economic and social purpose

Southern believes that its Plan, with tax consequences under present law as stated in the Ruling of the Internal Revenue Service, achieves certain very specific, and undeniably valuable and valid, obje tives. First, it assists Southern in attracting and keeping qualified management-level people in our Company and in our geographical area. Second, it enables Southern's key personnel to acquire a substantial proprietary interest in our Company. This will motivate them to increase their efforts to cause earnings to grow—which will benefit not only our stockholders, but also our community and the entire Southeast. And, finally, a major feature of Southern's Plan compels a participant to retain his stock for at least nine years if he wants to realize its full benefit. This will result in maximum effort for our Company and community for a significant period of time.

IV. The Committee Should Find That Changes in the Present Tax Treatment of Restricted Stock Plans Are Not Justified

A. Under existing law, the amount of tax involved is clearly related to the taxable event

In analyzing the tax consequences which should result from the issuance of restricted stock to employees, there are two elements to be considered:

1. The occurrence of a taxable event—that is, receipt by the employee of an item of property constituting intended compensation to him; and
2. The occurrence of events which permit the valuation for tax purposes of that compensation.

Upon the sale or distribution to an employee of restricted stock, he has received property intended as compensation. However, because of the restrictions, which in Southern's case include a requirement of continued employment which would constitute "a substantial risk of forfeiture," it is not possible to determine the fair value of such property to the employee and the amount of the intended compensation. Such determination must await the lapse of the restrictions, or at lease the lapse of substantial restrictions such as the requirement of continued employment. When this occurs, under present law, the amount of compensation is determined and tax is imposed, but the amount of such compensation and tax is related back to the occurrence of the taxable event—that is, the receipt by the employee of the restricted stock. On the other hand, Section 321 of H.R. 13270 would determine the amount of compensation and tax solely on the basis of the value of the stock at the time when no substantial restrictions remain. In the case of a plan such as Southern's, where substantial restrictions amounting to a risk of forfeiture continue with respect to some stock for as much as nine years, we submit that the result achieved by existing Regulation Section 1.421-6(d)(2), and by the Private Ruling issued to Southern, is reasonable and proper, and is a more equitable treatment than that proposed by H.R. 13270.

The inequity of the House proposal is apparent when it is applied to a plan such as Southern's which requires the employee to make a substantial cash investment in the restricted stock at the time it is issued to him. If the stock has appreciated in value on the subsequent date when it is no longer subject to a substantial risk of forfeiture, then under the House proposal the entire difference between its fair market value at such time and the amount invested by the employee will be treated as compensation and taxed as ordinary income. A portion of this appreciation, however, would represent an increase in value of the cash investment by the employee. As such, it clearly is not compensation and is entitled to be taxed as capital gain.

B. Comparison of restricted stock plans to non-exempt trusts is misleading

The Report of the House Committee on Ways and Means (Rept. 91-413, Part 1, p. 86) and the Staff Summary of H.R. 13270 (Committee Print, p. 51) undertake to justify the House proposal by comparing the issuance of stock to a non-exempt employees' trust and the issuance of restricted stock to an employee. The result stated when stock is issued to a non-exempt trust—that is, receipt by the employee of taxable compensation at the time of the transfer—occurs *only* if the interest of the employee is non-forfeitable at the time the contribution is made—that is, if there is no contingency which may cause the employee to lose his rights in the contribution (Internal Revenue Code Section 402(b); Regulations Section 1.402 (b)-1(a)(2)(i)). The House Report states that if stock is transferred to a non-exempt employees' trust and the employee will receive the stock at the end of five years if he is alive at that time, then the employee would be taxed on the value of the stock at the time of transfer.

This statement is apparently based on the provision in Regulations Section 1.402(b)-1(a)(2)(iii) that the mere fact that an employee may not live to the retirement date does not make his beneficial interest in contributions by the employer forfeitable. In its context, however, this statement in the Regulations has reference to a plan for pension or annuity payments, the duration and aggregate amount of which would be related to the life of the employee. It is questionable whether this provision would apply to the transfer of stock to a trust for delivery to an employee at the end of five years if he is alive at that time. Such a condition would appear to make the interest of the employee in such stock forfeitable under the statutory language of Internal Revenue Code Section 402(b).

The House Report also states that an employee with restricted stock can vote it and receive the dividends, while an employee-beneficiary of a non-exempt trust does not have these benefits. This is misleading, since in the latter situation

the trustee of the trust would presumably be entitled to these benefits on behalf of the employee as beneficiary, so that he has them indirectly.

If the present treatment of restricted stock and non-exempt employees' trust is to be compared, it is interesting to note that Regulations Section 1.402(b)-1 (a) (1) provides that if the employee's interest in a contribution to a non-exempt trust is forfeitable at the time the contribution is made, the amount of such contribution is *not* required to be included in the income of the employee at the later time when his interest becomes non-forfeitable. This contrasts with the treatment under present law of restricted stock plans like that of Southern, whereby the employee recognizes no income at the time the restricted stock is purchased, since it is "forfeitable" at that time, but is required to recognize income and pay tax at the later time when the restrictions lapse and his interest becomes non-forfeitable.

In any event, the transfer of stock to a non-exempt trust under the conditions stated in the House Report would be unusual. Likewise, the issuance of stock to an employee subject only to the restriction that it cannot be sold for five years differs substantially from a plan such as Southern's that contains a number of restrictions, including the requirement of continued employment. We submit that this example contained in the House Report is of questionable value and certainly does not justify the drastic change from present law that H.R. 13270 proposes.

C. Modification of present tax treatment will not result in increased tax revenues to the Government

We believe it is especially noteworthy that there has been no suggestion that the existing Regulations are resulting in any significant revenue loss to the Treasury Department or, conversely, that any new law will result in any significant increase in revenues. For example, your Committee's Print entitled "Summary of H.R. 13270, The Tax Reform Act of 1969," explaining arguments for the proposed amendments in H.R. 13270 does not contain the slightest hint along these lines (p. 52). In fact, one argument *against* H.R. 13270 is that "there is no real benefit accruing from making a change" since little revenue is involved (p. 52).

Actually, any change in the existing statutes or Regulations may have an adverse effect on the revenue. For example, if a corporate employer in the 48% tax bracket were to transfer 1,000 shares of its common stock, subject to restrictions which imposed a substantial risk of forfeiture, to an employee having taxable income of $20,000 (exclusive of the stock plan) at a time when the stock is worth $10 per share and—after the restrictions lapse five years hence—the employee were to sell the stock at its then value of $40 per share, the result on pre-surtax revenue to the Government would be:

1. Under existing law—Employee would pay additional taxes of $9,040:

	Taxable income	Individual's tax	Additional tax
Year risk of forfeiture terminates:			
Excluding stock	$20,000	$4,380	
Including stock	30,000	7,880	$3,500
Year of sale	35,000	9,920	5,540
Total			9,040

Corporation's tax reduction would be $4,800 (48% of $10,000).

Net revenue to the Government—a $4,240 gain ($9,040 minus $4,800).

2. Under a change compelling employee's tax to be based on market value when the risk of forfeiture terminates—employee would pay additional taxes of $17,920:

	Taxable income	Individual's tax	Additional tax
Year risk of forfeiture terminates:			
Excluding stock	$20,000	$4,380	
Including stock	60,000	22,300	$17,920
Year of sale (sale price and tax basis are same)	20,900	4,380	
Total			17,920

Corporation's tax reduction would be $19,200 (48% of $40,000).

Net revenue to the Government—a $1,280 less ($19,200 minus $17,920).

Thus, a change in the law based on the assumptions set forth above would result in a loss of net revenue to the Government of $5,520 ($4,240—the net revenue gain to the Government as shown above—plus $1,280—net revenue loss to the Government as shown above). And if the employee's taxable income before the stock plan were $200,000 or more, the difference in loss of net revenue to the Government would be less pronounced but would still amount to $900.

We recognize that the tax consequences of any participation by an employee in a given restricted stock plan will vary according to the circumstances of such employee's financial situation and the facts surrounding the purchase and sale of the restricted stock. We have used 32% and 70% tax bracket examples in this written statement in order to better illustrate for you and the members of the Committee the fact that mathematical results will flow from any modification of the present tax treatment of restricted stock plans and the further fact that such mathematical results almost always have an adverse effect upon the Government's revenues. Therefore, we submit that the suggested change or modification in the present tax treatment of restricted stock plans is solely for the sake of change (See Committee Print, *supra*, p. 52).

D. Southern's employees should not be penalized or punished for any abuses resulting from the plans of others

Southern's employees should not be penalized or punished for abuses—if abuses there be—by other companies which have adopted peculiar or undesirable plans or plans whereby property other than the employer's own common stock is distributed. We suggest that your Committee leave unchanged those portions of the tax laws which permit tax benefits to restricted stock plans whereby a company sells merely its own common stock subject to reasonable restrictions which adhere to all present applicable laws. Adoption of this suggestion will permit control of abuses without interfering with plans, such as ours, to which no taint of abuse attaches.

V. Southern Supports the Present Tax Treatment of its Plan and Opposes Modification of Such Tax Treatment

A. Present tax treatment should be continued

As the Committee knows (Committee Print, pp. 51–52), present law does not contain any specific rules governing the tax treatment of restricted stock plans. However, Treasury Regulation Section 1.421–6(d) presently provides that our employees will incur no tax until the year in which restrictions lapse on the stock purchased. At such time the employee is deemed to receive compensation, taxable as ordinary income, in an amount equal to the difference between the purchase price of such stock and the lesser of the market value of the stock (i) when originally transferred to him or (ii) when the restrictions lapse.

The plain facts are that the present tax consequences of restricted stock plans arise from well-considered attitudes of the Treasury Department after lengthy consideration of judicial pronouncements and there has been no public hue and cry for a change. Indeed, the need for such a change cannot be substantiated in law or fact and we respectfully submit that the public interest completely warrants and justifies the continuation of the existing tax treatment of restricted stock plans.

As we have pointed out elsewhere herein, stock option or stock trust plans simply do not provide any real "interest" in an employer's business and abuses and loopholes—if any there be—may be corrected and closed without doing irreparable damage to a proven benefit to personnel and community. We urge you and the Committee to reject the arguments advanced as being in favor of the change in the tax consequences of restricted stock plans as set forth in H.R. 13270.

B. The effects of changes as proposed in H.R. 13270 are undesirable

The proposed amendments contained in H.R. 13270 will have the effect of changing existing Regulations Sections 1.61–2(d)(5) and 1.427–6(d)(2) and thereby affect the tax treatment of restricted stock plans. Your Committee's Print sets forth seven arguments against adoption of the instant portions of H.R. 13270. These reasons—which we seek to emphasize by our endorsement—show that the change may:

"(1) * * * discourage employees' stock ownership of their employers' business.

"(2) * * * immediately tax the receipt of property which, in many instances, cannot be sold or otherwise disposed of by the taxpayer to pay the tax.

"(3) * * * tax capital appreciation of the property as ordinary income."

And that:

"(4) Restricted stock plans are not, in fact, deferred compensation arrangements, but rather are a means of allowing key employees to become shareholders in the business.

"(5) It is necessary to have these preferred stock plans so as to obtain and retain key employees.

"(6) These tax incentives increase the economic productivity of business; hence, the benefits to everyone concerned are increased.

"(7) Little revenue appears to be involved; hence, there is no real benefit accruing from making a change."

At the same time, adoption of the amendments of H.R. 13270 will punish all restricted stock plans—with or without abuses—regardless of the total benefits and merits of plans which have no abuses and which have been sanctioned by private rulings of the Internal Revenue Service. And, as Argument (7), *supra*, succinctly notes, adoption of such amendments will not produce significant additional revenue, if any at all.

Therefore, for all of the reasons contained herein, we are opposed to the amendments of H.R. 13270 and we urge that such proposed legislation be rejected, *in toto*, by the Committee. After all, if "no real benefit" will accrue from the proposed changes, there is no real reason for change. And, we respectfully submit, a "reform" measure which produces no benefit is a futile, empty gesture.

VI. Adoption of Any Modifications Should Not Be Made Retroactive

Even if it is assumed, *arguendo*, that existing law should be amended, such amendments should not be applied to plans—such as Southern's Plan—put into effect prior to the date that such amendments were originally proposed.

It is unfair and inequitable to penalize anyone by a change in long-standing and well-considered basic rules. Hence, we believe that even if certain changes in the law are adopted, such changes should not be applied to any restricted stock plan adopted prior to the date such changes were proposed, where such plan was adopted in reliance upon judicial decisions, announced administrative policy, private and published rulings (and, in the case of Southern's Plan, an express private ruling). The benefits of a plan so promulgated should not be terminated when, as here, the problem of retroactivity can easily be avoided without prejudice to anyone.

We submit that the Committee, if it sees fit for some reason to recommend changes in the tax treatment of restricted stock plans, should allow our Plan, which was adopted on May 1, 1968, to retain all of the tax consequences set out in the Service's Private Ruling *for the remaining four years of the Plan*. Any other result would penalize Southern's employees because Southern's Plan calls for short-term purchase rights rather than options running the life of the plan.

And finally, we note that H.R. 13270 proposes a cut-off date of February 1, 1970, on purchases of restricted stock made pursuant to a plan adopted and approved prior to July 1, 1969 (Section 321, amending Section 85 (f) of the Code). We urge your Committee to recognize the arbitrary and unreasonable character of such a cut-off date. The tax consequences of a plan which received express approval of the Internal Revenue Service should be permitted to continue for a reasonable phase-out period—in our case, until 1973, since only four more years are involved in the total plan. We note that reasonable phase-out periods are provided for in other Sections of H.R. 13270. For example, Section 201 provides a five-year phase-out period relating to unlimited charitable contributions deductions and Section 401, relating to multiple corporations, provides a phase-out period of seven years for multiple surtax exemptions, accumulated earning exemption and small business deduction limitation.

A similar seven-year phase-out period, in Section 401, is effective for treating the amount taxable on dividends received from affiliated corporations. And Section 442, relating to bad debt deduction of mutual savings banks based on percentage of income, provides a phase-out period of ten years beginning in 1969. These, as well as other examples contained in H.R. 13270, indicate very clearly a legislative intent to provide relief to those who have adopted courses of action

in reliance upon prior legislative or administrative rules and regulations. Fairness dictates, we submit, that comparable relief be afforded to companies which have adopted plans and employees who have accepted or continued employment, in good faith, in reliance upon existing law. Although the suggested cut-off date of February 1, 1970, indicates the desire to afford some relief such date fails to permit plans—such as Southern's Plan—to continue for a reasonable phase-out period, in our case only an additional four years.

VII. Conclusion

We support the present treatment afforded by existing law to restricted stock plans—such as our Plan—whereby the company merely sells its own common stock subject to reasonable restrictions. We oppose the modification of such tax treatment, principally because such modification is not necessary. It is also our position that any amendments to existing law should not be applicable to plans—such as our Plan—which were adopted before any changes were proposed.

At the same time, we want to make it crystal clear that we do not condone tax evasion or tax loopholes, nor do we deny our nation's acknowledged need for funds. Thus, it is important to note, without unduly repeating what we point out elsewhere herein, that the existing tax treatment of restricted stock plans is consistent with existing law, permits the amount of tax to be related to the taxable event and produces maximum revenue under the circumstances.

In sum, we believe that the Committee will ultimately conclude that the present tax treatment is fair and adequate, that modifications are unnecessary and that *changes need not be made merely for the sake of change.*

We very much appreciate the opportunity afforded by your Committee to submit this written statement. In addition, we respectfully invite your attention to our written and oral statements appearing in Tax Reform, 1969, Hearings Before The Committee on Ways And Means, House of Representatives, Ninety-First Congress, First Session, Part 7, pages 2631–2642.

If we can be of further assistance to you, to the Committee or to its counsel, please let us know.

Respectfully submitted.

Southern Natural Gas Co.
Lewis Carroll.
Harry C. Howard.

Arthur Andersen & Co.,
Chicago, Ill., September 12, 1969.

Re statement regarding H.R. 13270, Tax Reform Act of 1969, restricted property.
Committee on Finance, New Senate Office Building, Washington, D.C.

Dear Sir:

Summary of comments and recommendations

In an attempt to eliminate tax benefits which presently arise from the use of restricted property, the House has created potential inequities for taxpayers who receive such property in the future. The following matters should be revised to prevent such inequities:

1. Section 321 effectively taxes as compensatory income all appreciation on restricted property from the date of its receipt to the date restrictions lapse. No provision is made for equity or capital appreciation which may legitimately occur during this period, or for subsequent excess amounts which were never intended as compensation when the restricted property was transferred. Modifications should be made to limit the amount of appreciation which can be considered as compensatory, or alternatively the employee should be allowed an election to report the original transaction as if the restriction did not exist.

2. New Section 85(a) should provide for the deferral of actual payment of tax on any compensatory income until the property is transferable. The present proposals would require payment of tax even though other restrictions might prevent transferability until a much later date. An obvious hardship thus occurs, since the employee must provide cash from other sources to pay the tax incurred currently. Similar results will occur in revised Section 402(b). A deferral of tax

payment consistent with the provisions for other deferred compensation under new Section 1354 should be considered.

3. In view of the proposed amendments dealing with nonexempt trust beneficiaries, it seems appropriate now to revise the law to allow the employer a deduction at some point in time for a contribution to a nonexempt trust. Under present regulations, no deduction is ever allowed where taxability of income to the recipient is deferred. This inequity should be corrected. Also, there should be a statutory provision for employer deductions relative to restricted property.

BASIS FOR COMMENTS

1. Limitation on Compensation Element of Appreciation

The proposed legislation assumes that all restrictions placed on stock transferred to employees have been motivated by tax-saving and tax-deferral motives. In actual business practices, this is not the case. There are many instances where a closely held corporation will necessarily restrict the transferability of employee stock, in order to eliminate the possibility of a dissident minority group of shareholders, and to insure that control can be maintained. Similarly, employees can be required to place stock in a voting trust, or sell it back to the company at a fixed price for a certain length of time. Also, through forfeiture or price restrictions, the employee is motivated to perform well and continue his employment for a longer period of time. Such restrictions are not tax-motivated. Because of the narrow requirements for qualified and restricted stock options, these alternative arrangements are not necessarily possible in all instances, especially in closely held corporations.

With respect to the measure of compensation, it is quite possible that a closely held corporation's stock can have two values, depending on its owners' present philosophy:

(a) As long as it is the intent of those in control to continue their ownership, without public participation, any minority interest has a very low value.

(b) When those in control decide to offer all or a portion of their ownership to the public, either through direct offering or some combination with a public company, the minority ownership immediately takes on new value, since it will have a ready market and will be fully transferable.

Many transfers of restricted stock are made in closely held companies, based on the philosophy that ownership will continue to be controlled by a few. At this time, the intended compensation, both in the minds of employee and employer, is confined to the reduced value attributable to a minority interest. Philosophy can quickly change, though, in these times of mergers, acquisitions, conglomerates, and the attractiveness to various industries in "going public" at the right time. An employee holding restricted stock at the time of a philosophical change toward public ownership realizes immediate "paper" gain on his holdings. This "paper" gain was never intended to be compensation by his employer, but results solely from his holding of an investment. The present proposed law would tax such appreciation as compensation, at ordinary rates, possibly well in advance of the employee's being able to dispose of it. It seems that in eliminating one problem, another has been created. Remedies should be effected to offer the taxpayer relief from occasions where "unintended compensation" might otherwise arise. We suggest the following methods of rectifying these inequities:

(a) As evidence of nontax motivation in placing restrictions on stock or other property, provide the employee with an option of either reporting income under the present proposed law, or else reporting income at the time the restricted property is received, at its present value without restrictions. If the latter is elected, an ordinary deduction would be allowed in the future to the employee for the amount reported, should the stock be ultimately forfeited by terms of the restrictions. The latter treatment would seem to more closely reflect the actual economic consideration of the transaction, and eliminate conversion of legitimate capital appreciation into ordinary income.

(b) Alternatively, provide for a maximum percentage of original value (say, 200%) to be taxed as compensation in the event of any appreciation. For instance, if at the date of original transfer, the restricted property would result in ordinary income of $10,000 except for restrictions, the maximum compensatory element of future appreciation would be limited to an additional $10,000, or a total of $20,000. Such a limitation would effectively tax most contemplated compensation, and would provide substantial relief in cases of unusual appreciation which was never intended as compenastion.

2. Deferral of tax liability until restricted property is transferable

New Section 85(a) provides for immediate measure of compensatory income and imposition of tax whenever restricted property becomes transferable, or when there is no substantial risk of forfeiture, whichever is earlier. Therefore, tax can be incurred by the lapse of the forfeiture provisions, even though other restrictions may continue to prevent the taxpayer from disposing of the property. Similarly, Section 402(b) is to be amended to provide for acceleration of the occurrence of taxable income in the case of an employer's contribution to a nonexempt trust. Here, too, the employee will have tax to pay without being able to dispose of the asset which gave rise to the taxable income. This harsh result is inconsistent with the treatment to be accorded simple deferred compensation arrangements under new Section 1354, where the liability is computed based on the years in which the income was earned, but the actual tax payment is deferred until the year of receipt. We suggest that the spirit and intent of Section 1354 be expanded to encompass the provisions for restricted property and nonexempt trusts, so that tax will be incurred only when there is an ability to obtain cash for tax payment from the assets giving rise to the tax liability. Each of these areas of compensation are similar in that they are a type of deferred income, each having its particular method of achieving the deferral. It seems only logical to tax all benefits uniformly as to amount and timing.

3. Deduction provisions for nonqualified deferred compensation

Section 85(a) alludes to the deductibility of at least certain payments in a negative fashion. Otherwise, timing or amount of the employer's deduction is not mentioned. The Regulations under 402(b) have specifically prohibited a deduction for a contribution by an employer to a nonexempt trust, where the employee's rights are forfeitable, some court cases to the contrary notwithstanding. In view of the other changes, and in the interest of equity and consistency, a separate provision should establish the timing and amount of deductions for compensation reportable by the employee as income under such plans.

SUMMARY

The foregoing comments are not intended to indicate an approval or disapproval of the remaining portions of the Act, but are only indications of technical areas which obviously need clarification. This statement is submitted as part of a series of letters, each dealing with a particular area of the proposed legislation. It is intended that the comments and suggestions contained herein be made a part of the record of testimony relative to the legislative changes contemplated for restricted property. We shall be pleased to discuss these matters further with you or the Committee, either in person or by telephone. Please call us collect at 312-346-6262 if necessary.

Very truly yours,

ARTHUR ANDERSON & Co.
By JOHN MENDENHALL,
Director of Taxes.

COMMENTS OF MR. WILLIAM R. JUDY ON BEHALF OF REID AND RIEGE

RESTRICTED PROPERTY

We are especially concerned with the detrimental effects of Section 321 of the proposed bill relating to *Restricted Property*. If passed, this provision would deprive the small corporation in America of a most crucial competitive tool. Attracting and retaining key management personnel possessing imagination and expertise is a *sine qua non* for survival in the business world today.

The report of the House Ways and Means Committee directs the corporate employer to the use of statutory qualified stock options as the "appropriate means" by which key employees should be given an equity interest in the business, rather than non-statutory restricted stock plans which, in the opinion of the Committee, lean too much toward out-and-out "compensation". To the contrary, we would assert that the non-statutory restricted stock plan is more in the nature of an equity investment for employees than compensation, and secondly, that the statutory qualified stock option plan is not an appropriate or practical means for a small corporation to attract and retain key personnel.

The House Committee report makes much of the fact that the recipient of non-statutory restricted stock oftentimes pays nothing at all for his stock. On the other hand, the recipient under the qualified plan must pay at least 100% of the fair market value of the stock as of the date the option is granted. Superficially, it would appear that the qualified optionee is more in the nature of a true investor since he must pay his own hard cash for the stock, while the restricted stock recipient appears more as the donee of a gratuitous transfer of property. We believe, rather, that the contrary is true. The goal of creating an employee-stockholder is to provide incentive for that employee to work long and hard for the business so that both he and the corporation will benefit. Correlatively, the business profits. But consider now the employee who has paid almost full value for his stock as compared to the one who holds restricted stock that he received perhaps in lieu of cash but without a personal cash-outlay. This latter stockholder has not had to take after-tax dollars out of his savings to purchase his stock. Both are interested in the success of the business, but which is more apt to be nervous at the fluctuation of market value of his stock? Both have a stake in the business, but which will be more apt to retain his stock as a true long-term investment if the market value of the stock begins to decline? We are assuming that the desired goal is the employee who will keep his stock interest through thick and thin and work harder if the business takes an unexpected drop. As between the two employees, it is the one who has his current cash investment to lose who will be prone to unloading his stock in hard times to keep losses to a minimum. When this happens, that employee no longer is personally interested as an investor in the revival of the corporation. But on the other hand, the one who risked none of his current cash savings for the purchase of his stock will not feel the same sense of financial urgency. He is more prone to stick with his investment and labor to keep its value up. The qualified stock option, in effect, creates a propensity to defeat the very purpose of that legislation. For this reason we ask that the tax advantages of the non-statutory restricted stock technique be retained.

As further reason to delete Section 321 of the bill, we must point out that the use of the qualified stock option which the House Committee would recommend to corporations is not a practical and feasible alternative for the small corporation. We note that for a qualified stock option plan to be appealing to an employee, he must be given the opportunity to purchase a reasonably substantial number of shares of the corporation. The option to purchase just five or ten shares at slightly less than market value is not an especially compelling reason to come or to stay with a particular corporation. This problem of the number of shares available to distribute to employees is no staggering problem for the large corporation with hundreds of thousands of shares outstanding. But for the small concern with perhaps only a couple of thousand shares available, the qualified stock option becomes totally impracticable. Consequently, the small business leans toward distribution of a relatively small number of shares of restricted stock at little or no cash cost to the employee.

The vigor of American business management is dependent to a substantial degree upon incentives such as non-statutory restricted stock, especially in the case of the small corporation. To eliminate the attractiveness and propensity to encourage long-term investment in a corporation of such technique would cause genuine harm to our overall business structure.

As a final note on restricted stock, we would only point out that the Committee report also states that the revenue impact of this provision will be negligible, impliedly neither up nor down. We would only note that the proposed legislation might in fact cause a revenue loss. Taxpayers would pay more tax, but this could be more than offset by increased deductions for an employer who often would be in a larger tax bracket than the taxpayer.

LIGGETT & MYERS INC.,
New York, N.Y., September 23, 1969.

Re: Section 321 Tax Reform Act of 1969—Restricted Property

Hon. RUSSELL B. LONG,
Chairman, Committee on Finance,
New Senate Office Building, Washington, D.C.

MY DEAR SENATOR LONG: We request that this protest of proposed section 321 of the Tax Reform Act of 1969 ("the Bill") be considered by the Senate Finance Committee, and be placed in the record.

Our Company adopted a restricted stock plan in 1968, and the Plan was approved by stockholders in April, 1968. The purpose of the plan is to provide incentive to executives to make extra-ordinary contributions to the success and growth of the Company. In management's opinion, the Plan has been an important factor in increasing both the income of the Company, and the aggregate income taxes paid to the Federal and State governments.

Under our Plan, persons awarded Restricted Stock cannot sell it until after retirement, except to the Company; and if sold to the Company, the sale price is limited to the *lesser* of (1) 70% of value when stock is received, or (2) 70% of value on the date of sale.

We assume (but counsel advises the Bill is not clear) that the restricted stock issued under the Plan would be considered "forfeitable" within the meaning of the Bill.

Considering the fact that the Company receives no deduction until restrictions lapse (and that the deduction is then limited to the value of the stock when it was issued, or, if lower, its then value) we think the proposals in the Bill, as applied to our Plan, would not increase Federal tax revenues. To the contrary, to the extent that the Bill would discourage initiative and undermine our Plan, it would decrease both our net profits, and the income taxes paid by the Company.

We think that restricted common stock of an employer company serves a valuable management incentive function without cost or injury to the Federal revenues. On the other hand, we recognize that plans which use stock of corporations other than the employer corporation do not have this merit, and we think, insofar as the proposed legislation would effect such plans, it is justifiable. Accordingly, we suggest and urge that the Bill be revised so as to delete from its coverage restricted *common stock of an employer* awarded to an employee; and that existing law (as evidenced by existing regulations under section 421-6) continue to apply thereto.

I would point out that the question to be considered is not whether such plans contain an element of compensation. Clearly they do. But restricted common stock issued under such plans also carries with it a high degree of investment risk. The question, therefore, is the amount of compensation. We think it inequitable and unfair, considering the investment risk, to tax an amount greater than the value when the stock is issued as compensation.

In any event, in view of the small (if any) impact on revenues, we think existing law should continue to apply at least for five years to plans adopted and approved by stockholders prior to May 31, 1969.

Respectfully,

M. E. HARRINGTON.

STATEMENT OF THE SINGER COMPANY SUBMITTED BY W. J. BROWN, VICE PRESIDENT

SUMMARY

No abuse exists and therefore no "reform" is required in the tax treatment of restricted stock issued under plans such as Singer's which:

1. Limit the aggregate number of shares of the employer's stock which may be issued.
2. Have been approved by the shareholders of the company.
3. Contain a reasonable expiration date, such as five to ten years. (i.e., require further shareholder sanction for continuance.)
4. Contain restrictions on the sale, pledge, hypothecation, gift, or other transfer of the shares for a period of not less than two years, with provisions for forfeiture in the event of termination of employment.
5. Make eligible a broad class of participants—in an executive incentive plan, all officers and key employees based upon individual contribution; in a purchase plan, all employees having at least one year's service with the company.

In addition, if the Congress were disposed to apply to the tax treatment of restricted stock the same holding rules established in the stock option revisions for capital gains treatment, such would be regarded as consistent and reasonable.

We are concerned that legislation designed to curb abuses in the use of "restricted stock" would unnecessarily (and presumably unintentionally) adversely affect broad-based non-abusive restricted stock plans such as those of The Singer Company. These plans are an Executive Incentive Compensation Plan and a Stock Purchase Plan.

Under the Executive Incentive Compensation Plan, bonus awards of restricted stock may be made annually to some 1200 supervisory and managerial personnel depending on the earnings of the Company and the beneficiary's contribution to the performance of the Company as determined by the Plan Committee. The stock awarded contains restrictions against its sale, pledge, or other disposition for periods of not less than two years. The Plan also provides for forfeitures in the event of termination of employment before the restrictions have lapsed.

This Plan, which was adopted with the overwhelming support of the shareholders of The Singer Company, was designed to provide participating employees not only with incentive pay for past services but also, by awarding them restricted stock with forfeiture provisions, to induce them to perform efficiently on a career basis with The Singer Company. Thus the use of restricted stock places the employee "at risk" and provides an inducement to continued employment and high performance not available under qualified stock option plans. An executive given an option has just that—a choice. The same man has a commitment under our restricted stock plan.

The Restricted Stock Purchase Plan allows approximately 60,000 eligible employees to purchase stock in The Singer Company at 80% of its current market value. Payment for the stock is made through payroll deductions which are limited to 10% of the employee's salary. Restrictions on the stock provide that if the employee terminates his employment within two years of the date of acquisition of the stock, the Company has the right to re-acquire the shares upon repayment of the original purchase price. To date, the Company has, in fact, exercised its right to repurchase such shares in each instance.

We respectfully submit that legislation which substantially undercuts the effectiveness of broadly-based incentive plans such as ours is contrary to the interest of employees and shareholders and serves no discernible public interest.

Noting that the Congress in 1964 in reforming the rules with respect to qualified stock options established a three-year holding period as a condition of providing capital gains treatment, if additional safeguards are required in the treatment of restricted shares it would appear to be consistent and equitable to make a like requirement applicable to shares upon lapse of restriction.

In addition, it is our understanding that the Treasury wishes to consider in further study the taxability of deferred compensation. Clearly, the use of restricted shares is a significant form of deferred compensation. We urge that the tax treatment to be accorded restricted stock be given the same study and consideration which the Treasury observes is required in the case of other forms of deferred compensation.

STATEMENT OF ELIZABETH H. KURY, ESQ.* KURY AND KURY, SUNBURY, PA.

FORFEITABLE CONTRIBUTIONS BY A CHURCH, HOSPITAL, SCHOOL OR OTHER TAX EXEMPT ORGANIZATION TO A NON-EXEMPT TRUST SHOULD BE EXCLUDED FROM PROPOSED SECTION 321 (B)

If H.B. 13270 is enacted without the amendment herein submitted it will have a serious adverse affect on the churches, hospitals, schools and other charitable organizations which must compete with private industry to attract highly qualified personnel. The amendment proposed herein consists of the underlined portion of proposed new Section 321(b):

"(b) Nonexempt Trust and Nonqualified Annuities.—

"(1) Beneficiary of Nonexempt Trust.—Section 402(b) (relating to taxability of beneficiary of non-exempt trust) is amended to read as follows:

"'(b) Taxability of Beneficiancy of Nonexempt Trust.—Contributions to to an employees' trust made by an employer during a taxable year of the employer which ends within or with a taxable year of the trust for which the trust is not exempt from tax under section 501(a) shall be included in the gross income of the employee in accordance with section 85 (relating to restricted property). *If the employer is described in section 501(c) and exempt from tax under Section 501(a) and the beneficial interest of the employee in such contributions is forfeitable at the time the contributions are made, the preceding sentence shall not apply.* The amount actually distributed or made available to any distributee by any such trust shall be tax-

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*LL.B. University of Pittsburgh, 1963; LL.M. in Law of Taxation, N.Y.U., 1966; admitted to practice before all courts of Pennsylvania.

able to him in the year in which so distributed or made available, under section 72 (relating to annuities), except that distributions of income of such trust before the annuity starting date (as defined in section 72(c)(4)) shall be included in the gross income of the employee without regard to section 72(e)(1) (relating to amount not received as annuities). A beneficiary of any such trust shall not be considered the owner of any portion of such trust under subpart E of part I of subchapter J (relating to grantors and others treated as substantial owners).'

"(2) Beneficiary under nonqualified annuity.— section 403 (relating to taxation of employee annuities) is amended by striking out subsections (c) and (d) and inserting in lieu thereof the following new subsection:

"'(c) Taxability of beneficiary under nonqualified annuities or under annuities purchased by exempt organizations.—Premiums paid by an employer for an annuity contract which is not subject to subsection (a) shall be included in the gross income of the employee in accordance with section 85 (relating to restricted property). If the employer is exempt from tax under section 501(a) or 521(a), the preceding sentence shall apply only to that portion of the premiums paid which is not excluded from gross income under subsection (b). The amount actually paid or made available to any beneficiary under such contract shall be taxable to him in the year in which so paid or made available under section 72 (relating to annuities).'

"(c) Clerical amendment.—The table of sections for part II of subchapter B of chapter 1 is amended by adding at the end thereof the following new item:

"'Sec. 85. Restricted property.'

"(d) Effective rates.—The amendments made by subsection (a) and (c) shall take effect upon the date of enactment of this Act. The amendments made by subsection (b) shall apply to transfers made and to premiums paid after August 4, 1969."

Present law

Under Section 402(b) of the present law the employee-beneficiary of a non-exempt trust does not include in his gross income contributions made by a tax exempt charitable employer (or any other employer) if the employee's beneficial interest in the contribution is forfeitable when made. Only the amounts distributed to him are taxed, and such distributions are taxed in the year of distribution under Section 72 (relating to annuities).

Many churches, hospitals and universities which cannot compete with profit-corporations for highly qualified personnel by offering the pensions and other fringe benefits that the large corporations offer have used Section 402(b) to provide retirement benefits that they could not otherwise provide. Charitable institutions for which it is impracticable or undesirable to set up a tax exempt trust in conjunction with a qualified pension plan under Section 401 can easily set up a non-exempt trust under Section 402(b) by a simple employment contract with the employee and trust agreement with a bank. The charitable employer then simply mails periodic contributions as contracted for to the trustee and has no further responsibilities with respect to investments and distributions. Contributions are conditioned on the employee's future performance of substantial services and/or such other conditions as are advantageous to the employer, and do not vest or become non-forfeitable for a period of usually two or five years.

A similar provision of present law, Section 403(b), provides that premiums paid by a tax exempt charity for a *non-forfeitable* annuity are not includable in the employee's gross income except to the extent that they exceed twenty percent of his includable compensation. New Section 321(b)(2) specifically retains this exclusion which in present law applies only to tax exempt organizations.

The employee usually pays for at least part of retirement benefit provided by either the annuity or the tax-exempt trust by contracting for a lesser salary than he would otherwise be entitled if he did not elect to have his employer contribute to the trust or purchase retirement annuities. The trust or annuities are attractive, however, because of the tax deferment until payments are received. The provisions of Sections 402(b) and 403(b) have not been abused by charitable employers and have not opened the door to any treasury raid. It is a very, very rare contribution or premium by a tax exempt institution or distribution or payment to a beneficiary which equals or exceeds $10,000—the amount which new proposed Section 1354 permits any individual to receive from any employer as deferred compensation payment without tax penalty.

The non-exempt trust is a more attractive device than an annuity for funding a retirement program, however, because with competent management the trust fund will grow to provide a much more adequate retirement benefit that an annuity program. The institution generally prefers it to a straight deferred compensation payment because it does not wish to fund payments out of current income in the year of payment and does not wish to become involved in the investment management and bookkeeping incident to the funding of deferred compensation payments.

Proposed changes by H.B. 13270

Under proposed new Section 321(b)(1) all contributions by a charitable employer to a non-exempt trust would be taxable to the employee in the year they became non-forfeitable, by reference to proposed new Section 85. Where forfeitability is conditioned on performance of future services this would have disastrous consequences in the year of retirement or lawful termination of employment, for it would require the inclusion of the entire trust fund in the employee's gross income for that year. It is difficult to imagine forfeiture conditions which would remain in effect after retirement, and, therefore, proposed Section 321 (b)(1) effectively kills future use of forfeitable non-exempt trusts by tax exempt organizations.

Reasons why H.B. 13270 should be amended to exclude forfeitable contributions by tax exempt organizations from provisions of section 321(b)(1)

1. It is socially desirable to permit these institutions to provide employees with retirement benefits which could not otherwise be financed in competition with industry, through the device of a forfeitable non-exempt trust.

2. This amendment merely corrects an illogical inconsistency in H.B. 13270. It is illogical and inconsistent to defer until payment the tax on premiums paid for *non-forfeitable* annuities and to tax the accumulated *forfeitable* trust contributions of a charitable employer in the year they become non-forfeitable. Surely this result was not contemplated in the drafting of H.B. 13270.

3. Employee trust beneficiaries should enjoy at least as much tax deferment as is made available through straight deferred compensation payments. It is inconsistent to penalize the employee-beneficiary of a non-exempt trust by taxing him on any contributions in the year made or the year they become non-forfeitable when proposed Section 331 provides total and complete tax deferment without tax penalty from the year contracted until the year of payment on any straight deferred compensation payment of less than $10,000.

The general reasons for changing tax treatment of deferred compensation stated on page 90 of the Committee Report argue even more strongly for the amendment sought herein deferring tax on forfeitable contributions by charitable institutions to non-exempt trusts:

"It is anomalous that the tax treatment of deferred compensation should depend on whether the amount to be deferred is placed in a trust or whether it is merely accumulated as a reserve on the books of the employer corporation. An employee who receives additional compensation in the form of a promise to pay him that compensation in the future made by a large, financially sound corporation, is probably as likely to receive the compensation as an employee whose deferred compensation is placed in trust."

If changes in the treatment of deferred compensation are justified on the very sound theory that a deferred compensation payment is as certain to be received as a trust distribution, surely tax should be deferred on a trust contribution to a like extent without penalty, especially if the trust contribution is forfeitable in the year of contribution. The beneficiary of a forfeitable contribution to a non-exempt trust should be in no worse position than if the charitable employer promised to make a deferred compensation payment.

To provide the same benefit through a straight deferred compensation payment as can be provided through the trust the charitable employer must either (1) pay out more dollars in the year of payment than under the trust arrangement yearly or (2) manage its own investment program to fund the benefit. Most institutions which use the trust device cannot commit themselves to an unfunded deferred compensation program and are not equipped to manage investment programs to fund either single-employee trusts or trusts which pool the funds of several or many employees. A trust arrangement involving periodic payments to a bank, on the other hand, is economical and convenient.

4. The failure to exclude forfeitable contributions to non-exempt trusts by charitable organizations was probably an oversight due to the fact that Section

402(b) is general with terms and not specifically applicable to charitable organizations. See the Committee Report at page 89, which indicates an intention to preserve the provisions of the present law which provide tax deferment on retirement benefits to employees of tax exempt institutions.

5. The attractiveness of forfeiture provisions to the charitable institution as a means of insuring the loyalty of employees and the non-violation of employment contracts should not be overlooked. Such protection is not as readily afforded by either the Section 403(b) annuity or straight deferred compensation arrangement.

WEBSTER, SHEFFIELD, FLEISCHMANN, HITCHCOCK & BROOKFIELD,
New York, N.Y., July 24, 1969.

Re proposed amendments to Internal Revenue Code—Restricted stock

Hon. RUSSELL B. LONG,
Chairman, Committee on Finance, U.S. Senate, New Senate Office Building, Washington, D.C.

DEAR SIR: The House Ways and Means Committee has indicated that its proposals for amendment of the Internal Revenue Code will include a proposal to tax restricted stock differently than is provided by existing income tax regulations.

Insofar as the proposals relate to stock *other than common stock of an employer*, I think the proposals are appropriate and should be enacted.

But insofar as the proposals would alter the existing method of taxing restricted stock of an employer corporation received by an employee of the corporation, I think they are not in the best interest of either the Government nor of taxpayers, for the reasons stated below.

Existing law

Restricted Stock (i.e., stock subject to a restriction having a significant effect on its value) is not taxed when received. When the restrictions lapse, the employee pays ordinary income tax on the lesser of value when the stock was received, or value when the restrictions lapse. Any *appreciation* is taxed, when the stock is sold (if not held until after death) as capital gain.

House proposal

Restricted Stock would be taxed at its value when it "becomes non-forfeitable".

Proposal for consideration

Restricted Stock, *other than common stock of an employer*, will be taxed when it becomes nonforfeitable—as provided in House Proposal. Restricted Stock of an employer (if common stock) would be taxed to the employee when the restrictions lapse, *at the rates* applicable in the year the stock was issued in the name of the employee or otherwise delivered to him, on the *value* at the time issued or delivered (whether more or less than value when restrictions lapse).

Deduction to employer

In all cases the employer is allowed a deduction *for the year*, and for the same amount, as the employee is taxed. No change is proposed.

Reason for revised proposal

Restricted Stock (common) of an employer corporation is peculiarly appropriate for use in incentive compensation plans. The restrictions may tie the executive to the Company, so that if he leaves the employment of the Company, he will have to re-sell his stock without any benefit from interim-appreciation, and at a loss if there has been depreciation. At the same time, as a stockholder, he will have a proprietary interest which generates incentive and motivates maximum effort to increase Company profits.

No cost to revenues

With the deduction to the Company keyed to ordinary income to the executive, in the usual situation, an adoption of the proposal indicated above will not reduce tax revenues. Generally, the Executives tax bracket will equal or exceed the corporate tax rate as to the ordinary income portion; and as to the appreciation after issuance of the stock, capital gain tax will be received by the Government, and there will be no offsetting corporate deduction. Moreover, if such a plan, as is always contemplated, results in increased corporate profits because of the

greater motivation, the Government is approximately a 50-50 partner with the corporation in sharing in such profits.

Value when received is appropriate measure of compensation

In a situation where stock is issued, and where the executive will suffer economic loss if it depreciates, the stock represents an investment, and should be treated no differently than any other investment in the Company's stock made by a company executive.

Time for taxation

Under the cash method of reporting income, income is not reportable until it is available in cash or its equivalent. The application of this rule prohibits taxation until the stock is saleable at fair market value of unrestricted shares (generally when restrictions lapse).

Options

It may be necessary or desirable to change the rules with respect to options under plans which do not meet the requirement for treatment as qualified options under Section 422. The holder of an option has no investment risk, and, as pointed out by the Supreme Court in the LoBue case, in such a situation it may be appropriate to measure the compensation (and the time of taxation) by the value of the stock when, and the time when, the option is exercised. Accordingly, as to such options, I would concur in the recommendations made by the Ways and Means Committee.

Effective dates

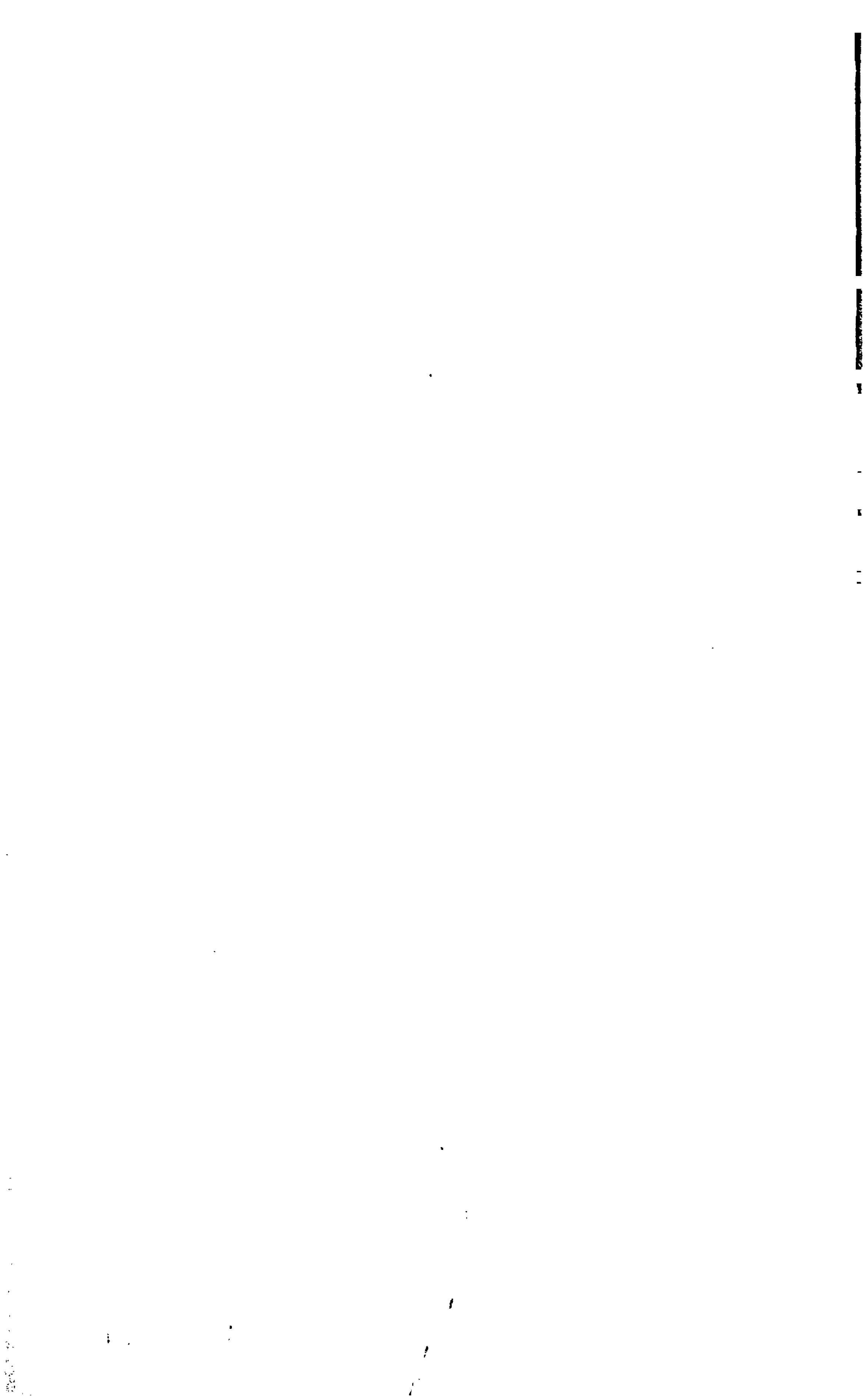
The effective date proposals announced by the Treasury and Ways and Means Committee on the whole appear fair. However, if the proposal made in this letter is not adopted as to Restricted Stock issued to an employee, the new legislation should provide a further exception (with perhaps a five year cut-off) for Restricted Stock issued under a written plan which was approved by Stockholders at a meeting held on or before October 31, 1968 (proposed change in regulations were announced late in October, 1968).

Very truly yours,

JOHN D. SMYERS.

APPENDIX D

WRITTEN TESTIMONY RECEIVED BY THE COMMITTEE EXPRESSING AN INTEREST IN THE SUBJECT OF CHARITABLE CONTRIBUTIONS



Written Testimony Received by the Committee Expressing an Interest in the Subject of Charitable Contributions

SMITHSONIAN INSTITUTION,
Washington, D.C., September 15, 1969.

HON. RUSSELL B. LONG,
Chairman, Committee on Finance,
U.S. Senate, Washington, D.C.

DEAR SENATOR LONG: Many of the provisions of H.R. 13270, now being considered by the Senate Committee on Finance, may have a substantial effect on the activities and resources of the Smithsonian Institution. The attached statement contains comments of a few of these sections of the bill and recommendations which may be summarized as follows:

1. that the provisions of section 201(c) of the bill not be extended to tangible personal property;
2. that museums, as a class, be included with the other educational institutions, contributions to which qualify for the extra thirty percent deduction under section 170(b)(1)(B) as amended in the bill;
3. that charitable contributions of appreciated property be deleted from the new Limit on Tax Preference and Allocation of Deductions provisions of the bill; and
4. that the provisions of the bill relating to private foundations be carefully reviewed as a whole, and specifically in order to clarify the rules on annual distribution of income and excess business holdings and to remove the punitive elements from the tax on private foundation investment income and from the treatment of donations of appreciated property to private foundations.

It would be greatly appreciated if this statement could be made part of the hearing record, for consideration by your Committee in its deliberations on this bill.

Sincerely yours,

S. DILLON RIPLEY, *Secretary.*

STATEMENT OF S. DILLON RIPLEY, SECRETARY OF THE SMITHSONIAN INSTITUTION

The Smithsonian, one of the oldest foundations in the United States, was chartered by the Congress to administer a private bequest for public purposes; it is a characteristic part of that remarkable partnership of private philanthropy and Government which sustains the welfare of the Nation and which H.R. 13270 may radically affect. The major purpose of those portions of the bill which deal with charity is to strengthen this partnership. Our concern is with those few provisions which seem likely to discourage the private contribution, thereby adding to the burdens of Government or perhaps crippling those activities which Government is unable or unwilling to undertake.

1. *Donations of Tangible Personal Property*

The Smithsonian's national collection, a priceless record of our natural and cultural history, owe their existence to more than a century of private gifts of tangible personal property. No amount of public funds could replace the treasures which the Smithsonian and the Nation's museums have received from individual citizens. On the other hand, tax incentives have played a major role in transferring objects of museum quality and national significance from private hands to museums accessible to the public.

H.R. 13270 would drastically reduce these incentives by limiting a donor's deduction to the cost of the object or, in the alternative, requiring him to include in taxable income any appreciation in the value of the object. This provision is inconsistent with the rule for gifts of appreciated securities. It will seriously affect the efforts of all our museums to preserve our cultural heritage, without

perceptibly increasing tax revenues. We concur, therefore, in the Treasury's recommendation that the provisions of section 201(c) of the bill not be extended to tangible personal property.

In recent years with the inflation of art prices generally, a few donors may have claimed, in their tax returns, exaggerated values for works of art. With the cooperation of the Association of Art Museum Directors, an independent advisory group was created by the Internal Revenue Service, and the problems of valuation have been substantially reduced, without impairing the continuing benefits to the Nation from the innumerable donations made in good faith. In our view, it is in the national interest that such donations should continue to be encouraged by the revenue laws. The retention of the limitation of deductions for appreciated property to thirty percent of gross income, and the phasing out of the unlimited charitable deduction, will insure that no one will escape taxation completely through such donations.

2. *Museums as public educational organizations*

A great many privately operated museums, although recognized for their outstanding cutlural and educational contributions to society, are nevertheless seriously disadvantaged by being ineligible for the additional ten percent deduction which is permitted for donations to other educational institutions. H.R. 13270 may make this disadvantage overwhelming for these museums since it increases the ten percent difference to thirty percent. We strongly support the proposal made by Rep. Brademas during the debate on this bill in the House of Representatives: the only adequate solution is to accord museums as a class the same recognition for public service as is given by the tax laws to colleges and hospitals. This should be accomplished by adding another category to section 170(b)(1)(B) as amended in this bill:

> ". . . (vii) a museum, defined as an organized and permanent nonprofit institution, essentially educational or aesthetic in purpose, with professional staff, which owns or utilizes tangible objects, cares for them, and exhibits them to the public on some regular schedule."

This definition is taken from the "Interim Report from the Committee on Accreditation for the American Association of Museums" issued May 26, 1969. It is more specific than that used for other educational organizations. Perhaps it would be sufficient to add just

> ". . . (vii) a museum"

to the bill and leave the definition to the report and the regulations. In any event, the use of even the vaguest formula would be preferable to continuing and enlarging this critical inequity which threatens serious injury to the museum profession as a whole. Such action would be especially timely *now*, since municipal support for museums is diminishing, or is seriously threatened, particularly in cities which are presently burdened with increased social disturbances.

3. *Charitable contributions of appreciated property*

Contributions of appreciated property, securities in particular, have for years been the backbone of private philanthropy of all sorts. H.R. 13270 would include all such contributions, along with such items as tax-exempt interest, in the new Limit of Tax Preferences and Allocation of Deductions provisions, in effect treating such property as if it had been sold and the appreciation in value as income to the donor. However, unless appreciated property is in fact sold, it does not create "economic income" like tax-exempt interest. The result of these provisions may be to defeat such gifts in whole or in part. Where the donor would be required to expend additional funds to cover the effects of these provisions, he may be unwilling to make the gift to charity and would either retain the property or sell it for his own account. If he should sell the securities he would have given and donate the proceeds, the gift to charity is reduced by the capital gains tax. If he should sell land or a work of art, the gift of any such unique property is completetly defeated.

These new provisions are so complex that no one can be certain of their ultimate cost to taxpayers, to the Government, or to charity. In the case of charitable contributions of appreciated property the rules appear to be circular: the amount of the deduction is thirty percent of gross income plus tax preferences, while the amount of the preference is based on the amount of the deduction. One thing is certain: that these uncertainties will seriously impede the flow of funds to every major charitable enterprise on which the welfare of our society now so heavily depends. For these reasons, we strongly support the Treasury's recom-

mendation that gifts of apprecited property to charity be deleted from the Limit on Tax Preference and Allocation of Deductions provisions of the bill.

4. *Private foundations*

The Smithsonian is no longer a "private foundation," but has for years relied on very substantial gifts and grants from such organization for many innovations in "the increase and diffusion of knowledge" for which public funds were not available. In general, these private institutions have demonstrated their value to the Nation by providing the venture capital for the basic research and social creativity which are beyond the immediate concerns of industry and Government. Many of the new sections in H.R .13270 are designed to correct those few instances in which the public privileges of foundations have been used for private advantage. There is some danger, however, that the cure will kill the patient. Undoubtedly the whole complex of interrelated provisions should be reviewed and clarified to insure that the administration of private charity for public purposes will actually be improved and strengthened and will not be uselessly penalized for the errors of a small minority. A few specific examples and suggestions are as follows:

(a) The proposed 7½ percent tax on the investment income of private foundations would appear to be punitive in intent, since it is in direct conflict with the principles on which tax exemption is granted in the first place. We support the Treasury's proposal to substitute a 2 percent fee solely to cover the estimated administrative cost of supervising private charity.

(b) The provisions requiring the distribution of income annually should be amended or clarified so that the income to be distributed is net income after deduction of all reasonable expenses such as the 2 percent fee referred to above. If a foundation is required each year to expend or distribute its corpus, its ultimate destruction is inevitable.

(c) The proposed rules on excess business holdings are rather inflexible. There are a variety of legal methods to accomplish the major purpose of separating control of a business from ownership of an interest therein. The "35 percent rule" should be amended to permit the Treasury, by regulation or otherwise, to accept any effective device, without setting specific and somewhat arbitrary limits on holdings of any particular class of stock.

(d) In the event that a workable system of supervision and restraint can be devised in this legislation to insure that the funds of private foundations will be used solely for charitable purposes of recognized benefit to society, it would then seem irrational and discriminatory to single out contributions of appreciated property to these organizations for treatment as sales subject to the capital gains tax. The inclusion of such gifts by H.R. 13270 in section 170(e) appears to be based on the unstated and untenable premise that the activities of private foundations are collectively less worthy than those of other charitable organizations.

A STATEMENT ON BEHALF OF THE TOLEDO MUSEUM OF ART IN RESPECT TO THE TAX REFORM ACT OF 1969, SUBMITTED BY HAROLD BOESCHENSTEIN, PRESIDENT

The Toledo Museum of Art has been built from nothing but an idea in 1901 to one of the great art museums of America—and of the world—today. This has been accomplished through the annual contributions, gifts and bequests of individuals and corporations. Admission to the Toledo Museum is free at all times. There were 465,220 visitors in 1968.

It has received, is receiving and expects to continue to receive grants and donations from foundations, and hopes for continuing gifts and bequests from individuals and corporations.

It receives *no* taxpayer support—federal, state, or local.

Adoption of the Tax Reform Bill of 1969 as passed by the House of Representatives will seriously reduce the Toledo Museum's income and force it to curtail its broad educational activities for all people.

The most serious problems are presented by:

1. Capital gains taxation of the donor on gifts of appreciated property.
2. The confusing allocation of charitable deductions between taxed and untaxed income.
3. Taxing foundations upon their investment income, including capital gains.
4. Requiring the disbursement of an unrealistic "income equivalent" on the part of foundations.

The generosity of the American people, of means both great and small, has excited the admiration—and envy—of the world. Considerate tax polic'es and the approval and appreciation of the community have reinforced these natural charitable inclinations.

If now the nation, through its Congress, turns its back on long established precedent, denies tax exemption for the market value of charitable gifts, appropriates to the Federal Treasury a portion of the income and capital gains of foundations and endowments, requires them to deplete and eventually exhaust their capital by spending more than they can earn, it will signify to the nation that the Federal Government is ready to assume responsibility for all philanthropy and release both individual and corporation from any responsibility to his fellow man or his community save through the tax collector and the officialdom in Washington.

There is no better way to relieve the taxpayers of the support of many public institutions than by continuing to maintain a climate favorable to their support by the donations of individuals, corporations, and foundations.

The many smaller foundations and endowments very generally direct their support to local colleges, hospitals, museums, Community Chests, YMCAs, YWCAs, Boy and Girl Scouts, and other welfare organizations, many of which have not yet found or sought a place in governmental budgets.

Endowment funds and foundations provide a source of stable support upon which charitable institutions can build. If not forced to deplete their resources by taxes on capital gains and income, and invasion of captial to meet an arbitrary distribution of an "income equivalent" they also provide a source of growing income, hopefully in step with inflation.

1. Taxation of gifts of appreciated property

Many gifts to the Toledo Museum have come in the form of works of art—appreciated tangible property—from people of modest as well as more ample means. Denial of deduction of the market value of these gifts will seriously restrict the number and greatly reduce their value. We cannot afford this loss. Growing needs for the Museum's services coupled with rising costs of both materials and personnel have far outrun current income and force constant appeals for funds and works of art.

The substantial support which the Museum received from foundations would be indirectly affected by the proposals concerning such foundations. It is eminently unfair to restrict the deduction for gifts or appreciated property to donor's cost when the gifts is to a foundation, while allowing market value for the gift to other organizations. If this first step is taken, it will be not long before similar restrictions are placed on gifts to other charitable entities. In the case of foundations, not they or their donors suffer, but only the philanthropies to whom they would distribute their income. Foundations are only reservoirs of capital producing income to pass along to operating charities.

Much of the increase in the prices of common stocks, real estate, and works of art alike is due to inflation. Although there are exceptions, many of these purchased twenty or thirty years ago, if sold today, return dollars of no greater purchasing power than those which were paid for them long ago.

2. Allocation of charitable deductions

The proposal to disallow all or a portion of the increase in value of a charitable gift seems based upon the erroneous assumption that such gifts create a realization of untaxed income.

The adoption of this concept would penalize charities by discouraging gifts of appreciated property and securities due to the confusion and uncertainty surrounding the amount of the deductible portion of the gift.

Moreover, it denies deductibility of a portion of the value of a gift because of items of untaxed or tax-sheltered income which are unrelated to the motivation of the gift.

3. Taxing foundations on investment income

The proposed income tax on foundations falls not upon them, but on their beneficiaries. It diverts to the national Treasury, where it will be lost among the billions, a few millions which could be better spent if left in the hands of the foundations and their donees. Surely, no one will argue that it will add to the Federal welfare programs enough to extend their scope. But local needs, for which there is no Federal appropriation, may be left unsatisfied.

If this tax is viewed as a "service charge," 7½% is exorbitant. A Certified Public Accountant's thorough and complete annual audit and report (by a firm of national stature) is costing one fund an average of about ¼ of 1% of its annual income.

4. The "Income Equivalent" disbursement

The 5% "income equivalent" disbursement will become a slow dissolution of foundations. The average gross yield (before expense of managing funds and collecting income) of 67 leading college endowments in 1967 was 3.63%. Only three, and those smaller ones, had gross income of over 5%. The low of the broad range was 2.32%. The 1967 average yield on Standard & Poor's A+ stocks was 2.6%, A stocks 3.2%, A– stocks 3.344%. The average yield on Treasury Bonds maturing after 5 years in mid-July of 1968 was 5.36%. But many funds were still burdened with 2½% Treasuries and 2% and 2¼% Municipals—some patriotically purchased in 1941–46.

This "income equivalent" requirement seems to be countered in the investments which "jeopardize the carrying out of any of its exempt purposes." This latter suggests that investment be only in conservative and usually low-yielding securities or properties. The 5% requirement suggests that funds be placed (when and if ever bonds return to the average 1935–65 yields) in more static or more venturesome situations.

In any event, such requirements will tend to concentrate the attention of foundations upon the fluctuations of the markets, rather than on sound long-term investments.

And—rather than such an indeterminate and subjective requirement as avoiding "jeopardizing the carrying out of its purposes" a requirement of application of the generally well understood "prudent man rule" should be most desirable and eminently fair—if applied to all exempt entities including pension funds, as was proposed in the Welfare and Pension Protection Act of 1968 (House Report, No. 1867, p. 8).

The objective of simplification has not been attained as the Bill stands.

We believe that a much simpler and more direct approach could close the "loop holes" which have been used by a very few to divert funds through foundations to private uses.

We hope that the Congress can give serious and positive thought to the encouragement of charitable giving to all philanthropic institutions, rather than visiting upon the thousands of honest organizations punitive retribution for the sins of a very few—admittedly no greater in this field than in many others to which such searching attention has not been directed.

WHEATON COLLEGE,
Wheaton, Ill., September 12, 1969.

HON. RUSSELL B. LONG, CHAIRMAN, AND
MEMBERS OF THE SENATE FINANCE COMMITTEE,
New Senate Office Building, Washington, D.C.

GENTLEMEN: Wheaton College is a private, interdenominational, coeducational, fully accredited liberal arts Christian college of 1700 full-time students located in Wheaton, Illinois, about twenty-five miles due west of Chicago. It offers courses leading to the bachelor's degree in arts, sciences and music in six basic divisions of study, with majors in some thirty academic fields. It has a graduate school of theology accommodating more than one hundred students offering the Master of Arts and the Master of Divinity degrees. Since its founding in 1860 with the motto "For Christ and His Kingdom" it has had but five presidents and has sought to provide a liberal education that introduces its carefully selected students to the organized fields of learning and presents the Christian theistic view of the world of man, and of man's culture in the light of Biblical and natural revelation. Its faculty numbers 150, more than 40% of whom have earned doctoral degrees. Students come to Wheaton each year from nearly every state and from some 30 countries. Regularly, 75% of its students come from outside the state of Illinois. A third of Wheaton's graduates enter into some phase of education professionally, and currently twenty-four alumni serve as presidents of institutions of higher education. Among its nearly 15,000 alumni, perhaps Dr. and Mrs. William (Billy) Graham are best known and epitomize the purpose of the College to encourage meaningful Christian service from its graduates to mankind everywhere. Wheaton is conservative in its theological

position and, in harmony with its Christian faith, continues to uphold, with sound scholarship, the principles upon which our nation was founded.

In an effort to maintain its academic and religious independence it has sought to gain its support from individuals, business interests, foundations and local churches (representing most of the evangelical denominations throughout the United States) rather than from Federal funds. In the last two decades, due to that private support, fourteen major buildings have been added to campus facilities increasing plant assets by nearly $9,000,000. The buildings and plant expansion mentioned above would not have been possible without the transfer of donor gifts with substantial capital appreciation. We observe that donors' capital appreciation is translated into essential educational facilities and current operating funds.

We have carefully studied the provisions of the proposed Tax Reform Bill (H.R. 13270). We are definitely in favor of those provisions of the Bill which curb long standing abuses and inequities such as the provisions dealing with the taxation of debt financed income and the extension of the unrelated business income tax to churches and religious organizations. We are also of the opinion, however, that certain provisions of the Bill, if enacted into law, would substantially discourage the making of gifts to all educational and charitable institutions and would also have an adverse effect by taxing gains on deferred gifts that have already been made to such institutions. The following is a summary of those provisions that we believe would have a detrimental effect on giving to our institution and thus on our ability to educate young people to assume roles of leadership and responsibility in our society.

I. Special limitations imposed on gifts of appreciated property

We are opposed to those provisions of the Bill which would discriminate against gifts of appreciated property. These provisions include the special percentage limitation on the deductibility of gifts of appreciated property (i.e., 30% of contribution base instead of 50%) and the limitation on the contribution deduction for gifts of future interests of appreciated property.

There is no sound basis for placing a more restrictive limitation on such gifts. Similar limitations have been considered in the past and have been rejected because it was recognized that charitable gifts of appreciated property should be generally encouraged. (S. Rep. No. 1567 75th Congress, 3rd Session 1938). Last year approximately 50% of the total gifts received by the College were gifts of appreciated property. These gifts were essential to meet the expense of current operations. A reduction in annual gifts of appreciated property would certainly limit and curtail the educational program of the institution.

The limitation on the deduction of gifts of future interests of appreciated property (i.e., the Donor's cost basis) will severely handicap current and future programs of educational institutions. As a practical matter this provision may completely eliminate the use of gift annuity contracts and life income contracts when appreciated property is involved. During the last two years the College received $2.2 million under gift annuity contracts and just over $1 million under life income agreements. Although these are classified as deferred gifts the College received substantial present benefits from these gifts. Because of the sound investment policy and actuarial experience last year, the College was able to use approximately 25% of the total amount of each deferred gift annuity received for current operations. In addition the College was able to make plans for future programs knowing that fixed amounts of principal had been irrevocably designated and set aside for the use and benefit of the College. These are distinct present benefits, benefits which would be lost if the present provision was enacted into law. During the past two decades the College has recieved more funds from deferred gifts of apreciated property than any other form of gift.

II. Charitable deduction for estates and trusts

The proposed Bill contains a provision limiting the annual charitable deduction for estates and trusts to amounts which are actually paid to charity. The effect of this provision is to impose a tax on realized gains from property which has been irrevocably set aside and designated for charitable purposes. This provision is apparently supposed to encourage current distributions to chrarity; however, in actual operation it will have the effect of reducing the net amount available to charity. Since this provision is applicable to life income trusts already in existence, and since these trusts are irrevocable and not subject to change, there can be no increase in current distributions; instead a tax will be imposed annually on realized gains thus reducing the net amount available for

charitable purposes. The property received under a charitable remainder trust has the same cost basis in the hands of the Trustee as it had in the hands of the Donor; therefore, the tax will be imposed not only on the gain realized after the transfer has been made for charitable purposes, but also the unrealized gain attributable to the period when the property was in the hands of the Donor. This not only imposes an undue tax burden on the institution but also will result in additional accounting and other problems for those institutions administering charitable trusts.

It is also possible that this provision would be applicable to the typical life income agreement, and the common fund held by many institutions for the administration and investment of funds received under life income agreements. If the rule were applicable to these situations it might also be applicable to other segregated endowment or other income funds held by charitable institutions. The enactment of this provision without well defined exceptions or limitations to cover the foregoing described inequities will result in an undue tax burden and hardship for charitable institutions.

III. The Unit Trust, limited tax preference and bargain sales

The Unit Trust concept, which has been used in the proposed Bill as a standard for qualifying charitable remainder trusts, is a concept which is untried and has many uncertainties. For example, it would appear that under this rule any transfer of appreciated property to a Unit Trust would result in a taxable sale or exchange with the Doner being taxed on the difference between the value of his annuity or fixed payment interest in the trust and the cost basis of the property transferred. There is no apparent coordination between this provision and the provision requiring a taxpayer making a gift of a future interest of appreciated property to elect either to pay a tax on the full appreciation or use his cost basis as the charitable deduction. We submit that the abuses which are intended to be corrected by this provision can be more simply corrected by requiring independent trustees, i.e., that is a Trustee other than the Donor for all charitable remainder trusts and requiring all such trust agreements to contain restrictions on the investing powers of the Trustee.

The limited tax preference and allocation of deduction provisions are extremely complicated. The charitable deduction, the unrealized appreciation in gift property and the unrealized portion of long term capital gains, all figure in the computation. As a result it will be extremely difficult to advise a prospective Donor of a major gift as to the tax implications of that gift. A charitable gift is a voluntary act and it has been our experience that although the tax incentive is not the sole incentive for making a gift, it is important to each Donor. If the Donor is uncertain as to the tax implications of his gift or if there is a possibility that he may incur a tax as a result of the gift or in some way reduce his other deductions by reason of the gift, then he will be persuaded to fatal inaction and the gift will never be made.

The provision dealing with the taxation of bargain sales will have a detrimental effect on gift annuity transactions. We submit that if this provision is retained, there should be added a special exception for gift annuity transactions similar to the exception which was added to the provision dealing with debt financed income.

Historically, endowment funds have undergirded private college finances and have provided long-term strengths. In recent years deferred giving programs have complemented and supplemented the inadequacy of endowment funds. We think that the aforementioned provisions of H.R. 13270 would place in jeopardy our entire Deferred Giving program (particuarly the Life Income Contract and Gift annuity programs) and would severely reduce the incentives for gifts for current operations.

Respectfully submitted.

HUDSON T. ARMERDING, *President.*

STATEMENT SUBMITTED BY ROBERT E. BURNS, PRESIDENT, ASSOCIATION OF INDEPENDENT CALIFORNIA COLLEGES AND UNIVERSITIES

SUMMARY

The attached statement is submitted on behalf of the Association of Independent California Colleges and Universities. The Association represents the accredited four-year independent institutions of higher education in the State of

California. Its member institutions educate more than one quarter of all California students in four-year and graduate programs.

The Association and its member institutions are deeply concerned with the grave consequences which would fall pupon all independent, nonprofit educational institutions shoulld the House-passed bill, H.R. 13270, be enacted into law without modification, for certain provisions presently provided therein would render a crippling, if not fatal, blow to all such institutions. These provisions are the ones which would erroneously classify certain charitable contributions as an item of tax preference for purposes both of limitation on such items and the allocation of deductions and also the ones which would seriously undermine the ability of the colleges and universities to obtain propery subject to life estates.

Under the House-passed bill, a charitable contribution of appreciated property would be classified as a "tax preference" both for purposes of determining the limitation on such preferences and the allocation of deductions. Also, the personal eductions which are subject to allocation include a taxpayer's charitable contributions. The very complexities of these provisions would of themselves discourage gifts. Certainly, the provisions in present law and in the House-passed bill which place direct percentage limitations on charitable contributions impose an effective and efficient restriction thereon. For this reason alone, there is little justification for further limiting the deduction for charitable contributions by classifying gifts of appreciated property as a tax preference. Moreover, unlike the other tax preference items, a taxpayer realizes no economic benefit from making such a gift. In the case of a gift to charity, a taxpayer must bear a financial burden without the promise of a corresponding financial benefit. It is thus obvious that when a taxpayer approaches his ceiling on tax preferences, he will attempt to conduct his affairs in such a way as to avoid as much as possible the loss of any deduction, and that, of all the so-called tax preferences, the contribution of appreciated property to a charity will be the first which he will reduce or eliminate because it is the only one which promises him no financial benefit and will result in a cost to him in any event. Moreover, the inclusion of charitable gifts in the deductions which would be disallowed as a result of an allocation of deductions produces an even greater discrimination against charitable gifts, because here, too, the taxpayer would often forego making such gifts in lieu of reducing or eliminating those items of tax preference which promise him financial reward.

There are several provisions in the House bill which would or could have an effect on gifts involving charitable remainder trusts, annuities, and life income contracts. Essentially, each of these three types of gifts allows a donor to make an immediate gift to a charity but retain an assured income for life. The importance of these gifts cannot be over-emphasized. In the case of many independent nonprofit educational institutions the annual value of these gifts represents 25 to 50% of the contributions which they receive each year. For these most important reasons, we ask the Com ittee to modify those provisions in the bill discussed below which would or could have an adverse effect on these three types of gifts:

(a) Subsection 121(d) of the bill should be clarified to make it inapplicable to income-producing property acquired by an exempt organization in exchange for a life income contract;

(b) Subsection 201(c) of the bill should be amended so as to make it inapplicable to gifts of future interests;

(c) Subsection 201(e) of the bill should be modified to be made clearly inapplicable to the three forms of gifts mentioned above;

(d) The concepts of "charitable remainder annuity trusts" and "charitable remainder unitrusts" should be removed from the bill by appropriate amendments to Subsections 201(e), (h), and (i) of the bill; and

(e) None of the provisions in the bill relating to charitable gifts should be made retroactive to a date prior to the date of enactment.

Since 1917 Congress has encouraged deductions for contributions to nonprofit educational organizations because it has recognized the significant and essential role which such organizations play in the continuing development of our society in this great nation. If the House bill is passed into law without the modifications requested above, Congress will discourage, and in some cases completely eliminate, the very gifts which it has historically sought to encourage. We do not believe that upon reflection, Congress would desire such a result because it conflicts with its historic position and would deal a serious blow to higher education.

STATEMENT

This statement is submitted on behalf of the Association of Independent California Colleges and Universities and each of its member institutions. It addresses itself to those provisions in the "Tax Reform Act of 1969," H.R. 13270, relating to the limitation on tax preferences, allocation of deductions and charitable contributions.

The Association of Independent California Colleges and Universities represents the accredited four-year independent institutions of higher education in the State of California. Its members range in size from small institutions with student enrollments of a few hundred, such as California Baptist and Dominican College of San Rafael, to such large institutions as Stanford University and University of Southern California with enrollments of over ten thousand. One great strength of this group lies in its diversity—not only in terms of size, but also in the ability of each institution to follow its particular philosophy of education, regardless of size. Thus, these institutions afford a richness of choice to students and play a major role in maintaining a pluralistic, decentralized and open society.

The member institutions of the Association educate more than one-quarter of all California students in four-year and graduate programs. This year they have enrolled 98,000 students and will award more than 10,000 undergraduate baccalaureate degrees and over 7,000 advanced degrees. Their graduates have gone on to contribute their diverse talents to all parts of our complex society, both public and private.

Such independent higher education does not mean exclusiveness. This year our members will be providing scholarship assistance to 25 percent of their students and other financial assistance to an additional eight percent. These independent institutions enroll a higher percentage of black students than do the four-year public institutions of California. This positive approach to the needs of underprivileged and minority groups evidences concern for critical social problems, willingness to become involved, and ability to adapt to such needs.

The Association and its member institutions hereby express their deep concern with the grave consequences which would fall upon all independent nonprofit educational institutions should the House-passed bill, H.R. 13270, be enacted into law without modification, for certain provisions presently provided therein would render a crippling, if not fatal, blow to all such institutions. These provisions are the ones which would erroneously classify certain charitable contributions as an item of tax preference for purposes both of the limitation on such items and the allocation of deductions and also the ones which would seriously undermine the ability of the colleges and universities to obtain property subject to life estates.

In order for it to appreciate fully the serious threat which these provisions in the House bill pose to educational institutions, we believe that the Committee should be aware of the present and future financial needs and problems of our members.

Our members had total assets in excess of 1½ billion dollars in the fiscal year 1966-67 and had educational budgets aggregating 211 million dollars. The sources of funds which satisfied the demands of these educational budgets for that year were:

Tuition and fees (48 percent)	$101,000,000
Private gifts and grants (18 percent)	38,000,000
Endowment income (10 percent)	21,000,000
Other sources (24 percent)	51,000,000
Total (100 percent)	211,000,000

In addition to those budgetary operating expenditures, capital expenditures were made in the amount of $73 million during the same year. Thirty-three percent of these capital expenditures were funded by private gifts. (Remaining sources were: Federal Government, 10%; Loans, 37%; and other sources, 20%.) If it were not for these private institutions and the private gifts which established and now support them, either the taxpaying public would have had to provide for these expenditures or the quantity and quality of education would have been greatly diminished.

The Association conducted a thorough analysis of the projected needs of its members for the ten-year period beginning with 1968 and ending with 1978. This

study indicated that, because of expected increases in costs per student as well as in enrollments, the Association's members must add 10 to 12% each year to their incomes. In the absence of additional revenues beyond that which can presently be anticipated, the prospect is for income to fall increasingly short of operating requirements—by a total for all members of as much as $36 million by 1973 and $96 million by 1978. Actually, the need for increased operating revenues has already assumed considerable urgency. During the period 1957–1965, an average of four member institutions per year experienced operating deficits of more than $50 per full-time student. Eight institutions had deficits in 1966. In 1967 the number jumped to 14. As a matter of fact, the deficit of 96 million dollars projected for 1978 might never be reached because a number of our institutions may well be forced to close their doors in the face of continued and growing deficit operations. It is obvious that, in order to avoid these projected deficits and the closing of some of our member institutions, it will be necessary to raise considerable funds, a significant part of which we expect to receive by way of private donations.

We point out that the operations of our members and those of similar institutions throughout the United States serve two purposes: not only do they help to fulfill the tremendous and critically important educational needs which this country must satisfy to continue to grow and prosper, but they also perform this function at little expense to the taxpaying public. Had these institutions not been established and had they not grown as they have, the direct burden on the taxpayers would be enormous. Congress has historically recognized these facts and for the past fifty-two years has provided tax incentives which have encouraged donations to these institutions. This is why we were not only alarmed but also startled by some of the alleged reform proposals pertaining to charitable contributions which are reflected in H.R. 13270.

We wish to make it quite clear that our members, without exception, believe that no donor should profit from his gift. Thus, there are certain provisions in the bill which we do not challenge because we recognize the need for true tax reform. There are, however, other provisions in the House-passed bill which cannot be classified as "reform" measures. Moreover, these latter provisions would have a disastrous impact upon all of our institutions.

Under the House-passed bill a charitable contribution of appreciated property would be classified as a "tax preference." The bill in effect imposes a limitation by way of a ceiling on the maximum amount of tax preferences which an individual could claim as deductions in any one year. That ceiling would equal 50% of a taxpayer's adjusted gross income plus his tax preferences. For this purpose, the items of tax preference are: (1) the excluded one-half of net long-term capital gains; (2) tax-exempt interest on state and local bonds (included in limited tax preferences gradually over the next ten-year period); (3) the excess of accelerated depreciation over straight-line depreciation; (4) certain farm losses; and (5) charitable contributions of appreciated property. However, in no case would an individual's deductible tax preferences be reduced below $10,000.

The House bill also provides that an individual must allocate certain personal deductions between his taxable income and his allowable tax preference items (to the extent that the latter exceed $10,000) with a resulting nondeductibility of that portion of such deductions allocable to the latter. For example (and ignoring the $10,000 floor), a taxpayer whose income is divided equally between his taxable income and his tax preference income would be allowed to claim only one-half of his otherwise allowable personal deductions. For this purpose, the tax preference items are generally the same as those five listed in the preceding paragraph (with certain adjustments) plus the excess of intangible drilling expenses over the amount of expenses which would have been recovered through straight-line depreciation and the excess of percentage depletion over cost depletion. However, for purposes of allocation, these items of tax preference are taken into consideration only to the extent that they have not exceeded the ceiling thereon which was described in the preceding paragraph. The personal expenses which must be allocated include interest, taxes, personal theft and casualty losses, medical expenses *and* the charitable deduction.

Initially, we must express our alarm with the obvious complexities of these provisions without even commenting on their substance. Just by examining these complexities, a taxpayer may well be discouraged from making charitable contributions. Moreover, and more importantly, the classification of gifts of appreciated property as a tax preference for purposes of both the limitation on tax preferences and the allocation of deductions provisions is illogical and inequitable.

Present law and the provisions in the House-passed bill place certain direct percentage limitations on charitable contributions which act as a simple but effective restriction upon the amount of contributions which a particular taxpayer may claim as a deduction. For this reason alone, there is little justification for further limiting the deduction for charitable contributions by classifying gifts of appreciated property as a tax preference.

Unlike the other tax preference items, a taxpayer realizes no economic benefit from making a gift to charity. In fact, those other items add nontaxed cash dollars to his income. On the other hand, in the case of a gift to charity, the taxpayer must bear the financial burden without the promise of a corresponding financial benefit. It is thus obvious that, when he approaches his limitation on tax preferences or faces a reduction of his deductions for personal expenditures, he will attempt to conduct his affairs in such a way as to avoid as much as possible that limitation or the loss of any deductions. Of all the so-called tax preferences, the contribution of appreciated property to a charity will be the first which he will reduce or eliminate because it is the only one which promises him no financial benefit and will result in a cost to him in any event. Moreover, the inclusion of charitable gifts in the deductions which would be disallowed in the event of an allocation of deductions would result in an even greater discrimination against charitable gifts because here, too, the taxpayer would often forego making such gifts in lieu of reducing or eliminating those items of tax preference which promise him financial reward.

Since 1917 Congress has encouraged deductions for contributions to nonprofit educational organizations because it has recognized the significant and essential role which such organizations play in the continuing development of our society in this great nation. However, and as pointed out above, by classifying gifts of appreciated property as an item of tax preference for purposes of the limitation on such items and the allocation of deductions and by including charitable gifts in those personal deductions which are subject to allocation, Congress will discourage the very gifts which it has historically sought to encourage and unfairly discriminate against those who make them. As a result of such a classification, Congress would create frequent situations in which a donor would find himself unable to make a gift which he would have otherwise made with significant cost to himself under present law. We do not believe that, upon reflections, Congress would desire such a result because it conflicts with its historical position and would deal a serious blow to higher education.

The final area of proposed changes in the present tax law which so profoundly concerns us relates to those provisions which would or could have an effect on gifts involving charitable remainder trusts, annuities, and life income contracts. A charitable remainder trust, simply stated, is the placing of property in trust with the income thereon payable to the donor for life and the remainder given to a charity at his death. The annuity is a contract by which the recipient charity agrees to pay an annuity to the donor for his lifetime as a result of his making a gift to that charity. The life income contract is an agreement by which the charity pays to the donor an annual income over his lifetime at the rate of the average annual net yield earned by the charity on that part of its pooled investment fund which is proportionate to the value of the donor's gift. Essentially, each of these three types of gifts allows a donor to make an immediate gift to a charity but retain an assured income for life. Also, in the great majority of cases, the donor not only reserves a life income to himself but also reserves a life income for his surviving spouse or minor or handicapped dependents.

Obviously, these type of gifts are advantageous both to the donor and donee. The donor is able to satisfy his desire to aid a charity by making the gift at present and yet be assured that he will have an income for life. The charity is presently assured of receiving funds and is therefore able to plan accordingly. The importance of these gifts cannot be over-emphasized. In the case of many independent nonprofit educational institutions the annual value of these gifts represents 25 to 50% of the contributions which they receive each year. That the provisions in the House-passed bill would discourage or eliminate these gifts is not open to question. For example, one of our member institutions which expected to receive such a gift which would have eventually resulted in the receipt of at least two and one-half million dollars is no longer assured of receiving that gift. Another was to receive such gifts totaling one one one-quarter million dollars and now faces the loss of those gifts. In such cases, the negative impact of the House-passed bill has been the reason why the gifts were not completed. For these most important reasons, we ask the Committee to modify

those provisions in the bill discussed below which would or could have an adverse effect on these three types of gifts:

(a) Subsection 121(d) of the bill provides that certain debt-financed income would be subject to tax if it arises with respect to property acquired with borrowed funds and the production of the income therefrom is unrelated to the purpose constituting the basis of the recipient organization's tax exemption. This tax, however, is inapplicable to income-producing property acquired in exchange for a gift annuity when certain tests are met. While it is unlikely, considering the purpose of these provisions, that they should or would apply to gifts subject to life income contracts, the question is not free from doubt. Therefore, we request that this subsection of the bill be clarified to make it inapplicable not only to income-producing property acquired in exchange for an annuity but also to that acquired in exchange for a life income contract. In this respect, we point out that the reasons for excluding an annuity from application of these provisions would be equally applicable to the exclusion of a life income contract.

(b) Subsection 201(c) of the bill in the case of certain specified gifts of appreciated property requires the donor either to include such appreciation in his taxable income or reduce his deduction by the amount of such appreciation. This choice applies to a charitable contribution of a future interest. In the experience of our member institutions, very few gifts of remainder interests involve anything other than appreciated property. Obviously, if the donor must pay a tax and yet part with the property, he would not make such a gift. Therefore, if this provision were enacted into law, this area of deferred giving would be foreclosed resulting in a severe blow to the revenues of private nonprofit educational institutions and thus to society as a whole.

(c) Where a taxpayer makes a sale of property to charity at less than its fair market value with the difference between the fair market value and the sales price representing a gift, Subsection 201(e) of the bill requires an allocation of his basis between the sale and the gift. Again, it would appear that this provision is not meant to apply to the three forms of gifts mentioned above, and such an application would be in inappropriate. However, in order to remove the doubt which would otherwise cloud these methods of giving, we request that this provision be amended to exclude clearly such gifts.

(d) Subsections 201(e) and (h) of the bill provide that no deduction will be allowed for purposes of the Federal income and estate taxes, respectively, for a gift of a charitable remainder interest of property subject to a prior estate in trust unless the trust is either a "charitable remainder annuity trust" or a "charitable remainder unitrust" as those terms are defined in Subsection 201(i) of the bill. Allegedly, these particular provisions were incorporated in the bill to provide assurance that the trust would not be administered in a manner which would jeopardize the value of the remainder interest to go to the charity. However, the particular means which the House chose to provide such protection would result in discouraging gifts. Therefore, we request that these provisions be deleted from the bill and that any substitute provisions simply provide that a deduction will be allowable for a gift of a remainder interest where the charity acts as the trustee, for this would provide the protection desired. We also point out that it is unlikely that more than a few donors would make gifts of charitable remainders under the provisions included in the House bill because the definitions of an annuity trust and a unitrust exclude trusts where more than one life estate is involved; thus, because most donors wish to provide for their surviving spouse or handicapped or minor dependents, they would seldom make such gifts.

We further note that certain provisions pertaining to charitable trusts are unfairly and unreasonably retroactive. Subsection 201(e) is applicable to gifts made on or after April 23, 1969, even though donors were not put on notice that such provisions might be enacted into law until August 1, 1969, the day upon which the House bill was reported out of the Committee on Ways and Means. In fact, several of our member institutions received gifts after April 22, 1969 from donors who were relying on the provisions of present law. Subsection 201(h) would deny a charitable deduction for Federal estate tax purposes with respect to certain existing charitable remainder trusts. Subsection 201(f) would deny the deduction now available for purposes of the Federal income tax to existing

trusts in the amount of any capital gains which are permanently set aside for charity. Both of these subsections would be applicable even if the trust was established long prior to August 1, 1969 and was irrevocable as of that date. The retroactivity of all three of these provisions is patently unreasonable and unfair and would result in undue hardship on all parties.

The bill has been carefully studied by the legal advisors of our member institutions as well as the legal counsel of the Association of Independent California Colleges and Universities. It is our considered opinion that the House-passed version of the "Tax Reform Act of 1969" might well have the most profoundly detrimental impact on independent higher education in the United States in its history. This restrictive measure would come, not at a time of lessening demand or need, but during a period of unprecedented challenge and constantly widening horizons.

We urge you, therefore, to consider with the utmost care the present tax incentives to charitable giving before making any changes. It is essential that, in your understandable zeal and well-warranted concern to distribute the tax burden more equitably and to correct present abuses, you do not penalize the private sector of higher education which has contributed so much to the unique fabric that is our American society.

PRESIDENT AND FELLOWS OF HARVARD COLLEGE,
Boston, Mass., September 24, 1969.

Hon. RUSSELL B. LONG,
Chairman, Senate Committee on Finance,
Washington, D.C.

DEAR MR. CHAIRMAN: Like others who bear responsibility for maintaining high standards in the field of private education, we at Harvard are concerned over the potential impact on charitable giving of certain provisions of the Tax Reform Act of 1969 as passed by the House of Representatives. While we understand the desire of the Congress to ensure a fair distribution of the tax burden, we suggest that some provisions of the proposed statute may go further than is reasonably necessary or desirable. They would, we believe, discourage charitable giving, at a time when, with the sharply rising cost of higher education, any reduction of charitable giving would have serious conseqences to institutions that depend, as does Harvard, upon continued and substantial support from individuals.

We do not wish to burden the Committee with an extended discussion of the several provisions of the bill affecting charitable gifts which have been covered in detail in testimony and statements submitted by others. The American Council on Education, of which Harvard is a member, has submitted a statement, and we strongly endorse the Council's proposals, particularly those under the headings "Limit on Tax Preferences and Allocation of Deductions", "Gifts of Appreciated Property", "Limitation on Gifts by Individuals" and "Charitable Remainder Trusts." Mr. Arland F. Christ-Janer, President of Boston University and President of the Association of Independent Colleges and Universities in Massachusetts, of which Harvard is also a member, has submitted a statement and testimony which we heartily endorse. We wish only to add brief comments on four aspects of the bill which we believe to be especially deserving of reconsideration.

1. The Secretary of the Treasury has recommended that appreciation on securities and other property donated to educational and other publicly supported institutions be eliminated from the list of tax preferences. The treatment of such appreciation as a tax preference, for purposes both of the "limitation on tax preferences" and the "allocation of deductions", would, of course, affect most heavily persons who are in a position to make substantial gifts. It is a fact of life that while colleges and universities receive numerous gifts from relatively small contributors, they necessarily depend to a major extent on a relatively small number of large gifts from individuals; and it is these large gifts, we believe, which the provisions in question would most seriously jeopardize. Accordingly, we urge that the Committee on Finance adopt the recommendation of the Secretary of the Treasury in this regard.

2. We respectfully suggest that the treatment of charitable contributions as a deduction subject to allocation between taxable and nontaxable income merits careful reappraisal. While such allocation of any non-business deduction can obviously be rationalized, the matter is essentially one of legislative policy; and we question whether circumstances warrant such a drastic reversal of the long-

continued policy of the past. There is every reson to expect that such treatment of charitable contributions would have a seriously detrimental effect upon charitable giving.

3. We urge also that the Committee adopt the Secretary of the Treasury's recommendation that the provision of the bill which requires a donor of works of art and other tangible personal property either to limit his deduction to the basis of the property or to include in income the excess of fair market value over basis be modified so as to make it applicable (if at all) only to property donated by its creator. It cannot be too strongly emphasized that the long-standing Congressional policy of allowing liberal tax deductions for such gifts to educational institutions, museums and the like has been responsible in large measure for the development of the great collections of art and literature in this country. American libraries, for example, now lead the world in the dynamic growth of their research collections, and many such collections have been preserved for the use of scholars and the general public only because private collectors were able to derive tax benefits from giving them to libraries. At Harvard alone where, contrary to popular belief, inadequate funds are available for such acquisitions, many individual examples of such gifts could be cited.

The only apparent justification for differentiating between gifts of tangible property and gifts of securities is that tangible property may present somewhat greater difficulty in valuation. Thus, to the extent that there is a problem, it is one of administration of the law, and it appears that the problem is not regarded as serious by those charged with such administration. In his statement to the Committee on September 4, 1969, the Assistant Secretary of the Treasury for Tax Policy pointed out that problems involved in valuing art objects and the like "have been substantially resolved by changes in the income tax form, by improved audit programs, and by creation of a special advisory group to the Committee of Internal Revenue on valuations of art objects."

4. Finally, we urge reconsideration of the provision in the House bill which would require that a donor of a "future interest" in property which has appreciated in value either report the appreciation as taxable income or limit his deduction to the basis of the property. The chief impact of this provision would be on charitable remainder trusts and we believe that it would largely put an end to the creation of such trusts which have proved to be a significant source of contributions to educational institutions.

Yours truly,

GEORGE F. BENNETT, *Treasurer.*

GIBSON, DUNN & CRUTCHER,
Los Angeles, Calif., September 30, 1969.

Re Comments on Section 201(h) of H.R. 13270.

Finance Committee of the Senate,
Washington, D.C.

DEAR SIR: We appreciate this opportunity to bring to your attention important errors and omissions in proposed Section 201(h) of H.R. 13270.

The purpose of Section 201(h), as set forth in the Report of the Ways and Means Committee, is to extend certain of the new restrictions on charitable gifts which are proposed in Bill Section 201(a) for income tax purposes to the estate and gift tax law. In making this extension, the drafters have included provisions which, if interpreted literally, would make it impossible to obtain a charitable deduction for any gift in trust. This is true even if a charitable remainder annuity trust or charitable unitrust is used. Moreover, even if this problem is eliminated, other provisions have the effect of arbitrarily denying a charitable deduction for certain types of gifts while allowing a deduction for other gifts on the basis of distinctions which have nothing to do with the tax abuses which the House of Representatives sought to correct.

As you know, there is a great concern that H.R. 13270 will seriously impede the ability of qualified charities to raise funds. It will be up to the Congress how far it wishes to go in reducing gifts to charity in order to prevent possible tax abuses. My concern—which I am sure you will share—*is that charitable gifts are not further diminished by unnecessary or inadvertent provisions which will prevent charitable gifts without closing any "loopholes" or area of tax abuse.*

This problem is particularly acute in the estate and gift tax areas because denying the charitable deduction does not merely remove the tax incentive to make a charitable gift. It affirmatively penalizes the gift. If the gift tax deduction is denied the donor must pay a tax which he would not have had to pay if he had spent the money instead of giving it to charity!

By reason of the complexity of the subject matter, we have attached as Exhibit "A" specific technical comments on Section 201(h). Experience has shown that the structure and objectives of the estate and gift tax laws are sufficiently different from the income tax laws that simultaneous amendments of any complexity are rarely successful. Bill Section 201(h) in its present form is one of a number of illustrations of what can happen when such simultaneous amendments are attempted. We anticipate that you will conclude that you and your Staff have more than you can do in developing a worthwhile income tax bill and will recommend that Section 201(h) be considered as part of the estate and gift tax reform bill which is now pending in the House of Representatives rather than as part of H.R. 13270. However, in the event the committee determines to retain Section 201(h) we have taken the liberty of including in Exhibit A for your consideration proposed language to correct at least the major problems inherent in Section 201(h) in its present form.

If we can be of any additional assistance, please do not hesitate to call upon us.

Sincerely yours,

ROBERT D. BURCH, *of Gibson, Dunn & Crutcher.*

Enclosure

TECHNICAL ANALYSIS OF OVERSIGHTS IN BILL SECTION 201(h)

1. FAILURE TO RECOGNIZE THE SPECIAL PROBLEMS OF "SPLIT TRUSTS"

Proposed Section 2055(e)(1) and Section 2522(c)(1) incorporate the requirements of proposed Sections 4941(d), 4943(c), 4944 and 4945(b) into the estate and gift tax law. Sections 4941 et. seq. deal with private foundations and, as drafted, it is impossible for a trust which has both charitable and non-charitable beneficiaries to meet some of the requirements of these sections. Proposed Section 4947(b) recognizes this problem in the income tax area, but no comparable provision has been incorporated in the estate and gift tax area. The result is to effectively deny a charitable deduction for any gift in trust, even if it is in the form of a guaranteed annuity or a qualified remainder interest in a charitable annuity trust or unitrust. For example, if a decedent provides that an annuity of Five Thousand Dollars ($5,000) per year shall be paid to a qualified charity for ten (10) years and the trust estate be paid to decedent's son at the end of ten (10) years, the trust could not qualify for an estate tax deduction—i.e. the right of the trust to pay reasonable trustee fees would disqualify the trust under Section 4945(b)(5) even though these fees were payable solely from the son's share and would not reduce the amount passing to the charity. Although this is an extreme sample, it points up the arbitrary manner in which Sections 2055(e)(1) and 2522(c)(1) would operate.

The most practical solution to the problem is to recognize that the legislative objective is to ensure that amounts for which a charitable deduction has been allowed are not diverted to private purposes. If the application of Sections 4941 et. seq. is so limited, this purpose can be achieved without preventing otherwise qualified gifts and bequests to charitable organizations.

2. SECTION 2055(e)(2) INADVERTENTLY DENIES A DEDUCTION FOR GIFTS OF GUARANTEED ANNUITIES OR INCOME EQUAL TO A FIXED PERCENTAGE OF YEARLY VALUE TO QUALIFIED CHARITIES

The proposed income tax provisions restrict deductions for gifts of income interests to charity unless they are in the form of a guaranteed annuity or a fixed percentage of yearly value (see proposed Section 170[b] [1] [H] at Page 115 of H.R. 13270). Gifts of remainder interests are similarly restricted unless they are in the form of a charitable annuity trust or unitrust (see proposed Section 170[H] at Page 127 et seq. of H.R. 13270).

Section 2055(e)(2) extends to the estate tax area the income tax rule denying a deduction for a gift of a remainder interest unless it is in the form of a charitable annuity trust or unitrust. In doing so, it inadvertently also disallows deductions for all types of income interests. This obviously was not intended, since it would serve no purpose. The prime example of a charitable interest that can

never be diverted to private purposes is a guaranteed charitable annuity in a fixed amount. As discussed in Paragraph 3 below, proposed Section 2522(c) (2) restricts the gift tax deduction for gifts of an income interest to guaranteed annuities or fixed percentages of yearly value as defined in Section 170(b) (1) (H), but through an oversight, has no restriction on gifts of a remainder interest.

Section 2055(e) (2) should be amended to allow an estate tax deduction for gifts to charity of guaranteed annuities and fixed percentages of the yearly value of the trust (as defined in Section 170[b] [1] [H]).

3. SECTION 2522(C) (2) REACHES UNINTENDED RESULTS BY THE METHOD SELECTED TO COORDINATE WITH THE INCOME TAX LAW

Proposed Section 170(b) (1) (H) is designed to deal with two income tax problems relating to charitable trusts:

(a) To deny a deduction for the charitable gift unless the charity is assured of getting the income. This is accomplished by requiring the interest to be in the form of a guaranteed annuity or an income interest equal to a fixed percentage of yearly fair market value.

(b) To prevent the so-called "double benefit" whereby the income from a qualified trust is excluded from the donor's income under I.R.C. Section 671 and, in addition, donor is allowed a charitable deduction for the value of the income interest. This is accomplished by denying the charitable deduction for the value of the income interest unless the income from the trust is taxed to the donor under Section 671. In other words, the donor may either exclude the income from his gross income or claim a charitable deduction, but not both.

Proposed Section 2522(c) (2) obviously intended to extend only the first change to the gift tax law. It makes no difference for gift tax purposes whether the donor obtains his income tax benefit by excluding the trust's income from his gross income under Section 671 or by deducting the value of the income interest under Section 170. However, the language at the top of Page 134 clearly extends both changes to the gift tax law. The result would be that:

(a) If the donor transfers property to a trust to pay the income to charity for over ten (10) years, he must pay a gift tax. If the income is paid to the donor for as little as one (1) day during the first ten (10) years there would be no gift tax, whether or not the income was thereafter paid to the charity for a term of more than ten (10) years.

(b) If the donor transfers property to a trust to pay the income to charity for more than ten (10) years, he may still avoid the gift tax if he or a non-adverse person retains any forbidden power under Section 671 et seq.—e.g. the power to vote stock in a closely held corporation in a non-fiduciary capacity.

Proposed Section 2522(c) (2) fails to include any restriction on the gift tax deduction for remainder interests. It is submitted that the objective is the same for both estate and gift tax purposes. If Congress feels that estate and gift tax restrictions are necessary to assure that the charity receives the property for which an estate or gift tax deduction is allowed, both the estate and gift tax law should require that:

(1) If the gift is in the form of an income interest it must be a guaranteed annuity or fixed percentage yearly of the fair market value of the trust property (See Section 170[b] [1] [H]), and

(2) If the gift is in the form of a remainder interest it must be in a charitable remainder annuity trust or charitable remainder unitrust, as defined in Section 664(d).

EXHIBIT A

Page 3.

PROPOSED REVISION OF BILL § 201(h) OF H.R. 13270

(h) DISALLOWANCE OF ESTATE AND GIFT TAX DEDUCTIONS IN CERTAIN CASES.

(1) Estates of citizens or residents.—Subsection (e) of section 2055 (relating to disallowance of charitable deductions in certain cases) is amended to read as follows:

"(e) DISALLOWANCE OF DEDUCTIONS IN CERTAIN CASES.

"(1) No deduction shall be allowed under this section—

"(A) for transfer to or for the use of an organization described in section 501(c)(3) (relating to exempt organizations) unless the organization—

"(i) is exempted from the requirements of section 508(a) and (b) pursuant to subsection (c) thereof, or

"(ii) complies with section 508(a), (b), and (g); or

"(B) for a transfer in trust (other than one to which the provisions of subparagraph (A) of this paragraph apply) unless the governing instrument of the trust includes provisions, the effects of which are to prohibit the trust from—

"(i) engaging in any act of self-dealing (as defined in section 4941(d)),

"(ii) retaining any excess business holdings (as defined in section 4943(c)),

"(iii) making any speculative investments in such manner as to subject the trust to tax under section 4944, and

"(iv) making any taxable expenditures (as defined in section 4945(b)).

"This subsection shall not apply to a trust which is not exempt from tax under § 501 (a), not all of the unexpired interests of which are devoted to to one or more of the purposes described in § 170(c)(2)(B), if—

"(i) the permitted investment, expenditure or transaction does not reduce the amount otherwise payable to any organization described in subsection (a) for which a deduction has been allowed under this section, or,

"(ii) the permitted taxable expenditures (as defined in § 4945(b)) are limited to expenditures described in § 4945(b)(5) which are reasonable and necessary for the proper administration of the trust. Any such expenditures must be allocated among the beneficiaries described in subsection (a) and other beneficiaries in a fair and reasonable manner.

COMMENT

This modification permits transactions which affect only the non-charitable beneficiaries of the trust. This is proper since no estate tax deductions has been allowed for property passing to these beneficiaries. It also permits payment of trustees fees and similar trust administration expenses, even though part of these expenses are paid from the charity's share of the property if the expenditure is reasonable in amount and fairly apportioned between charitable and noncharitable beneficiaries.

"(2) Where an interest in property passes or has passed from the decedent to a person, or for a use, described in subsection (a) and an interest in the same property passes or has passed (for less than an adequate and full consideration in money or money's worth) from the decedent to a person, or for a use, not described in subsection (a), no deduction shall be allowed under this section for the interest which passes or has passed to the person, or for the use, described in subsection (a) unless

"(A) 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 described in section 664(d), or

"(B) the interest is in the form of a guaranteed annuity or the trust instrument specifies that the interest shall receive a fixed percentage yearly of the fair market value of trust property (determined yearly).

COMMENT

This provision provides assurance that property for which an estate tax deduction is allowed will be received by the charity by limiting the estate tax deduction to the type of income interest approved for income tax purposes in Section 170(b)(1)(H) and to the type of remainder interest approved for income tax purposes in Section 170(H).

(2) Estates of Nonresidents Not Citizens—

Subparagraph (E) of section 2106(a)(8) (relating to disallowance of deductions in certain cases) is amended to read as follows:

"(E) Disallowance of Deductons in Certain Cases.—The provisions of section 2055(e) also shall be applied in the determination of the amount allowable as a deduction under this paragraph."

(3) Gift Tax.—Subsection (c) of section 2522 (relating to disallowance of charitable deductions in certain cases) is amended to read as follows:

"(C) DISALLOWANCE OF DEDUCTIONS IN CERTAIN CASES.

"(1) No deduction shall be allowed under this section—

"(A) for a transfer to or for the use of an organization described in section 501(c)(3) (relating to exempt organizations) unless the organization—

"(i) is exempted from the requirements of section 508 (a) and (b) pursuant to subsecttion (c) thereof, or

"(ii) complies with section 508(a), (b), and (g); or

"(B) for a transfer in trust (other than one to which the provisions of subparagraph (A) of this paragraph apply), unless the governing instrument of the trust includes provisions the effects of which are to prohibit the trust from—

"(i) engaging in any act of self-dealing (as defined in section 4941(d)),

"(ii) retaining any excess business holdings (as defined in section 4943(c)),

"(iii) making any speculative investments in such manner as to subject the trust to tax under secttion 4944, and

"(iv) making any taxable expenditures (as defined in section 4945(b)).

"This subsection shall not apply to a trust which is not exempt from tax under § 501(a), not all of the unexpired interests of which are devoted to one or more of the purposes described in § 170(c)(2)(B), if—

"(i) the permitted investment, expenditure or transaction does not reduce the amount otherwise payable to any organization described in subsections (a) and (b) for which a deduction has been allowed under this section, or,

"(ii) the permitted taxable expenditures (as defined in § 4945(b) are limited to reasonable and necessary expenditures for the proper administration of the trust and such expenditures are allocated among the beneficiaries described in subsections (a) and (b) and other beneficiaries in a fair and reasonable manner.

COMMENT

This modification permits transactions which affect only the non-charitable beneficiaries of the trust. This is proper since no estate tax deduction has been allowed for property passing to these beneficiaries. It also permits payment of trustees fees and similar trust administration expenses, even though part of these expenses are paid from the charity's share of the property if the expenditure is reasonable in amount and fairly apportioned between charitable and non-charitable beneficiaries.

"(2)(A) Where a donor transfers an interest in property to a person, or for a use, described in subsection (a) or (b) and an interest in the same property is transferred or has been transferred (for less than an adequate and full consideration in money or money's worth) from the donor to a person, or for a use, not described in subsection (a) or (b), *no* deduction *shall be* allowed under this section for the interest which is, or has been transferred to the person, or for the use, described in subsection (a) or (b) *unless*:

"(A) 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 described in § 664(d), or

"(B) the interest is in the form of a guaranteed annuity or the trust instrument specifies that the interest shall receive a fixed percentage yearly of the fair market value of the trust property (determined yearly).

~~shall not be greater than the amount allowed to the donor as a deduction under section 170 in respect of such interest, determined without regard to the percentage limitation in subsection (b) thereof. For purposes of this subparagraph, where the donor has elected the alternative set forth in subparagraph (B) of section 170 (e) (1) (relating to electing valuation of gifts of appreciated property), the deduction allowed under section 170 shall be deemed to be the deduction that~~

~~would have been allowed had the alternative set forth in subparagraph (A) been elected.~~

~~"(B) Where any readjustment under section 170(b)(1)(H) is made in the donor's income at the time the readjustment is made the donor shall, for purposes of this chapter, be considered as making a gift (which is not a gift of a present interest in property and for which no deduction shall be allowed under this section) of property in an amount equal to the amount required to be included in income as a result of the readjustment, except that if the alternative set forth in subparagraph (B) of section 170(e)(1) had been elected, the amount of such gift shall be considered to be in an amount equal to the amount which would have been required to be included in income as a result of the readjustment if the alternative set forth in subparagraph (A) of such section had been elected.~~

COMMENT

This modification incorporates the identical restriction provided for estate tax purposes into the gift tax law to assure that the charity will in fact receive the property for which a gift tax deduction is allowed.

AMERICAN ASSOCIATION OF UNIVERSITY WOMEN,
Washington, D.C., September 12, 1969.

Hon. RUSSELL LONG,
Chairman, Senate Finance Committee,
U.S. Senate, Washington, D.C.

DEAR SENATOR LONG: The American Association of University Women is comprised of approximately 175,000 women graduates of colleges and universities, organized in 1,660 local branches and in fifty state divisions. This Association has long been interested in the improvement of our colleges and universities and in extending opportunities for higher education to all qualified young people. To that end, we have supported many Federal-state education programs enacted by the Congress in recent years, and have endeavored to explain to the public the meaning of these programs and the need for additional support of higher educational institutions, both public and private.

The American Association of University Women Educational Foundation, established in 1958, is the avenue through which Association members channnel their charitable and public service funds. This Foundation's primary activity is the granting of scholarships and fellowships to women students, principally at the graduate and post-doctoral level. The monies for this program—the present endowment is approximately five million dollars—come from contributions from AAUW members, usually in dimes and dollars, not in hundreds and thousands.

In presenting this statement, I ask, on behalf of the AAUW, that the Senate Finance Committee give serious consideration to reducing the proposed tax on foundation income. We ask also that the Committee delete from the House-passed tax measure the provision to include appreciation on donations of property to charities, colleges, and other tax-exempt activities in the Limit on Tax Preferences and the Allocation of Deductions.

We believe these proposals would have a deleterious effect upon the colleges and universities and upon charitable foundations supporting educational activities. Our Association has long supported the position that both public tax support and private giving are essential to maintenance of a free and healthy educational system. We are deeply concerned that the above mentioned provisions in the House-passed tax reform bill will reduce incentives to charitable giving.

Members of the AAUW are fully aware of the need for tax reform, for a more equitable distribution of the tax burden, and for the closing of loopholes which have permitted some taxpayers to avoid their share of the burden. We applaud this Congress for undertaking the onerous task of revising tax legislation. Yet we also ask that institutions and foundations dependent upon charitable giving not be injured in the name of tax reform.

Sincerely yours,

ALICE BEEMAN,
General Director.

STATEMENT OF THE ASBURY THEOLOGICAL SEMINARY, SUBMITTED BY FRANK BATEMAN STANGER, PRESIDENT

The Officers of Administration of Asbury Theological Seminary wish to express their appreciation to the members of the Senate Finance Committee for the thorough research and study that is being given to the important responsibility of amending the Federal Tax Code.

There are many proposals that are excellent and should be enacted, for example:

(1) Taxing organizations on income received from debt-financed investments—e.g., Clay Brown transactions;

(2) Extending the unrelated business income tax to cover all organizations now exempt;

(3) Appreciated property gifts which would generate ordinary income if sold, e.g., inventory;

(4) Two-year trusts;

(5) The unlimited charitable deduction;

(6) Rent-free use of property.

It is not necessary for an extended statement to be made for the importance of maintaining the strength and capability of the privately supported educational institutions of the country. The moral and spiritual fiber of our nation is a matter of grave concern to Asbury Theological Seminary. The continuation of this Institution is in the best interests of the general welfare of the nation.

The Federal Government has over the years continually liberalized the tax benefits for those who voluntarily contribute to the philanthropies of the country. Each time the committee stated that the liberalization was designed to further aid the charities to meet rising costs and the increased needs of our society. In these critical days and with the problems facing our country there is need for increased tax incentives (rather than decreased) to those who generously contribute to the welfare of mankind.

We believe the following benefits are of vital importance to the religious educational institutions. Therefore, we strongly urge that the following long established tax incentive be retained:

(1) *Gifts of appreciated property.*—Present law allows a deduction for the fair market value with no capital gains tax on the appreciation. This should be retained. Also, appreciation in the value of property donated to charity should not be considered a tax preference which under the Allocation of Deductions provision would reduce a donor's itemized deductions for interest, taxes, medical expenses, charitable contributions, etc. To enact such a provision would be an indirect way of taxing appreciation on property gifts and would greatly inhibit important support from the private sector.

It is not a Congressional oversight that a contribution of appreciated property entitles a donor to a deduction for the property's full present fair market value with no capital gains tax on the appreciation. In 1938 the House of Representatives passed a bill calling for the contribution deduction to be measured by donor's cost—not the fair market value at the date of the gift. However, the 1938 Tax Act as finally passed did not contain the House provision eliminating the added tax benefit on the donation of appreciated property to charity. The Senate Finance Committee rejected the House provision. The Senate Finance Committee stated:

"Representations were made to the Committee by officials of educational and charitable institutions that the effect of such a provision would be to discourage the making of charitable gifts in property. The Committee believes that charitable gifts generally are to be encouraged and so has eliminated the provision of the House Bill." (S. Rep. No. 1567, 75th Cong. 3rd. Sess. 1938).

(2) *Allocation of Deductions.*—The charitable deduction should not be subject to the allocation rule and thus should not be reduced because a donor has capital gain income, tax-exempt income, etc.

(3) *Life income (deferred) gifts.*

Charitable remainder trusts.—Present law provides there is no capital gain on the transfer of appreciated property to fund a charitable remainder (life income) trust; nor is there a capital gain if the property transferred is later sold by the trust and the gain permanently set aside for the charity. These rules should be retained. Abuses in investment policies of these trusts are rare and means are now available to (and used by) the Internal Revenue Service to curb any abuses which exist. 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. However, should the Congress decide to abolish existing charitable remainder trusts (substituting the annuity trust and unitrust), the law should *not* be retroactive to April 22, 1969 but be effective with the passage of the Tax Reform Act. In any event, whether a new trust format is adopted or the present type of trust is retained, 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 gain 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.

Life Income Contracts.—Present law governing these contracts (no capital gain or transfer of appreciated property nor capital gain when properly transferred is later sold by the life income pooled fund) should be retained. As with the charitable remainder trust: (1) The deduction should be based upon the full fair market value without imposition of capital gains tax. (2) Capital gains incurred by the life income pooled fund and permanently set aside for charity should not be taxed.

Charitable Gift Annuities.—Present tax treatment when apreciated property is contributed for the annuity should be retained. (Detailed in *Rev. Rul.* 62-136, 1962-2 C.B. 12). If the House Bill's provision on bargain sales is enacted, the law should specifically staate that the transfer of appreciated property for a charitable gift annuity is not a bargain sale.

(4) *Floor on Gifts to Charity.*—The present law does not put a floor on gifts to charity. The proposed 3% floor will severely cripple many institutions, associations and churches because millions of taxpayers give only small amounts which would not exceed the 3% floor if enacted.

During 1966 charitable gifts from all private individuals amounted to more than $9.1 billion. Many privately supported educational institutions would have to close without the benefits of private giving. Such a condition would place a greater burden upon the already crowded tax supported educational institutions. President Nixon said on April 21, 1969, "The rules affecting charitable deductions would be tightened—but only to screen out the unreasonable and not stop those which help legitimate charities and therefore the nation." We believe the privately supported educational institutions do benefit the general welfare by lessening the tax burden for educating the yourth of the nation.

For the reasons set forth above, we respectfully request that the present provisions referred to above in the Federal Tax Code be retained.

Statement of Dr. E. J. Boling, Vice President for Development and Administration, University of Tennessee

Although The University of Tennessee is a tax-aided institution, state tax funds supplied only 36% of the University's operating budget for the 1938-69 fiscal year. Approximately 14% of the budget was provided directly from student fees. Of the remaining percentage, gifts and grants accounted for 23% of the total support. Gifts to The University of Tennessee subsidize scholarships, faculty salary supplements, library endowments and other "extras" necessary to satisfy the requirements for academic excellence.

Without private philanthropy, the Unievrsity would have to curtail many programs which are so vitally necessary to the whole concept of education.

The following chart indicates the total amount of gifts that The University of Tennessee recieved in 1968-69 from private philanthropy:

Annual giving program	$373,150.33
Deferred gifts program	763,999.09
Business and corporate gifts programs	752,892.00
Special (no Federal Moneys)	2,568,136.91
Total	4,458,178.33

Without these monies, 83 freshmen scholarships, 20 freshman merit awards, 8 distinguished service professorships, 15 upperclass scholarships, 10 National Merit Scholarships and many other programs would not have been available. Again, in the future, we must rely on the same type of private support to fulfill these vital needs.

The Tax Reform Bill encompasses a broad field as evidenced by the 300-page plus document passed by the House and now before the Senate Finance Committee. Undoubtedly, tax reform is warranted and indeed much of the proposed bill contains desirable legislation. This is where the real danger looms. The idea of tax reform is so appealing that apparently members of the House voted for the entire package without carefully scrutinizing the contents. We are for laws aimed at taxing organizations on income received from debt-financed investments (such as the Clay Brown transactions) and extending the unrelated business income tax to cover all organizations not exempt. These are things that need to be corrected.

However, we contend that there are some provisions in that same bill that would cripple philanthropic support of our nation's legitimate charities including educational institutions; and here, it is worthy to note that through the years, Congress has repeatedly liberalized the tax laws encouraging individuals to support educational institutions. For example, the Senate Finance Committee rejected a House provision passed in the 1938 Tax Act which would have eliminated the added tax benefits on the donation of appreciated property to charity in these words:

> "Representations were made to the Committee by officials of educational and charitable institutions that the effect of such a provision would be to discourage the making of charitable gifts in property. The Committee believes that charitable gifts, generally, are to be encouraged and so eliminated the provision of the House bill." (S. Rep. No. 1567, 75th Cong., 3rd Sess. 1938).

Once again we ask the Senate Finance Committee to eliminate those provisions which would impede charitable giving. We are most concerned with those which would affect: (1) Gifts of appreciated property; (2) Life income contracts; (3) Charitable remainder trusts and the section which would subject the charitable deduction to the allocation of deductions formula. Changes in the present law governing any of these situations will have a drastic effect on the private support obtained by the University.

We know from talking with our largest contributors, that some of our gifts would have never been made had the Tax Reform Bill been in effect. The University's largest living benefactor, Mr. Clayton Arnold, retired farmer and postman, recently made the statement, "I would not have entered into charitable life income agreement with The University of Tennessee had the current 'Tax Reform Bill' been law." In addition, the tax benefits of his most current gift, $225,000, are in jeopardy because of the retroactive dates attached to the bill as passed by the House. Mr. Arnold's statement sincerely expresses the attitude of the majority of our substantial contributors.

Contrary to the common interpretation of the new tax bill, tax revision would not affect contributions of just wealthy individuals. Nine out of the 10 gifts of $50,000 or more received by the University during the past three years have come from people who could not have been classified in the millionaire category. Rather, they have come from farmers or elderly couples without dependents who were willing to give the majority of their estates through charitable remainder trusts whereby they could receive the income during their lives. Eighty percent of these same gifts previously mentioned were all gifts of appreciated securities or appreciated real estate.

The Treasury will not be guaranteed any immediate revenue by enacting the provisions we have previously discussed if the prospective donor loses his charitable incentive. He will more than likely hold the appreciated securities until death, thus avoiding capital gains tax anyway! Estate taxes could be diminished

Let us say again that we are for tax reform, but not to the extent that it would hinder philanthropy. We urge the members of the Senate Finance Committee to amend the bill passed by the House and in finality, to bring forth a bill which will continue to encourage private support for educational institutions.

ROLLINS COLLEGE.
Winter Park, Fla., September 15, 1969.

Senator EDWARD J. GURNEY, Jr.,
Senate Office Building,
Washington, D.C.

DEAR SENATOR GURNEY: I know that you are concerned over the great harm which would be done to educational and charitable institutions if the present

version of the proposed tax bill is passed. In opposition to the bill there has been much publicity given the penalty on donations of appreciated property. However, there has not been as much publicity about a companion provision, which would penalize gifts which contain unrealized earned income, such as farm crops. These gifts are very important to colleges located in agricultural areas. We know of many institutions besides Rollins who receive an important part of their income from gifts of farm products.

We believe that these hospitals, colleges and churches deserve just as much consideration as those whose gifts come entirely in the form of appreciated property. We believe that the income from all such institutions should be protected, regardless of the nature of their gifts. We should not be discriminated against because we are in an agricultural area.

The whole concept of making it less attractive for people to make gifts is dangerous. We are pleased to see that President Nixon is also against it. The United States is unique in the voluntary support which its people give to colleges, churches, hospitals, symphony orchestras and charitable organizations. These gifts make this country a much finer place in which to live. It would be a tragedy for all of us if these institutions were seriously damaged.

It is ironic that if these laws were passed it might become necessary for the Federal Government to step in and make up what the institutions lose in donations in order to continue their existence. If this happens, the Government would have to pay considerably more than it would gain in taxes, because the loss would include the entire amount of gifts rather than the portion which was saved in taxes.

Although I have not had the pleasure of meeting you personally, I look forward to that opportunity. I have learned that you have been a strong supporter of Higher Education, and particularly of Private Higher Education. I hope that you will continue to show your support by opposing this portion of the tax bill, calling particular attention to the need for gifts which contain unrealized earned income.

Thank you very much for your time and interest in the problems of Higher Education.

Sincerely yours,

JACK B. CRITCHFIELD, *President.*

COLUMBIA UNIVERSITY
IN THE CITY OF NEW YORK,
PRESIDENT'S ROOM,
New York, N.Y., August 18, 1969.

Hon. RUSSELL B. LONG,
Chairman, Senate Finance Committee,
Washington, D.C.

DEAR MR. CHAIRMAN: Your Committee is about to begin hearings on tax reform legislation in a setting in which the House of Representatives has already passed H.R. 13270.

The provisions of the House bill that give me most concern as the head of a University which historically has drawn the bulk of its support from private giving are those dealing with the tax treatment of charitable contributions including contributions of appreciated property. I wish to indicate to you the serious dimensions of the financial problem that will be created for this University and its sister institutions—both public and private—if these provisions become law.

Some people here have had a look at the likely effects of the House bill on private philanthropy, and I am sending you with this letter an analysis done here which suggests that enactment of the law is likely to dry up the sources of funds on which this institution chiefly depends for its support. You will note that the analysis deals with taxpayers likely to be in a position to make fairly substantial gifts. We are glad and grateful for every gift to the support of this University, but it is a fact that much of what exists here at Columbia would never have been begun without the generosity of persons who were in a position to give us large amounts.

Let me indicate for you how important private gifts are to the existence of this institution. In a typical recent year (1968) this University received in excess of $32 million in total gifts. Of that amount, approximately $15.5 million came from University alumni and other individuals. More than $6 million of this

amount constituted gifts of securities—virtually all of them appreciated above the donor's basis. To this should be added $500,000 representing the valuation of books, non-deliverable art objects and paintings. These amounts aggregate more than $7 million—roughly half of the total of gifts from individuals.

Columbia University is currently engaged in a capital campaign. Another way of putting our problem can be seen in the following table showing receipts of gifts and securities by Columbia in the last three years:

Fiscal year ending June 30—	*Securities*
1966	$2,658,000
1967	3,178,000
1968	6,038,000
Total	11,874,000

You will note a sizable increase in gifts of securities during the last year. I believe the reason for the increase lies in the capital campaign I have already mentioned. That campaign is still under way and we are in need of additional gifts of the same sort if we are to preserve this University at the level of excellence that will make possible its continuing contribution to teaching and learning in this country. I am bound to say that the House bill's provisions concerning tax treatment of gifts of appreciated property are likely to hurt us grievously.

Like most of her sister institutions—both public and private—Columbia faces serious immediate and long-range difficulties in financing a program of first-quality education. I may add that our financial report for 1968—despite the generosity of our benefactors—showed a deficit. We have been engaged in severe budget-cutting, but all costs in the economy are rising, and education is not immune to those pressures.

Many provisions of the House bill concerning tax treatment of gifts of appreciated property (including the provisions on ordinary income property, tangible personalty, future interests, bargain sales, and the trust provisions) can have an effect on giving to Columbia if enacted into law. But the inclusion of all charitable contributions deductible under the percentage limitation of code section 170 under the "personal itemized deductions subject to allocation" will, I am informed, be likely to hit us hardest of all. And the inclusion of gifts of appreciated property under the limit on tax preferences will also have a serious effect.

The income tax law has presently built into it a recognition that private support of educational institutions has its place in American society. The law gives an incentive to a taxpayer to part with something of value to him (representing both his basis and his appreciation) and allows him to choose the legally recognized worthy cause to which he will give it. Charity having existed before the tax law, the desirability of charity has been recognized in this way by the tax law, and great institutions in the public interest have received private support as a result. If the House bill provisions are to be passed by the Finance Committee and the Senate, a choice will have been made concerning the future support of higher education. As the attached analysis suggests, the only way left may be direct public support. It would be delightful to those of us concerned with university budgets not to have to worry about raising money by donation, but it is at least open to question whether the people of the country, when they understand the consequences, will say that private support should come to an end and all funds going to higher education should first flow through the hands of government.

Should you approve, I would be grateful if you would make a copy of this letter and the attachments available to each member of your Committee, and I am sending with the original enough sets for that purpose.

Respectfully yours,

ANDREW W. CORDIER.

ANALYSIS

On August 7 the House passed, and sent to the Senate, its much publicized Tax Reform Bill. There is a popular misconception that this Bill will not seriously hinder charitable giving. In fact, however, some of its provisions pose a grave threat to educational institutions, which depend substantially upon private philanthropy.

The provisions of most concern are part of the proposed "minimum tax". They are highly technical, and involve some rather complicated mathematical relationships. But their effect can be better understood by seeing the dollars-and-

cents result of combining the two sets of calculations that would comprise the "minimum tax".

It is essential to recognize the dimensions of the likely impact of the minimum tax upon charitable gifts.

Attached to this Memorandum is a Schedule which shows the after-tax cost of charitable gifts in two examples—examples which fairly represent the likely tax effects in a very significant number of cases. This material shows a number of startling things.

1. At income levels of $50,000 and upward, even donors with the simplest tax picture—no deductions more complicated than state income tax and home mortgage interest—will incur a significant additional tax cost in donating property, or even in donating money where the taxpayer has a significant amount of tax preference. This is bound to affect the ability and willingness of many such persons to support educational and other philanthropic causes.

2. At the same income levels, donors having large amounts of "tax preference items" (long-term capital gain, accelerated depreciation, etc.) will lose almost all income tax benefits of donations made in kind. The after-tax cost of such donations will be virtually 100% of their value, as compared with roughly 30% to 50% under present law. For donors in this category, of whom there are many, the new rules would obviously be a substantial deterrent to generosity.

It is difficult to estimate precisely how much in future donations would be lost by operation of these rules. But there is no question that the effect would be substantial, and that the resulting loss in donations would aggravate an already serious financial situation for every educational institution relying on private support—and that includes public as well as private institutions of learning.

Treasury officials are quoted as predicting benefits for public charities under the Bill which would offset losses of individual donations. The indicated source of these benefits is private foundations, which would be required under the Bill to make small distributions to public charities. However, it is highly doubtful that such compulsory distributions would provide sufficient support to offset the loss. Moreover—and, in many ways, far more important—most foundations have been unwilling to appropriate unrestricted gifts but instead have insisted on giving their support to particular research or teaching projects, so that the loss of private philanthropic support for general educational purposes would not be remedied even if the amount of foundation grants were large.

Part of the void resulting from the reduced public participation may, in the final analysis, be filled by grants from the Federal government. That necessarily implies, however, a further drain on federal or state budgets with concomitant need for tax money.

I. ADJUSTED GROSS INCOME, $250,000; CHARITABLE GIFT, $75,000

	If taxpayer has no "tax preferences," before giving effect to charitable gift	If taxpayer has "tax preferences" of $250,000, before giving effect to charitable gift
Income tax, after giving effect to gift	$86,191	$132,939
Income tax if no gift made	122,880	133,233
Increase (decrease) in income tax resulting from gift	(36,689)	(294)
Value of gift	75,000	75,000
After-tax cost of making gift	38,311	74,706

II. ADJUSTED GROSS INCOME, $50,000; CHARITABLE GIFT, $15,000

	If taxpayer has no "tax preferences," before giving effect to charitable gift	If taxpayer has "tax preferences" of $250,000, before giving effect to charitable gift
Income tax, after giving effect to gift	$5,804	$12,558
Income tax if no gift made	10,790	12,908
Increase (decrease) in income tax resulting from gift	(4,986)	(350)
Value of gift	15,000	15,000
After-tax cost of making gift	10,014	14,650

RESOLUTION OF THE TRUSTEES OF COLUMBIA UNIVERSITY

I, George E. Warren, do hereby certify that I am Clerk of the Board of Trustees of the Trustees of Columbia University in the City of New York, a New York educational corporation, and as such a custodian of the records and the official seal of said corporation; that the following is a true and correct

copy of a Resolution duly adopted at an adjourned stated meeting of the Board of Trustees of said corporation duly held on the 7th day of October, 1969 in accordance with the provisions of the By-Laws of said corporation; that said Board of said corporation consists of twenty-four Trustees; and that a quorum of said Board, as required by said corporation's Charter and By-Laws, is eleven; and that a quorum was present throughout the entire meeting of said Board:

Whereas, the Trustees of Columbia University in the City of New York are charged with ultimate responsibility for the financial affairs of the University including the heavy task in the times of raising funds for its support; and

Whereas, the Trustees are aware of the provisions of H.R. 13270, especially those dealing with tax treatment of charitable contributions of appreciated property; and

Whereas, the Trustees are convinced that the financial difficulties of Columbia University and her sister institutions will be sharpened and made more burdensome by the enactment of the proposed provisions; and

Whereas, the Trustees are aware of the letter addressed to the chairman of the Senate Finance Committee by the University's President on August 18; and

Whereas, the Trustees are also aware of the position taken by the American Council on Education before the Senate Finance Committee in its testimony on September 18;

Now, therefore, be it resolved, That the Trustees of Columbia University in the City of New York endorse the positions taken by President Cordier and, subsequently, by the American Council on Education in its Finance Committee testimony and urge the Senate Finance Committee to amend the proposed legislation in the particulars advocated by Dr. Cordier and by the American Council on Education.

In witness whereof, I have hereunto set my hand and affixed the seal of said Corporation this 15th day of October 1969.

GEORGE E. WARREN, *Clerk.*

VOTING TRUSTEES OF THE COLUMBIA UNIVERSITY IN THE CITY OF NEW YORK

Frederick VanPelt Bryan, William A. M. Burden, Benjamin J. Buttenwieser, Andrew W. Cordier, Daniel F. Crowley, William T. Gossett, Frank S. Hogan, Frode Jensen, Vincent G. Kling, Arthur B. Krim, Robert D. Lilley, Charles F. Luce, Harold F. McGuire, William S. Paley, William E. Petersen, Harold A. Rousselott, Arthur O. Sulzberger, Franklin A. Thomas, Percy Uris, Samuel R. Walker, Lawrence E. Walsh, W. Clarke Wescoe, M. Moran Weston, Lawrence A. Wien.

CORNELL UNIVERSITY,
Ithaca, N.Y., October 3, 1969.

Senator RUSSELL B. LONG,
Senate Office Building,
Washington, D.C.

DEAR SENATOR LONG: Just as Cornell University communicated its views on key aspects of tax reform to the Ways and Means Committee of the House of Representatives, we must now seek your aid on this subject as it comes before the Senate Finance Committee and, eventually, before the Senate, itself. The views of Cornell on this topic parallel those of every other college and university—both public and private—with whom we have had recent contact, and our views have also found articulate expression in the presentations made by various mutual interest groups to which we belong.

Members of the University's administration have shared in various ways in the preparation of the statement presented to the Senate Finance Committee on September 18, 1969, by the American Council on Education. Reports are that the Finance Committee took great interest in the ACE's careful and thoughtful analysis of those tax reform proposals of greatest interest to higher education, and followed the formal presentation with private questioning. I wish to record Cornell University's endorsement of the ACE's presentation.

Timely and appropriate tax reform is, I am sure, desired by you and by all American colleges and universities, including the correction of any abuses in the area of charitable giving. However, we see no useful point in penalizing donors to charities who, after all, must reduce their wealth by the gifts they make. It should be a basic tenet of tax law that no one should be able to realize personal financial profit from the making of charitable gifts. If in any way our

present tax laws are deficient in achieving that objective, they should be corrected. Certain proposed tax reform measures, however, particularly those which require the allocation of deductions and which impose limits on certain tax preferences, together with those restricting gifts of charitable remainders, would penalize private charities at the very time in their existence when many of them, especially colleges and universities, are in the midst of severe financial difficulty.

Gifts of securities made up 25% of all individual gifts to Cornell in 1968–69, and our present life income plans in force have an asset value of $6,903,000. Both of these vital sources of support are essential to the fulfillment of our multiple roles as educator of the nation's youth, resource to the entire world and the originator of new knowledge, yet both are dangerously threatened in H.R. 13270.

As long as this nation is prosperous and its laws encourage private capital as one aspect of wealth, Cornell, and all colleges and universities, ought to be able to receive a share of that wealth from its alumni and special friends in order to maintain our hard-won and highly prized levels of excellence.

With personal regards, I remain,

Sincerely yours,

DALE R. CORSON, *President.*

STATEMENT OF H. STEWART DUNN, JR.

I. CHARITABLE CONTRIBUTIONS

I wish to endorse strongly certain recommendations made by Secretary Cohen in his statement to this Committee of September 4, 1969, with respect to charitable contributions. The revisions recommended by Secretary Cohen which I consider to be of paramount importance are:

(1) The House Bill would totally disallow the estate tax deductions for an income interest in trust and would have the practical effect of disallowing the income and gift tax charitable deductions for an income interest in trust. The objectives of the House Bill would be fully met if the charitable income interest in trust were in the form of an annuity trust or a unitrust, and an income, estate and gift tax deduction should be allowed for this form of income interest. Secretary Cohen has recommended this change. The annuity trust or unitrust format assures that the charitable beneficiary will actually receive an amount commensurate with the charitable deduction allowed to the donor. Under the Treasury's proposal, if the donor makes a complete transfer to the trust, he will not be taxable on the income of the trust. However, he receives no "double benefit" since he would also avoid taxation on the income by creating the trust solely for noncharitable beneficiaries. Under the Treasury's propoosal, the donor receives only a single tax benefit for a transfer of an income interest in an annuity trust or a unitrust to a charitable income beneficiary rather than to a noncharitable income beneficiary. This single benefit is a charitable deduction based on the present value of the portion of the annuity trust or unitrust.

(2) Section 201(h) of the Bill would amend sections 2055 and 2522. In the case of the estate tax provision, this amendment is made applicable to decedents dying after the enactment of the Act. Several persons have noted that a longer period must be provided in order to permit persons to revise wills and revocable trusts. Some provision must also be made in the case where the person is no longer competent to revise his will.

I would like to call to your particular attention another inequity of the effective date of this provision, which I certainly believe was unintended. In the Report of the Joint Committee of Internal Revenue on the Effective Date Provisions of H.R. 13270, it is stated that the provision is prospective only. This may be literally true, since it only affects estates of decendent's dying after enactment. However, in its present form, the Bill would disallow an estate tax deduction on a trust created prior to the effective date of the Act even though the charitable portion is irrevocable. There are many persons who have created trusts in which the charity has a vested remainder and in which there is a noncharitable income interest which will extend beyond the life of the grantor. Typically, in these trusts the charitable remainder is irrevocable. The consequence of the effective date of the House Bill is to include this charitable remainder in the gross estate of the donor of the trust without any offsetting charitable deduction, even though the remainder was deductible from the gross estate at the time the trust was created and the donor has no right to terminate

or otherwise decrease the charitable remainder. I strongly support Secretary Cohen's recommendation that this provision be changed so that it is inapplicable to trusts created before the effective date of the Act (or, possibly August 1, 1969), where the charitable remainder is vested and irrevocable.

For much the same reasoning, the effective date of the income tax provision dealing with the deductibility of a remainder interest in trust should be moved forward from April 22, 1969, to the effective date of the Act (or possibly August 1, 1969). Neither the Treasury proposal of April 22, 1969, nor the Ways and Means Committee Press Release of May 27, 1969, gave any indication that a charitable deduction would be disallowed for a remainder interest in trust which was not a unitrust or an annuity trust. There was no notice of this possibility until the release of the Bill. In fact, in view of the notice which was given relating to all other charitable deduction issues by the Treasury's proposal of April 22, 1969, and the Ways and Means Committee Press Release of May 27, 1969, taxpayers were left with the clear impression that charitable remainders would continue to be deductible under the present rules of law. Therefore, anyone creating such a trust prior to August 1, 1969, should not be denied the benefit of the tax laws governing charitable deductions at the time of creation. Again, it is my understanding that the Treasury concurs in the desirability of this correction.

(3) The House Bill would include as an item of tax preference for purposes of section 301 and, also, as an allowable preference for purposes of section 302, the appreciation in the value of property contributed to a charity which is allowable as a charitable contribution. These provisions are inconsistent with the charitable deduction provisions of section 201 of the Bill.

Notwithstanding the severe limitations which are placed on charitable deductions under section 201, the House concluded that contributions of appreciated securities to public charities should be deductible at the fair market value of such property, except to the extent of property described in proposed section 170(e)(2) and subject to a thirty percent limitation.

Under section 302, however, charitable deductions and certain other deductions are reduced by a fraction, the numerator of which is the allowable preference. Thus, the inevitable consequence would be that even though the taxpayer had no other allowable preference, a gift of appreciated property would necessarily result in a partial disallowance of his deduction under section 302. This is contrary to section 201, which allows this type of deduction. The interworking of this provision has a very harsh result on persons who make charitable gifts to public charities by means of appreciated securities. It would not only result in disallowing a part of his charitable deduction, but would also result in disallowing an allowable portion of the donor's deductions for interest payments, tax payments, and several other deductions.

On May 27, 1969, the Ways and Means Committee stated that it was considering two alternatives with respect to appreciated property. In its Bill it decided to pursue an alternative of allowing a charitable deduction for gifts of appreciated property to public charities which were not in the form of property included in proposed section 170(e)(2). Not only did the Committee make a wise policy decision, it also limited the type of appreciated property which may be deducted at fair market value, the type of charity which may receive the property and the amount of property which may be contributed in any one year. It thereby prevented any abuse by donors of appreciated property. Nevertheless, this wise course of action would be largely nullified unless a comparable correction is made and appreciation of securities is excluded from allowable preferences under section 302 of the Bill. Therefore, I strongly endorse Secretary Cohen's recommendation to this Committee on September 4, 1969, that the donation of this type of property to a public charity be excluded as an allowable preference.

In addition to supporting the above changes which have been recommended by the Treasury Department, I wish to call to the attention of the Committee provisions which would produce clearly unintended results and appear to be technical errors. In order to qualify any contribution to a private foundation as a charitable deduction for income, estate, or gift tax purposes, a private foundation must comply with proposed sections 508(a), (b) and (g). See proposed sections 170(b)(7)(ii), 2055(e)(1)(A)(ii) and 2522(c)(1)(A)(ii). However, it would not be possible for a private foundation to comply with section 508(b) since that section requires the filing of a statement that the organization is not a private foundation. There is also a possibility that a private foundation will not be able to meet the requirements of section 508(g). Therefore, some technical revisions are necessary in order to avoid disqualifying all contributions to private foundations.

Proposed section 170(b)(8) also should be revised to avoid unintended consequences. This section provides that where a taxpayer makes a nontrust charitable contribution of less than his entire interest in property, a deduction shall be allowed only to the extent the value of the interest contributed would be allowed as a deduction under this section if such interest had been transferred in trust. The principal purpose of this provision was to disallow a charitable deduction for contributions to charities of the right to use property. H. Rep. No. 91-413 (Pt. 1) 91st Cong. 2d Sess. 57 (1959). Presumably, this provision would also be applicable to other forms of successive interests such as legal life estates. However, the provision in its present form may disallow contributions for transfers such as creating a tenancy in common between the donor and the charity or an assignment of a percentage interest in a patent. In these cases, the donor is tranferring all of his interest in a portion of the property. There are no successive interests and the charity receives the entire interest in the transferred portion of the property. In order to clarify this provision, I urge that proposed section 170(b)(8) be revised so that is is applicable only to a transfer of less than all of the donor's entire interest or less than all of a portion or percentage of the donor's entire interest in the property.

II. TREATMENT OF EXCESS DISTRIBUTION BY TRUSTS

Section 341 of the Bill provides that accumulations of income by a trust will be taxed to the recipient upon the distribution of such accumulated income under either the "exact" or "short-cut" methods with credit being allowed to the recipient of the tax being paid by the trust in the year of accumulation. Contrary to present law, no exceptions are made to these proposed rules on the taxation of accumulated income. In order to make the proposed rules administerable and to avoid unnecessary burdens where there is little or no tax avoidance, I recommend three modifications to section 341 of the Bill. These are:

(1) I support the recommendation of the Treasury that the present law be continued for accumulation of income in taxable years before April 22, 1969, and that the unlimited throwback provided by the Bill apply only to accumulations made in taxable years beginning after that date.

(2) I recommend that an exception be continued for accumulations during minority. This would relieve trust companies and other professional fiduciaries of a tremendous administrative burden without opening any significant possibilities for tax avoidance. Rarely will a person who is a minor receive any significant amount of income in his own name. Thus, the application of the throwback rule during minority, which would have the effect of adding the trust income to the minor's own income, would normally produce no greater amount of tax. If the House Bill is not amended to provide an exception for accumulations during minority, there will be a tendency to make distributions of income to minors in order to avoid the terribly complex computations that will be required when the child reaches majority. It is undesirable for the Federal Government to create this pressure for distribution of income to minors unless there is some clear showing that accumulations for a minor have resulted in significant tax avoidance. Furthermore, the policy of section 341 of the Bill is directly contrary to the policy of section 2503(c) which permits an exclusion from gift tax for transfers in trust to accumulate income for minors; whereas, transfers in trust to accumulate income under other circumstances would not be eligible for the annual gift tax exclusion.

(3) Under the House Bill, the exact method of computation would not be available if the recipient were not alive during each of the preceding years of the trust in which there was an accumulation. It is recommended that the "exact" and "short-cut" methods be available at the election of the recipient in all cases. Because of the complexities of applying the exact method where the recipient was not alive in each of the years in which an accumulation occurred, the recipient may elect to apply the short-cut method, but there is no reason why these complications should deny him the benefit of the exact method when the records of his predecessor in interest are available for this computation.

As an alternative, a recipient should be permitted to use a short-cut method based on his life. Under such an alternative, the average increase for each year of accumulation would be added to his income for each year of his life for purposes of determining the average increase in tax liability. The resulting figure would then be multiplied by the number of years of accumulation to determine the additional tax liability of the recipient.

III. ALLOCATION OF DEDUCTIONS BY TRUSTS AND ESTATES

Section 302 of the House Bill applies not only to individuals, but also to trusts and estates. This will present a tremendous administrative problem for banks and other professional trustees. Wherever a trust has allowable preferences in excess of ten thousand dollars, section 302 would result in a reduction of allowable deductions. The philosophy behind section 302 is that the so-called "page two" deduction (personal deductions) may be defrayed either from taxable income or from limited tax preference sources. However, a trust cannot really be said to have any personal expenses in the sense in which an individual does. A trust or an estate must follow the requirements of its governing instrument and state law. It is administered by a person who is serving in a fiduciary capacity. Therefore, it is not in a position to make choices about personal expenditures to give rise to a typical "page two" deduction statement. Therefore, there is no need to extend section 302 to trusts and estates.

GIRL SCOUTS OF THE UNITED STATES OF AMERICA,
New York, N.Y., July 28, 1969.

HON. RUSSELL LONG,
Chairman, Committee on Finance,
U.S. Senate, Washington, D.C.

DEAR SIR: As a member of the National Board of Directors of Girl Scouts of the U.S.A. I have been following the various developments in connection with tax reform and had the privilege of appearing before the House Ways and Means Committee on February 24, 1969. A copy of our testimony is attached along with some additional information which we forwarded to The Honorable Wilbur D. Mills. We know that your Committee is giving very serious consideration to the important question of tax reform, but it is our understanding that the recent plans for public hearings have been cancelled. We would like you to have the material which we submitted to Mr. Mills. It reflects the information on developments as we know them to date which we feel should be available to those considering tax reform.

At such time as your Committee schedules hearings, depending on the issues and proposals, Girl Scouts of the U.S.A. may wish to submit testimony either in person or in writing. With this in mind, may we request that when the public hearings are scheduled by the Senate Finance Committee on the subject of tax reform, an invitation to present testimony be sent to Girl Scouts of the U.S.A. To expedite matters, the information can be sent directly to Miss Louise A. Wood, National Executive Director, Girl Scouts of the U.S.A., 830 Third Avenue, New York, New York 10022.

In the meantime, we appreciate the opportunity of bringing the enclosed information to your attention. We have every confidence that you and the members of your Committee will give it very careful consideration.

Sincerely yours,

MRS. ORVILLE LOTHROP FREEMAN,
National Board of Directors.

GIRL SCOUTS OF THE UNITED STATES OF AMERICA,
New York, N.Y., July 28, 1969.

HON. WILBUR D. MILLS,
Chairman, Committee on Ways and Means,
House of Representatives, Washington, D.C.

DEAR SIR: It was my privilege on February 24 to appear before the House Ways and Means Committee in behalf of Girl Scouts of the U.S.A. to present testimony on the subject of tax reform. Speaking both personally and in behalf of Girl Scouts, we are keenly aware of the importance of tax reform and wish to be helpful to you and your Committee in every way possible.

Our basic concerns are contained in the testimony which I presented on February 24, 1969—a copy of which is attached. In following the continuing work of your Committee, the Press Release announcing tentative decisions (May 27, 1969) has been carefully reviewed. In this Release, item 9, page 5, it is indicated that a private foundation would be defined to include all 501(c)(3) organizations with specific listed exceptions. One of these exceptions is: "an organization which normally receives a substantial part of its support from a governmental unit or from contributions from the general public."

This exception would cover our 400 some local Girl Scout councils since their major financial support comes from united funds and hence these are contributions from the general public. It does raise a question, however, concerning the National Organization of Girl Scouts of the U.S.A. which I know you would want me to bring to your attention.

A substantial part of the support of the National Organization derives from the payment of one dollar annual dues by all Girl Scouts. We are not certain whether dues income from each individual Girl Scout will be considered "contributions from the *general public*." If it were held that they are not, this Organization would be considered a "private foundation." Such a result we are sure your Committee does not intend.

It is our belief and request that the specific list of exceptions, in addition to churches, colleges, and safety testing organizations, should be enlarged to include: "organizations which are principally engaged in furthering the advancement of youth through informal educational and recreational programs."

We point out that such a definition would include the Girl Scouts, the Boy Scouts, the Y.M.C.A., the Y.W.C.A., the Camp Fire Girls, the Girls Clubs, and many others. We feel you would agree with the merit of this added exception to the original list.

If this method is not accepted we urgently request that it be made clear that dues income of this and like organizations be considered "contributions from the general public." We recognize that existing law, in respect of comparable language for other purposes, has generally been so interpreted, but we believe it important to clarify it again in respect to this legislation.

I know you and the members of your Committee will give this matter your thoughtful consideration.

Sincerely yours,

MRS. ORVILLE LOTHROP FREEMAN,
National Board of Directors.

STATEMENT OF GIRL SCOUTS OF THE UNITED STATES OF AMERICA

I am Mrs. Orville L. Freeman of Chevy Chase, Maryland and a member of the National Board of Directors of Girl Scouts of the U.S.A. I have the honor of appearing on behalf of Girl Scouts of the United States of America which is the National Organization chartered by Act of Congress and which guides the Girl Scout program now administered for 3,265,000 girls by 660,000 adult volunteers who freely given their time in furtherance of the Girl Scout Movement in the United States.

Our program is conducted through Girl Scout Councils which are chartered by the National Organization and which are locally incorporated to provide the Girl Scout program at the community level. Presently there are 383 of these local Councils which together cover the entire United States. These Councils organize and serve 158,500 Girl Scout troops. They enlist girl members, organize Girl Scout troops, train troop leaders and bring the Girl Scout program to girls. Girl Scout Councils are all tax exempt organizations by reason of rulings of the Internal Revenue Service.

We sincerely believe that our program orientated as it is toward youth, is serving a special need. The problems of youth have never been greater. Girl Scouts through the citizen volunteer has had success in bringing its program to girls living in disadvantaged areas, to the handicapped, to the young in hospitals and institutions, to girls of migratory families, and to American Indian girls.

We are particularly concerned about the potential adverse effects that certain proposals now pending before this Committee may have on our 383 local Councils. These Girl Scout Councils are supported primarily by contributions received from the general public.

Much of these contributions come through United Funds and other federated fund-raising groups. Other sources of revenue are "cookie" sales and direct contributions. The Girl Scouts depend on these voluntary contributions and on the free and voluntary service of our adult volunteers.

THE PROPOSAL AS TO DENIAL OF DEDUCTIBILITY OF CONTRIBUTIONS UP TO 3% OF THE DONOR'S INCOME

One of the proposals pending before the Committee would change existing law by providing that the charitable deduction would be restricted to the amount by which contributions exceed 3% of the taxpayer's adjusted gross income.

We believe that our organization would be seriously and adversely effected were this change to be made in existing law. As a result, our ability to serve girls would be lessened or reduced.

The figures before the Committee show that of 27 million returns itemizing charitable deductions in the year 1966, the number of taxpayers who contributed less than 3% of their adjusted gross income was over 14 million or more than half of all returns with contribution deductions. This reflects the fact that a large number of people who make charitable contributions do not reach the proposed threshold figure of 3%.

We are aware that the major source of our funds comes from contributors of small or medium income families. It is made up of small individual amounts given by a great number of donors.

We believe that the deductibility of these amounts is an important consideration in our ability to induce people to contribute. We further believe the denial of deductibility would lessen the willingness of people to make contributions and that the removal of deductibility will increase the resistance of contributors to appeals for help.

The figures before the Committee suggest that the consequences of this proposed change might be to reduce charitable contributions up to as much as $300 million per year. We fear, therefore, that because of our particular reliance on the small contributors the Girl Scout movement may be particularly disadvantaged by the imposition of any "threshold" percentage in the itemization of contributions.

THE PROPOSAL AS TO ADVERTISING INCOME

One question pending before the Committee is presented in this manner: "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."

When we publish a periodical directly related to the furtherance of our program, we believe the income derived from advertising therein should be free of tax.

An important service to girls is the *American Girl* magazine published by Girl Scouts of the U.S.A. as a companion to our program. It translates our Girl Scout purposes and beliefs into magazine form. Since subscriptions cannot cover the cost of the *American Girl* magazine, advertising appropriate to girl activity and magazine content is sought. The sale of advertising helps to meet the cost, and at present additional subsidy also is required from Girl Scout operations. If at sometime our limited advertising revenue were to be taxed, Girl Scouts of the U.S.A. would have to reduce its other services for girls accordingly. In fact, the question probably would have to be faced whether Girl Scouts of the U.S.A. could continue to publish this important vehicle to youth.

The*Leader* magazine is also published by Girl Scouts of the U.S.A. It is our major means of communication to our 660,000 adult volunteer members, most of whom serve as Girl Scout leaders. There is no subscription to the *Leader* magazine. Advertising revenue only partially supports this magazine. As in the case of the *American Girl* magazine, any tax to be paid on this revenue would result in further reduction of services to our membership.

We therefore respectfully request any new legislation make provision that where a magazine is published as a part of the program, advertising revenue not be made subject to tax even if net income exceeds costs. We make this request even though at the present time our magazines show a substantial loss.

THE PROPOSAL AS TO COST OR APPRECIATED VALUE OF GIFTS OF PROPERTY

Another proposal before the Committee raises for decision the question of whether when gifts of property are made the donor should be subject to an income tax on any appreciation in value realized from the time of acquisition by the donor.

We believe this to be an unwise course to follow since it penalizes philanthropy. It could seriously threaten gifts of land for camps and donations for other purposes.

We urge that this proposal not be accepted.

THE PROPOSAL AS TO CHANGES IN CLASSIFICATION OF EXEMPT ORGANIZATIONS

In the press release outlining the subject of these hearings the question was raised as to changes in the classification of exempt organizations.

We are aware that in the broad range and variety of charitable and philanthropic organizations total uniformity as to tax treatment may no longer be possible or suitable. We are not able to suggest the lines of distinction and division that might be made.

We do, however, wish to tell the Committee members that we believe that if changes in classification are to be made, they should give particular recognition to the distinguishing character of Girl Scouts as an organization providing service through volunteers for the character building of youth. We realize that any special category which included Girl Scouts would also encompass other worthy volunteer organizations that were also rendering needed and special service to the United States in behalf of young people, in the field of education and social welfare, or in other activities where the service of the citizen volunteer was particularly needed and valuable.

SUMMARY

1. *The proposal as to denial of deductibility of contributions up to 3% of the donor's income.*—There should not be a denial of deductibility on contributions up to 3% of donor's adjusted gross income, or any "threshold" percentage.

2. *The proposal as to advertising income.*—Adverti ing income should *not* be characterized as unrelated in the case of magazines and other periodicals published where the editorial matter of the publication is related to its exempt function.

3. *The proposal as to cost or appreciated value of gifts of property.*—Deduction for charitable contributions should be limited to the amount of cost or other basis of the taxpayer in the property contributed, i.e., if there is appreciation in value, such appreciation at the time of the contribution should *not* be included in income at that time.

4. *The proposal as to changes in classification of exempt organizations.*—Any change made in the classification of exempt organizations should recognize the distinguishing character of Girl Scouts as an organization providing service through *volunteers* for the character building of youth.

PINE MANNER JUNIOR COLLEGE,
Chestnut Hill, Mass., September 8, 1969.

SENATE FINANCE COMMITTEE,
New Senate Office Building,
Washington, D.C.

GENTLEMEN: I am concerned that in an effort to close tax loopholes which should be closed, this bill may inadvertently injure colleges our society sorely needs. If this were to occur, the nation would lose more in the long term than it gained in immediate tax revenue.

Just to illustrate what this type of giving meant to private colleges and universities in Massachusetts in 1968

Total gifts received: $88, 555, 000.

Received in securities and properties: $49,288,000—56%.

56% of the gifts received by private colleges and universities in 1968 were in the form of appreciated properties.

May I urge that the Finance Committee safeguard the present free transfer of appreciated securities and property to non-profit colleges free of capital gains. If this is not done, private giving will be drastically curtailed. This in turn will reduce the effectiveness of private colleges and universities, and will in fact endanger their very survival. This the nation cannot afford.

Respectfully submitted.

FREDERICK C. FERRY, Jr., *President.*

NORTHROP INSTITUTE OF TECHNOLOGY,
Inglewood, Calif., August 26, 1969.

Hon. RUSSELL B. LONG,
Senate Office Building,
Washington, D.C.

DEAR SENATOR LONG: We view with apprehension the suggested charitable deduction revisions of the Internal Revenue Code which were passed by the House of Representatives. As we are unable to appear before the Committee

personally, we trust that the comments set forth in this letter will be acceptable.

We are a relatively young, private college. In the past two years we have been actively seeking funds for future endowment and building purposes through our Deferred Giving Program. To accomplish this, we have been encouraging individuals to create charitable remainder trusts or enter into life income contracts with us. Thus far, our efforts have assured us of over one million dollars which will come to the college through such arrangements.

We are currently seriously hampered in our efforts to raise an additional one million dollars of gifts currently being processed because we are unable to advise these donors, with any degree of certainty, as to what the charitable giving tax effect of the gifts will be due to the present House proposed tax revisions. This would be a terrible loss to our need for future funds.

We appreciate the current concern over abuses created by some individuals and foundations who perhaps have questionable motivations regarding tax deductions or are seeking special advantages under the tax laws. We feel that certain portions of the proposed legislation designed to correct these limited abuses would seriously impair our ability to obtain gifts in the future. We feel that the House Ways and Means Committee, in attempting to prevent unfair tax advantages from being utilized by a few abusers, would harm many potential donors who rely on historically well established income and estate tax benefits to be derived from giving.

We specifically wish to call your attention to certain specific proposals of the House Ways and Means Committee and state our position. In setting forth our feelings, we are confident in the belief that our thoughts are shared by every college and university in our nation.

Tax deductible treatment of gifts of appreciated property.—The present law permits a deduction for the fair market value of appreciated property without a capital gains tax being levied on the appreciation. This should definitely be retained. A donor frequently can be encouraged to make a larger gift than was believed possible by being able to give appreciated property instead of cash. We know of several instances of donations in our own history which were increased because of this fact. We further are opposed to that section of the proposed law which would reduce a donor's deduction for charitable contributions because of the required "allocation" of a deduction where appreciated property has been given to a charity. Such a provision is merely an indirect way of taxing the appreciation on property gifts.

Charitable remainder trusts.—Present law states that when appreciated property is transferred to a charitable remainder trust, no capital gains tax is payable on the appreciation when the trust is created, nor is a capital gains tax due when the property transferred is sold by the trust and the gain is permanently set aside for charitable uses. We also find that the proposed provisions to limit charitable remainder trusts to the "annuity" or "unitrust" type would complicate our ability to explain such trusts to potential donors and also these types of trusts would be difficult to administer, and thus would place a serious burden on our college administrative staff.

Life income contracts.—In these contracts, as in the charitable remainder trust, no capital gains tax is payable on appreciated property over the donor's cost at the time of establishing such a contract. The current provision of the tax law in this regard should definitely be retained. Further, capital gains incurred in a life income pooled fund permanently set aside for charity should not be taxed.

Charitable gift annuities.—The present tax treatment should also be retained. As the House Bill's provision on bargain sales enacted the law should specifically state that the transfer of appreciated property for a charitable gift annuity is not a bargain sale.

Although this college has not been involved in a "*two-year trust*" we feel that it is to the interest of our nation's colleges and universities that the current tax treatment of such a trust be retained. The same is true of the current provisions for *unlimited charitable deductions*. Regarding the *rent free use of property*, we believe that a donor of such property is parting with something of value in favor of a charity and that the tax benefits he might derive from such generosity should be as liberal as possible.

We do support certain aspects of the House Bill to wit:

1. Taxing of organizations on income received from debt-financed investments;

2. Extending the unrelated business income tax to cover all organizations now exempt.

We further wish to encourage your support of a higher ceiling on the deductibility on charitable contributions (now 30 percent of adjusted gross income). We approve of the proposed 50 percent limit. We have seen situations with our own donors where, under the present 30 percent limitation (even with a five-year carryover for contributions in excess of this amount), they can not receive full tax deduction benefits for their gifts. This is because those who have or will enter into life income trust or contract arrangements with us simply do not have a high enough income to receive full tax benefits for their generosity, yet want to make a gift to the college and must retain income for their security in later years.

We are particularly opposed to any consideration for the retroactivity in provisions effecting charitable giving for the tax year 1969. Should any changes come about, please do not make such changes effective prior to December 31, 1969. Our efforts for the balance of this year have been made most difficult because of the present uncertainty in the current tax law. To make any proposed changes retroactive would be a severe blow to the efforts of all colleges and universities.

Sincerely,

HOMER GRANT, *President.*

WASHINGTON, D.C., *October 2, 1969.*

SENATE FINANCE COMMITTEE,
New Senate Office Building,
Washington, D.C.

GENTLEMEN: I strongly urge that section 201 of the tax reform bill be revised, as recommended by Assistant Secretary Cohen on September 4, to continue to allow a charitable contribution deduction for income, gift and estate tax purposes in the case of income interests given to charity for a term of years in the form of a guaranteed annuity or a "unitrust", as defined in the bill.

However, gifts to charity of income interests and charitable remainder gifts by owners of family enterprises will be virtually eliminated unless the bill is also revised to permit charitable income interest trusts and charitable remainder trusts to hold stock of the family corporation for the limited period of the trust, without applying the proposed Private Foundation rules with respect to "excess business" holdings. Also, it should be made clear in the statute or by appropriate reference in the Committee report, that the holding of stock of the family business by a charitable income interest trust or a charitable remainder trust will not be regarded as a speculative investment by the trust which jeopardizes its charitable purpose, within the meaning of proposed section 4944.

Amendments along these lines are needed to prevent owners of family companies from being treated as second-class citizens under the charitable contribution provisions of the bill. It seems most undesirable to deny owners of family corporations the means of making substantial charitable gifts in trust in the form of a guaranteed annuity or a remainder interest in the only valuable property they may own, unless they, their spouses, brothers and sisters and lineal descendants dispose of their stock in the family company or the trust itself gets rid of the stock given to it.

Because of the relatively short-term nature of charitable gifts of income rights with non-charitable remainders, or the retention of such income rights for the grantor's family, with the remainder interest given to charity, there is no real need to apply the proposed Private Foundation rules to such situations.

Attached is a draft of language amending the bill to achieve the objectives outlined above.

Very truly yours,

JAY W. GLASMANN.

PROPOSED AMENDMENTS TO SECTIONS 101 AND 201 OF H.R. 13270 TO CONTINUE TO PERMIT GIFTS OF STOCK OF FAMILY CORPORATIONS TO CHARITABLE INCOME INTEREST TRUSTS AND CHARITABLE REMAINDER TRUSTS

1. Page 115 of the Bill as passed by the House (Union Calendar No. 172), beginning with line 7 through line 9, strike "and the grantor is treated as the owner of such interest for purposes of applying section 671".

2. Page 115, beginning with line 13, strike out all through page 116, line 11.

3. Page 121, line 8, renumber paragraph (8) as paragraph (9) and insert new paragraph (8) as follows:

"(8) Subparagraph (B) of Paragraph (7) shall have no application to a charitable remainder annuity trust or a charitable remainder unitrust described in section 664(d), or to a charitable present interest annuity trust or to a charitable present interest unitrust described in section 2055(f)."

4. Page 131, line 14, renumber paragraph (2) as paragraph (3) and insert new paragraph (2) as follows:

"(2) Subparagraph (B) of paragraph 1 shall have no application to a charitable remainder annuity trust or a charitable remainder unitrust described in section 664(d) or to a charitable present interest annuity trust or a charitable present interest unitrust described in section 2055(f)."

5. Page 131, beginning with line 23, strike out all through page 132, line 6, and insert the following:

"the interest is in the form of—

"(i) a remainder interest in a trust which is a charitable remainder annuity trust or a charitable remainder unitrust described in section 664(d), or

"(ii) a present interest in a trust which is a charitable present interest annuity trust or a charitable present interest unitrust as described in section 2055(f)."

6. Page 137, after line 19 and before line 20, insert the following:

"(j) CHARITABLE PRESENT INTEREST TRUSTS.

"(1) CONFORMING AMENDMENT. Subsection (f) of section 2055 (relating to cross references) is amended by striking out '(f)' and inserting '(g)'.

"(2) A new subsection (f) of section 2055 is inserted to read as follows:

"'(f) CHARITABLE PRESENT INTEREST TRUSTS.—

"'(1) CHARITABLE PRESENT INTEREST ANNUITY TRUST.—A charitable present interest annuity trust is a trust—

"'(A) From which a sum certain is to be paid, not less often than annually, to an organization described in section 170(c), for a term of years or for the life of one or more persons, and

"'(B) Following the termination of the annuity described in subparagraph (A) the remainder interest in the trust is to be transferred to, or for the use of a person (other than the grantor or his estate) who is not a person or organization described in section 170(c).'

"'(2) CHARITABLE PRESENT INTEREST UNITRUST.—A charitable present interest unitrust is a trust—

"'(A) From which a fixed percentage of the net fair market value of its assets, valued annually, is to be paid, not less often than annually, to an organization described in section 170(c), for a term of years or for the life of one or more persons, and

"'(B) Following the termination of the interest described in subparagraph (A) the remainder interest in the trust is to be transferred to, or for the use of a person (other than the grantor or his estate) who is not a person or organization described in section 170(c).'"

7. Page 133, line 17, renumber paragraph (2) as paragraph (3) and insert the following new paragraph (2):

"(2) Subparagraph (B) of paragraph 1 shall have no application to a charitable remainder annuity trust or a charitable remainder unitrust described in section 664(d) or to a charitable present interest annuity trust or a charitable present interest unitrust described in section 2055(f), provided none of the trustees is the grantor or a related or subordinate party to the grantor (or would be such if the grantor were living), as defined in section 672(c)."

8. Page 133, beginning with line 23, strike out all through page 135, line 2; and in lieu thereof insert the following:

"section (a) or (b), no deduction shall be allowed under this section for the interest which passes or has passed to the person, or for the use, described in subsection (a) or (b) unless the interest is in the form of—

"(i) a remainder interest in a trust which is a charitable remainder annuity trust or a charitable remainder unitrust described in section 664(d), or

"(ii) a present interest in a trust which is a charitable present interest annuity trust or a charitable present interest unitrust as described in section 2055(f)."

9. Page 52, line 7, after the comma insert "(except a charitable present interest annuity trust or a charitable present interest unitrust described in section 2055(f), or a charitable remainder annuity trust or a charitable remainder unitrust described in section 664(d))".

MORTON F. PLANT HOSPITAL,
Clearwater, Fla., July 17, 1969.

Senator RUSSELL B. LONG,
Chairman, Senate Finance Committee,
U.S. Senate,
Washington, D.C.

DEAR SENATOR LONG: On March 25th this year I wrote you as President of the Morton F. Plant Hospital Association, Inc. to register the official opposition of our organization to certain of the Treasury's "Tax Reform Studies and Proposals".

I now understand that these proposals and others may soon be considered by hearings in the Senate Finance Committee. This letter is to reemphasize our objections to such proposals as inimical to the best interests of our democratic society which has long encouraged maximum support of society's problems by private philanthropy rather than government subsidy.

In saying this I speak for more than 4,000 members of our Association who in the last twelve years have contributed over half of the more than $8,000,000 that have been expended for the construction of facilities and purchase of equipment for this hospital. In addition, the hospital provides an average of $100,000 yearly in treatment of our medically indigent citizens, part of which is also underwritten by the charitable gifts of our membership.

While there may be merit in improving some of the existing tax laws such as taxing income from debt-financed investments and extending the unrelated business income tax, I strongly recommend that certain vital and long established tax incentives should be retained as follows:

a) Gifts of Appreciated Property should continue to be allowed a deduction for the fair market value with no capital gains tax on the appreciation. Such gifts to this institution currently average about 10% of the total gifts received and are becoming an increasingly important source of support, both in the size of the gift and the number of donors.

b) Life Income Gifts should not be subject to capital gains tax for all or part of the appreciation as under present law. While this institution has only recently initiated a deferred giving program to encourage this type of gift, it is believed it will become an increasingly important source of long-range funds because of the security and freedom from investment worries it offers to many contributors.

c) There should be no threshold, 3% or otherwise, on the deductibility of charitable gifts. As indicated by our membership of 4,000 we have a large number of relatively small contributors. While their individual deductions are not large, it is probable that many would forego giving if the gift were not deductible. On the other hand, wide support of the hospital, however small in monetary value, exemplifies the very spirit of mutual endeavor in a worthwhile cause that our democratic system has always fostered.

I strongly recommend that you and the members of your Committee reject these proposals in Committee. Now is the time to foster support of social problems by the private sector rather than curtail it. In our own case we face an urgent need to again expend our facilities to meet the demands of our service area. The cost of such expansion will undoubtedly exceed our past expenditures and without the community support these tax incentives encourage we are certain to fail in meeting our responsibilities to the community.

Sincerely yours,

HAROLD L. HOFFMAN, *President.*

NEW YORK UNIVERSITY,
New York, N.Y., October 1, 1969.

Hon. RUSSELL B. LONG,
Chairman, Senate Finance Committee,
New Senate Office Building,
Washington, D.C.

DEAR SENATOR LONG: We have followed with great interest the evolution of the tax reform legislation now under consideration by the Senate Finance Committee. It is particularly encouraging, in these times of impatience with established social institutions, that the legislative response to the demands of the public for tax reform has been so prompt and so comprehensive.

As president of an institution which is crucially dependent upon the generosity of its alumni and friends, however, I am obliged to express my concern with certain aspects of H.R. 13270 which, if enacted into law, would seriously undermine the incentive to make charitable contributions and the long-standing public policy of encouraging such contributions. Owing to the operation and interaction of the bill's provisions as regards the limitation on tax preferences (the so-called minimum tax) and allocation of deductions, an individual otherwise disposed to make a substantial gift of appreciated property to a church, school or public charity may be severely inhibited from so doing by the lack of any determinable tax benefit. Even persons unlikely to be affected by the minimum tax or allocatoin of deductions may be deterred from making charitable contributions because of the uncertainty engendered by the extreme complexity of these provisions,

The cause of tax reform undeniably required the elimination of those abuses which have permitted public and private charities to share the bounty in schemes primarily designed to increase the donor's after-tax net worth. The reform bill will end such devices and in this regard must be acclaimed. Yet true reform, while destroying unwarranted tax preferences, must preserve those incentives which stimuate *bona fide* charitable gifts. Aside from the charitable deduction itself, the allowance of a deduction for the full value of appreciated property is the incentive most vital to the welfare of our nation's colleges and universities. Diminution of this incentive, as would occur were H.R. 13270 to become law, should only be permitted upon the considered judgment that the purposes served justify the risks of fiscal paralysis in higher education and of consequent increases in governmental expenditures and control.

It is a most doubtful proposition that permitting a donor to deduct the full value of appreciated property creates the same kind of "tax preference" as does the deduction for capital gains, the receipt of interest on municipal bonds, accelerated depreciation or the other items which, under the bill, would cause the imposition of a minimum tax and the allocation of deductions. Unlike the taxpayer who realized a long-term capital gain or receives tax-exempt interest, the donor of appreciated property has reduced his net worth; that is, he has realized no income and has become entitled to a charitable deduction only by giving away property worth more to him than the deduction. Thus the donor of appreciated property is "preferred" only in the sense that the source of part of his deduction is attributable to untaxed *appreciation*, not untaxed *income*.

While there is a considerable question, therefore, as to whether equity requires inclusion of the appreciation component of gifts to charity among the class of tax preferences, there is little doubt as to the drastic and immediate effect of such inclusion. All private educational institutions are dependent upon the continuing support of individual contributors, and it is no exaggeration to say that our aspirations can only be realized if we are able to attract contributions from those best able to make them. Such contributions, usually in the form of appreciated securities, underwrite our continuing struggle for excellence and determine our potential for growth in service to society. Private education, in its present form, cannot endure, nor should our society condone, the sacrifice of such critical sources of revenue upon the dubious rationale which the tax reform bill appears to offer.

I have attached hereto a memorandum which discusses this and other tax reform issues and proposals which have been of particular concern to New York University.

Sincerely,

JAMES M. HESTER.

Enclosure.

STATEMENT BY JAMES M. HESTER, PRESIDENT, NEW YORK UNIVERSITY

I am grateful for the opportunity to present, for your consideration, the views of New York University on certain provisions of H.R. 13270, the tax reform bill, and I should also like to express my personal satisfaction with the thoughtful and comprehensive response of the Congress to the demands of the public for basic reforms in our system of taxation. I am confident that your deliberations will greatly advance the cause of equity in taxation.

The provisions of the tax reform bill with which New York University is principally concerned are those which would effect basic changes in the treatment of charitable contributions. Many of the provisions in this area are meaningful reforms, and we heartily endorse the elimination of those incentives which have encouraged charitable contributions solely as a means to increasing the donor's after-tax net worth. Yet we feel that in some respects the bill would reach too far, destroying those legitimate incentives which stimulate private support for our colleges and universities and thus severely jeopardizing this nation's capacity to meet the educational challenges of tomorrow.

Our primary concern is with the provisions which make the appreciation element of gifts in property a "tax preference" item for purposes of both the limitation of tax preferences and allocation of deductions. The House Ways and Means Committee recognized that permitting the donor to deduct the full fair market value of gifts to schools, hospitals and other publicly supported charities serves as a crucial stimulus to make substantial gifts, but by making appreciation a preference item most of the benefit of that stimulus will be lost. As you are well aware, most of the support for any private educational institution comes from a relatively small number of alumni and friends, and large gifts are typically made in the form of appreciated property. It is a doubtful proposition at best that reform would be served by deeming a contribution of appreciated property a preference akin to the receipt of tax-free interest, and to endanger the quality of higher education on this premise seems a rash course indeed.

There is a fundamental difference between making a gift of appreciated property and those other transactions which are considered tax preferences under the bill for purposes of LTP and allocation of deductions. Allowing a donor to deduct the full fair market value of his gift, upon meeting the restrictions set forth in the bill as to the type of property contributed, will encourage him to contribute by reducing the net cost of such gift to him, but it does not permit him to profit; his net worth will have been reduced. Tax-free interest and capital gains, on the other hand, represent untaxed income, while accelerated depreciation and farm losses are tax benefits arising out of profit-seeking activities which produce an increase in net worth through lessening of tax. In short, the donor of appreciated property is "preferred" only in the sense that the source of part of his deduction is attributable to untaxed *appreciation*, not untaxed income. Granted that it may be less painful for the owner of substantially appreciated securities to make a contribution than for one who makes an equivalent cash gift, each has acted charitably because each has reduced his net worth. The donor of appreciated property is preferred only in that he possessed such property and in that the law recognizes that its contribution, at less net cost to him than its full value, serves a desirable social purpose.

While there is considerable doubt, therefore, as to whether fairness requires that the appreciation element be included among the items of tax preference, there is none whatsoever about the immediate and drastic effect of such inclusion. While precise calculation of the cost to higher education is impossible, uncertainty about the net cost of major contributions, which would be dependent upon all items of income and deduction which bear upon the LTP and allocation formulas, would induce hesitancy in any case and outright refusals to give in many. It would surely create a climate in which expert income-and-deduction juggling would reduce the cost of contributions, and college and university fund-raisers could rarely advise prospective major donors as to the real cost of their gifts. Indeed, we have already observed a reluctance to consider major gifts pending the resolution of this problem.

Finally, it is not at all inconceivable that severe diminution of the private sector's incentive to support higher education through contributions would be a first step to vast expansion of public assistance programs. Private institutions like New York University can maintain their activities only so long as they can sustain a constant flow of contributions. Lessening of private support would require increased public support or radical retrenchment of education services essential to our society. The decision that the public has to assume an obligation to

provide substantial support for institutions heretofore privately sustained is not one that should be made by indirection, especially on the dubious premise that tax equity demands it.

GIFTS OF FUTURE INTERESTS IN APPRECIATED PROPERTY

In recent years New York University has benefitted from a significant number of gifts of future interests in property. By permitting donors to reserve income from contributed property for life, we are able to attract important gifts from persons of relatively modest means—gifts which such persons simply could not afford to make without the benefits of retained income and an income tax deduction for the present value of the remainder interest. The bill, in denying a deduction for the fair market value of a future interest in appreciated property unless the donor elects to include the appreciation in income, would effectively destroy all incentive to use this plan.

As to the portion of the appreciated property which may be considered to fund the life income interest, the donor reaps an unwarranted benefit in avoiding tax on the appreciation. But the solution posed by the bill goes beyond correction of the abuse. What is necessary is not a blanket denial for all gifts of future interests in appreciated property, but rather a separation of the transaction into two elements, similar to the treatment afforded "bargain sales." Thus a portion of the donor's basis in the entire property should be allocated to the life-income interest, and he would be taxable on the appreciation attributable to that portion, but his fair market value deduction would be preserved as to the remainder interest.

PERCENTAGE LIMITATION ON GIFTS OF APPRECIATED PROPERTY

The House bill imposes a special limitation of 30 percent of a taxpayer's "contribution base" on the deduction for gifts of appreciated property, while the general limitation on gifts to churches, schools, hospitals and publicly supported charities is 50 percent. It is at least questionable whether gifts of cash and property which has not appreciated in value are entitled to such comparatively favorable treatment, but even assuming that they are, the 30 percent limitation should have reference to the appreciation, not to the entire value of the gift. Under the bill, a donor with a contribution base of $10,000 who makes a contribution in property worth $5,000 in which he has a basis of $4,900 would be limited to a $3,000 deduction, but were his basis $5,000, he would be entitled to the full $5,000 deduction. The inequity is obvious and should be remedied.

TAX ON FOUNDATION INVESTMENT INCOME

Under the House bill, private foundations, in addition to becoming vulnerable to a variety of penalties for overstepping their charitable bounds or indulging in certain proscribed investments, are liable for a 7½ percent tax on "net investment income." New York University depends heavily on foundation grants for support of many of its programs. We assume that this 7½ percent levy would have the effect of reducing the amounts of funds which we might expect to receive from these foundations. Furthermore, such a tax would seem to bear no relation to costs incurred in supervising the activities of foundations; in effect it would create an anomalous special class of partially tax-exempt organizations. Accordingly, we endorse the Treasury recommendation to reduce the suggested tax to two percent, an amount which bears a reasonable relation to the anticipated increased costs of governmental administration and supervision.

THE "CLAY-BROWN" PROVISIONS AND THE URBAN UNIVERSITY

In mounting an assault on the "Clay-Brown" situation in which the purchase of a business or other income-producing property by an exempt organization is financed out of future profits, H.R. 13270 permits debt-financed acquisitions to escape the unrelated business income tax where "all the use" of the acquired property is related to the performance of the acquiring organization's exempt purposes. It also excepts acquisitions of neighborhood land provided that it is contemplated that the land will be used within 10 years in furtherance of such exempt purposes, and if the intended future use requires that any structure on the land at the time of acquisition be demolished or removed.

Meeting one or the other of these exceptions may prove most difficult for the growing urban university. If New York University, for example, has an opportunity to purchase, at an attractive price through debt-financing, an apartment

hotel for eventual use as a dormitory, it may not be possible, for financial or other reasons, to make an immediate complete conversion to dormitory use, yet eventual use would not contemplate demolition. As a result, until conversion has been completed, a percentage of rentals derived from both students and holdover tenants would be subject to tax.

Perhaps the most equitable solution to this problem would be to tax only revenues from persons whose occupancy is not in furtherance of the acquiring organization's exempt purposes. Or, in recognition of the fact that demolition provides unequivocal evidence of intent but is an inappropriate requirement, it could be deleted, permitting the exception to be satisfied if the building were completely converted to educational purposes within 10 years.

September 25, 1969.

STATEMENT SUBMITTED BY WILLIAM T. HUTTON, ATTORNEY, RE: AREAS OF PARTICULAR CONCERN FOR NEW YORK UNIVERSITY

H.R. 13270, the tax reform bill passed by the House of Representatives on August 7 and now under consideration by the Senate Finance Committee, will effect changes of unprecedented scope in our system of Federal income taxation. We at New York University recognize the need for basic and comprehensive reforms, and it is by no means our intention to convey the impression that tax reform, per se, will be detrimental to University interests. A fairer apportionment of the tax burden will strengthen our society and increase confidence in government, and thus we heartily endorse the bill's elimination of unwarranted tax preferences, despite the possibility that some of the proposed changes may reduce University revenues.

In certain respects, however, the bill would seem either to have gone beyond the needs of legitimate reform or to have struck an improper balance between the dictates of reform and the necessity to provide for the continued growth of higher education. The provisions about which the University is particularly concerned are those which would effect basic changes in the treatment of charitable contributions and the proposed tax on private foundation investment income. Many of the provisions in the charitable contributions area are meaningful reforms, and we approve the elimination of those incentives which have served to encourage contributions solely as a means to increasing the donor's after-tax net worth. Yet we feel that the bill would destroy certain valid nonabusive incentives which stimulate private support for our colleges and universities and thus would severely restrict our capacity to meet the educational challenges of tomorrow. This memorandum, which supplements the comprehensive statements of the American Council on Education and the Association of American Universities, to which we subscribe, briefly discusses such problems and offers some suggestions toward their solution.

GIFTS OF APPRECIATED PROPERTY—LTP AND ALLOCATION

Our primary concern is with the provisions which make the appreciation element of gifts in property a "tax preference" item for purposes of both the limitation of tax preferences (which creates, in effect, a minimum tax) and allocation of deductions. The House Ways and Means Committee recognized that permitting the donor to deduct the full fair market value of gifts to schools, hospitals and other publicly supported charities serves as a crucial stimulus to make substantial gifts, but by making appreciation a preference item most of the benefit of that stimulus will be lost. Not only will the net cost of substantial contributions of appreciated property be increased by amounts which, in most cases, will be virtually impossible to determine, but the sheer complexity of the provisions in questions may be expected to create a long period of uncertainty and inaction. It is a doubtful proposition at best that reform would be served by deeming a contribution of appreciated property a preference akin to the receipt of tax-free interest, and to endanger the quality of higher education on this premise seems a rash course indeed.

There is a fundamental difference between making a gift of appreciated property and those other transactions which are considered tax preferences under the bill for the purposes of LTP and allocation of deductions. Allowing a donor to deduct the full fair market value of his gift, upon meeting the restrictions set forth in the bill as to the type of property contributed, will encourage him to contribute by reducing the net cost of such gift to him, but it does not permit

him to profit by actually increasing his after-tax net worth. Tax-free interest and capita gains, on the other hand, represent untaxed income, while accelerated depreciation and farm losses are tax benefits arising out of profit-seeking activities which produce an increase in net worth through lessening of tax. In short, the donor of appreciated property is "preferred" only in the sense that the source of part of his deduction is attributable to untaxed *appreciation*, not untaxed income. Granted that it may be less painful for the owner of substantially appreciated securities to make a contribution than for one who makes an equivalent cash gift, each has acted charitably because each has reduced his net worth. The donor of appreciated property is preferred only in that he possessed such property and in that the law properly recognizes that its contribution, at less net cost to him than its full value, serves a desirable social purpose.

While there is considerable doubt, therefore, as to whether fairness requires that the appreciation element be included among the items of tax preference, there is none whatsoever about the immediate and drastic effect of such inclusion. While precise calculation of the cost to higher education is impossible, uncertainty about the net cost of major contributions, which would be dependent upon all items of income and deduction which bear upon the LTP and allocation formulas, would induce hesitancy in any case and outright refusals to give in many. It would surely create an unhealthy climate in which expert income-and-deduction juggling would be necessary to reduce the cost of contributions, and college and university fund raisers could rarely advise prospective major donors as to the real cost of their gifts. Indeed, we have already observed a reluctance to consider major gifts pending the resolution of this problem.

Finally, it is not at all inconceivable that severe diminution of the private sector's incentive to support higher education through contributions would be a first step to vast expansion of public assistance programs. Private institutions like New York University can only hope to maintain their present programs and provide adequately for growth so long as they can sustain a constant flow of contributions. The lessening of private support would necessarily bring retrenchment unless funds could be found elsewhere. And the decision that the public has an obligation to provide substantial support for institutions heretofore privately sustained is not one that should be made by indirection, especially on the dubious premise that tax equity demands it.

Accordingly, we strongly recommend that appreciation on gifts of property be removed from the list of tax preference items for both LTP and allocation of deduction purposes.

GIFTS OF FUTURE INTERESTS IN APPRECIATED PROPERTY

In recent years the University has benefitted from a significant number of gifts of future interests in property. By permitting donors to reserve income from contributed property for life, we are able to attract important gifts from persons of relatively modest means—gifts which such persons simply could not afford to make without the benefit of retained income and an income tax deduction for the present value of the remainder interest. The bill, in denying a deduction for the fair market value of a future interest in appreciated property unless the donor elects to include the appreciation in income, would effectively destroy all incentive to use this plan.

As to the portion of the appreciated property which may be considered to fund the life income interest, the donor may reap an unwarranted benefit if he is able to avoid tax on the appreciation. But the solution posed by the bill goes beyond correction of the abuse. What is necessary is not a blanket denial of the deduction for all gifts of future interests in appreciated property, but rather a separation of the transaction into two elements, similar to the treatment afforded under the bill to "bargain sales." Thus a portion of the donor's basis in the entire property should be allocated to the life-income interest, and he would be taxable on the appreciation attributable to that portion, but his fair market value deduction would be preserved as to the remainder interest.

PERCENTAGE LIMITATION ON GIFTS OF APPRECIATED PROPERTY

The House bill imposes a special limitation of 30 percent of a taxpayer's "contribution base" on the deduction for gifts of appreciated property, while the general limitation on gifts to churches, schools, hospitals and publicly supported charities is 50 percent. It is certainly questionable whether gifts of cash and property which has not appreciated in value are entitled to such comparatively

favorable treatment, but even assuming that they are, the 30 percent limitation should have reference to the appreciation, not to the entire value of the gift. Under the bill, a donor with a contribution base of $10,000 who makes a contribution in property worth $5,000 in which he has a basis of $4,900 would be limited to a $3,000 deduction, but were his basis $5,000, he would be entitled to the full $5,000 deduction. The inequity is obvious and should be remedied.

TAX ON FOUNDATION INVESTMENT INCOME

Under the House bill, private foundations, in addition to becoming vulnerable to a variety of penalties for over-stepping their charitable bounds or indulging in certain proscribed investments, are liable for a 7½ precent tax on "net investment income." New York University receives substantial support from private foundations, and we predict that this 7½ percent levy would have the effect of substantially reducing the amounts of funds which we might expect to receive from such foundations. Furthermore, such a tax would seem to bear no relation to increased costs to be incurred in enforcing the bill's restrictions and in supervising the activities of foundations; in effect it would create an anomalous special class of partially tax-exempt organizations. The restrictions upon activities and limitations on investments contained in the bill provide ample protection against the abuses which have arisen with respect to a minority of private foundations; there is no further need or justification for diminishing the social utility of all such organizations through the power to tax. Accordingly, we endorse the Treasury recommendation to reduce the suggested tax to two percent, an amount which bears a reasonable relation to the anticipated increased costs of governmental administration and supervision.

THE "CLAY-BROWN" PROVISIONS AND THE URBAN UNIVERSITY

In mounting an assault on the "Clay-Brown" situation, in which the purchase of a business or other income-producing property by an exempt organization is financed out of future profits, H.R. 13270 permits debt-financed acquisitions to escape the unrelated business income tax where "all the use" of the acquired property is related to the performance of theacquiring organization's exempt purposes. It also excepts acquisitions of neighborhood land provided that its is contemplated that the land will be used within ten years in furtherance of such exempt purposes, and if the intended future use requires that any structure on the land at the time of acquisition be demolished or removed.

Meeting one or the other of these exception may prove most difficult for the University. If we have, for example, an opportunity to purchase, at an attractive price through debt-financing, an apartment hotel for eventual use as a dormitory, it may not be possible, for financial or other reasons, to make an immediate complete conversion to dormitory use, yet eventual use would not contemplate demolition. As a result, until conversion has been completed, a percentage of rentals derived from *both* students and holdover tenants would be subject to tax.

Perhaps the most equitable solution to this problem would be to tax only revenues from persons whose occupancy is not in furtherance of our educational purposes. Or, in recognition of the fact that while demolition provides unequivocal evidence of intent, it is an inappropriate test, such requirement could be deleted, permitting the exception to be satisfied if the building were completely converted to educational purposes within ten years.

The foregoing discussion is addressed to our principal concerns with the tax reform legislation. While various technical problems, such as those having to do with the effective dates of certain portions of the bill, are also of interest to us, we are confident that these are essentially problems of recognition, not of policy, and that they have been brought to the attention of the Senate Finance Committee and its staff.

WILLIAM T. HUTTON,
Attorney.

UNIVERSITY OF NEVADA,
September 11, 1969.

Hon. ALAN BIBLE,
U.S. Senate,
Washington, D.C.

DEAR SENATOR BIBLE: I am writing to you and Senator Cannon to express my grave concern, as Chairman of the Board of Regents of the University of Nevada, concerning tax Section 201(h) contained in H.R. 13270, the new Tax

Reform Act of 1969. We feel strongly that the provisions of this Section will be damaging to the future development of the University of Nevada System. In recent years, the University of Nevada has received great benefit from the gifts of individuals and foundations in developing programs and in constructing facilities which the State would otherwise have been unable to provide. It is vital that we be able to continue to obtain these gifts in the future.

At the present time, the charitable income trust is a useful method through which charities can get needed support. Under a charitable income trust, income from principal goes to charity for a fixed number of years, with the principal then reverting to the donor. For example, a hospital or college which is undertaking a twelve-year building program can get a donor (who has property which he is unwilling to give up permanently) to transfer such property to a trustee who will pay the income from the property to the college or hospital for twelve years. At the end of the building program, the property is then returned by the trustee to the donor.

Under Section 201(h) of H.R. 13270, the donor will receive no income tax deduction for his gift to the college or hospital. In addition, he will have to pay gift taxes (or estate taxes, if he dies) on the amount of the gift. In other words, the donor will have to pay a gift tax for the privilege of giving to charity.

Worthy charities and educational institutions have a hard enough time raising funds under the present law which permits the donor to receive an income tax deduction for the value of his charitable gift. If he is now to be denied the income tax deduction and, in addition, obliged to pay the same gift tax as if he made the gift of income to his child or grandchild, it is unlikely that a donor would choose to give the income to a charity before giving it to a member of his own family.

During the past five years, the Treasury Department, the American Law Institute and the Brookings Institution have been conducting the most detailed study ever made of the Federal estate and gift tax laws. As a result of these studies, the Treasury has made proposals to Congress which Congressional leaders have indicated will result in a major revision of the entire Federal estate and gift tax laws, once the current income tax reform bill has been completed. *The approach to charitable gifts contained in Section 201(h) is directly contrary to the recommendations made by these institutions to the Congress.*

Even more important, Section 201(h) concerns only the Federal estate and gift tax laws. As such it should be considered, in context, as part of the pending revision of the Federal estate and gift tax law. With respect to its inclusion in H.R. 13270, it bears no closer relationship to the income tax reform than any of a hundred other provisions of the Federal estate and gift tax law. If there are any meritorious ideas in Section 201(h), they should be studied as part of the revision of the Federal *estate and gift tax* laws and not inserted at the last minute as part of the *income tax* reform bill.

In short, Section 201(h) should be deleted from H.R. 13270 because:

1. It is a complicated and obscure piece of gift and estate tax legislation that can be adequately considered only as a part of a broad revision of the Federal gift and estate tax laws.

2. It will capriciously discriminate against certain forms of charitable giving, while ignoring others.

3. The imposition of gift and estate taxes on charitable giving is certain to discourage such gifts. As a consequence, no tax revenue will be raised and charitable organizations will be denied important and unique sources of funds.

I am sure from the foregoing that our concern is understandable. This Section, 201(h), will be harmful to all institutions of higher learning, hospitals and other eleemosynary institutions. As you both undoubtedly know, in addition to other fund-raising facilities, the Board of Regents has created two foundations, the Nevada Southern Land Foundation for the University of Nevada, Las Vegas, and the University of Nevada Land Foundation for the University of Nevada, Reno. We have also received a great deal of help from other charitable foundations and from gifts by individuals. Any legislation such as this would discourage private giving and charitable foundations and be most unfortunate for the University of Nevada.

We certainly hope that you and Senator Cannon will be able to get this Section stricken from H.R. 13270 and that it will be given more mature and detailed consideration when the revision of the Federal estate and gift tax laws comes up, probably next year.

Warmest regards.

Yours sincerely,

PROCTER HUG, Jr., *Chairman.*

MEMORANDUM

Re Technical analysis of Bill Section 201(h) of H.R. 13270.

Section 201(h) was a last minute addition to H.R. 13270. It adds to the Federal *income tax* reform bill a complicated change in the Federal *estate and gift* tax law. Section 201(h) deals solely with changes in the Federal estate and gift tax law and is independent of any of the proposed income tax changes in H.R. 13270. Since the Treasury has already proposed major changes in the Federal estate and gift tax laws and Congressional leaders have indicated that this will be the next major tax legislation considered, Section 201(h) should be considered as part of the proposed Federal estate and gift tax bill rather than being arbitrarily inserted in the income tax reform bill.

This memorandum is divided into four parts:

(1) Part I describes how the Federal estate and gift tax systems operates. It also shows what the practical effect of Section 201(h) would be.

(2) Part II traces the history of both H.R. 13270 and the companion Federal estate and gift tax legislation which is now pending in the House of Representatives. It concludes that it is illogical for Section 201(h) to be considered as part of H.R. 13270 rather than as part of the pending Federal estate and gift tax legislation.

(3) Part III discusses the objectives which almost all estate and gift tax experts agree Federal legislation should seek to achieve. It then measures the key proposal in Section 201(h) against these standards and explains why this proposal is poor legislation.

(4) Since Section 201(b) is so complicated as to be virtually incomprehensible. Part IV analyzes and attempts to restate its provisions in understandable language.

I. THE FEDERAL ESTATE AND GIFT TAX SYSTEM DESCRIBED

IRC Section 2501 initially includes all gifts as taxable gifts. IRC Section 2522 eliminates charitable gifts from those on which a gift tax must be paid.

Section 201(h) would change this. The present simple provision which allows a deduction for the value of all property given to a qualified charitable organization would be replaced by five pages of complicated rules. Under these proposed rules some charitable gifts would qualify for a charitable deduction and some would not. It is important to note that under the gift tax law a charitable deduction can never reduce the amount of gifts to anyone other than the charity. If you deny a deduction for a gift to a charitable organization this is simply another way of saying that the donor will be required to pay a gift tax on his charitable gift. Furthermore, if a gift to charity is taxed in any year, this charitable gift will be added to the donor's total gifts in all future years. Since the gift tax rate is computed on the cumulative amount of gifts made in prior years added to gifts in the current year, the donor not only has to pay a gift tax on the gift to charity in the year he makes the gift, but if he makes gifts to his children or other persons in any future year, these non-charitable gifts will be taxed at a higher rate than if the charitable gift had not been made in the earlier year. The same will hold true for taxable gifts to charity in future years.

The Federal estate tax applies to gifts made at a person's death in the same manner as the gift tax applies to lifetime gifts. Under present law all of a decedant's property is initially included as part of his gross estate and a deduction is then allowed for the value of the property given to a qualified charity. The effect is to tax only the property which is given to non-charitable beneficiaries. The charitable deduction cannot be used to offset or reduce the amount of property passing to non-charitable beneficiaries which is subject to tax. No income tax deduction is allowed for gifts to charity at a person's death so no income tax benefit is obtained by making such gifts. No one will pay estate taxes for the privilege of giving property to charity at his death. If Section 201(h) becomes law, people will simply cease making charitable gifts which would be subject to estate tax.

II. BACKGROUND OF PENDING FEDERAL TAX LEGISLATION

(a) *Treasury proposals*

In early 1969, at the request of Congress the Treasury Department submitted detailed suggestions for major changes in the Federal *income* tax laws. At the same time, the Treasury submitted proposals for a major revision of the Federal *estate and gift* tax laws. The Federal estate and gift tax recommendations grew

out of concurrent five year studies by the Treasury, the American Law Institute and the Brookings Institution.

(*b*) *Action by House of Representatives.*

The House of Representatives has now passed H.R. 13270 entitled "A Bill to Reform the Income Tax Laws". It contains 363 pages of detailed proposals for the most thorough revision of the Federal *income* tax in the past fifty years. Congressional leaders indicate that this massive income tax reform will be followed by an equally thorough and extensive revision of the Federal *estate and gift* tax law.

The proposals contained in Section 201(h) were not part of the original Treasury proposals for revising the Federal estate and gift tax law and, of course, were not part of the Federal income tax revisions proposals. Bill Section 201(h) appears to be a last minute addition by someone who felt that as long as income tax provisions relating to charitable gifts were being passed, some estate and gift tax provisions should be aded. The only reference to Section 201 (h) in House Report 91-413 (Part 1) which accompanied H.R. 13270 was at the top of Page 62 where, after discussing the income tax changes, it states that the bill also provides "comparable . . . gift tax" treatment.[1] The actual wording of the bill not only provides this gift tax treatment (as if income tax and gift tax problems of charitable trusts were comparable), it violates the legislative intent by adding estate tax liability as well.

Congressional committees and committees of tax experts have from time to time made attempts to correlate the income tax treatment of a transaction with its estate and gift tax treatment. These committees have uniformly concluded that the functions and objectives of the income tax are so different from those of the estate and gift tax that the two systems shoud be kept separate. The desirability of this is illustrated by the current income tax and gift tax proposals relating to charitable income trusts. The fundamental point is that, the effect of a *gift tax charitable deduction* is entirely different from an *income tax charitable deduction.*

An income tax charitable deduction reduces the tax payable on other income; a gift tax charitable deduction does not reduce the tax payable on other gifts. In other words, if a taxpayer makes a gift to charity and is *allowed* a charitable *income tax* deduction, he pays *less tax* than if he had not made the gift. If he is *not allowed* an *income tax* deduction for his charitable gift he pays the *same* income tax as if he had not made the gift. The gift tax result is just the opposite. If a *gift tax deduction is allowed* for the charitable gift, the taxpayer pays exactly the *same gift tax* on his other gifts as if he had *not made* the charitable gift. His tax on his other gifts is the same as if he had kept the money which he gave to charity. If *no gift tax deduction* is allowed for the charitable gift, he *pays a greater gift tax* than if he had kept the money and spent it on himself instead of making the charitable gift. He must pay a gift tax on his gift to charity and, since all taxable gifts are combined in setting rates, he will pay tax at a higher rate on other gifts in the year of the gift and all future years.

Section 201(h) concerns only the Federal estate and gift tax laws. As such it should be considered, in context, as part of the pending revision of the Federal estate and gift tax law. With respect to its inclusion in H.R. 13270, it bears no closer relationship to the income tax reform than any of a hundred other provisions of the Federal estate and gift tax law. If there are any meritorious ideas in Section 201(h) they should be studied as part of the revision of the Federal *estate and gift tax* laws and not inserted at the last minute as part of the *income tax* reform bill.

III. STANDARD FOR ALLOWING A CHARITABLE DEDUCTION FOR FEDERAL ESTATE AND GIFT TAX PURPOSES

The recent exhaustive studies of the Federal estate and gift tax law by respected experts have developed certain basic objectives which Federal legislation should seek to achieve. Those listed below are taken from the objectives developed by Professor A. James Casner and part of the American Law Institute study. Other experts may describe the objective in different language, and may

[1] The subsequent Supplemental Report of the House Ways and Means Committee (91-413-Part 2) has a more accurate description of what was actually done, but fails to either carefully analyze the effect of the proposed changes or any justification for them.

attach differing degrees of importance to the various objectives. However, almost all experts agree that these are the standards which good Federal estate and gift tax legislation should seek to achieve. They are listed and discussed here in detail for two reasons. First, it will be apparent that proposed Section 201(h) cannot be considered good legislation under any of these tests and must be considered as affirmatively bad legislation under most of them. Secondly, although the Treasury, American Law Institute and Brookings Institution experts differed on the details, all favored a major revision of the Federal estate and gift tax structure which is based on the objectives listed below. Section 201(h) is in direct conflict with these objectives.

(*a*) *The law should seek simple but not simplistic solutions.*

1. *Simplicity.*—There has been a growing concern that the tax laws have become so complicated that only the most sophisticated tax specialists really understand them. This is obviously undesirable. New tax legislation should strive to be as simple as possible. Some complications are necessary to make the law fair and to prevent tax evasion, but a conscious effort should be made to draft these provisions in the simplest, most understandable manner.

2. *Avoid simplistic solutions.*—The estate and gift tax law should recognize that peoples' circumstances differ. For example, the elderly bachelor with an invalid sister may want to provide that the income from his property goes to his sister for life with the remainder to charity. In contrast, the father with young children who wants them to learn to rely on themselves before recieving his money may want the income to be paid to charity for a stated period of time before the remaining property is turned over to his children. The simplistic solution ignores these differences.

Section 201(h) decrees that only certain types of charitable gifts will not be taxed. It arbitrarily denies a deduction for other equally worthy gifts. As has been pointed out above, *a gift or estate tax deduction does not provide any affirmative tax benefit to the donor.* A charitable deduction should not be denied by reason of the form of the gift which fits the donor's circumstances.

Section 201(h) violates both of these rules. It is so complicated that even a tax expert cannot understand it without first studying its provisions in detail. Furthermore, it provides a simplistic, arbitrary solution. If you want to transfer $25,000 to a trustee who must pay $1,000 per year to charity for fifteen years and then deliver whatever is left to your son, you must pay a gift or estate tax on the money which goes to charity as well as on the property which your son will receive. If, instead, you want to transfer property in trust to make payments to your son and eventually pay what is left to charity you will not have to pay tax on the money left to charity.

(*b*) *Tax neutrality*

The ideal estate and gift tax system is one which will reduce, if not eliminate, the situations in which the form of the gift changes the tax results. Some experts feel that an exception should be made if a valid social or economic purpose would be served by encouraging a particular form of transaction. In such instances they feel it is proper to provide incentives to encourage taxpayers to adopt the socially or economically desirable form of the transaction.

Section 201(h) is bad legislation under either rule. It arbitrarily provides that gifts to certain "charitable remainder unitrusts", "charitable remainder annuity" trusts, and outright transfers will not be taxed but gift and estate taxes will be imposed on all other forms of charitable gifts. As long as a qualified charity is assured of receiving the gift, there is no reason to tax some charitable gifts and not others. The law should be continued in its simple, easily understood present form. If the charity will receive the money, a gift or estate tax deduction should be allowed for the value of the gift to the charity. If the charity is not assured of getting the money, no deduction should be allowed. The form of the gift should be immaterial as long as the form of the gift does not jeopardize the charity's interest in the property.

It is not desirable to tax some forms of charitable gifts and not others. If there is any rational basis for the determination of which form of gift will be taxed under Section 201(h), it is not apparent from any of the statements in the Treasury's original proposal to Congress nor from any of the published legislative history. The only explanation may lie in the Biblical directive—"The last shall be first and the first shall be last." *If the donor puts private interest first and the charitable interest last,* he can qualify for a charitable deduction. If $25,000 is transferred to a trustee with directions to pay $1,000 per

year to the donor's friend for fifteen years and, at the end of the fifteen years to pay what is left to charity, a charitable deduction is allowable. *If the donor puts the charity first and the private interest last, he is not entitled to a charitable deduction.* If it is the charity which is to receive $1,000 per year for fifteen years and, when it is paid in full, the friend gets what is left, no charitable deduction is allowed.

(c) Taxpayers who are similarly situated should be treated in the same manner

The existing Federal estate and gift tax rules for charitable gifts are generally recognized as fair rules which treat all persons alike. This is not true of proposed Section 201(h).

For example, if a donor transfers $25,000 to an independent trustee to pay the income to charity for ten years and one month and then return the property to the donor, a gift tax would be imposed on the gift to charity. If the transfer were for nine years and eleven months there would be no gift tax. This distinction between gifts for more or less than ten years was not adopted for any reason having anything to do with estate or gift taxes. It is the accidental result of cross reference to the income tax law where a taxpayer was required to give the income on his property to someone else for at least ten years if he was to avoid being taxed on the income. Where the policy of the income tax law was to require the property to be given away for at least ten years, Section 201(h) now penalizes the taxpayer who does so. However, in many cases the taxpayer can avoid that result by retaining rights over the property. For example, if the property transferred to the trust was stock in a corporation which the donor controlled he could avoid a gift tax by retaining the right to vote the stock transferred to the trust. Similarly, he could avoid any gift tax by retaining a power to reacquire the trust assets by substituting other property of equivalent value.

Tax legislation which treats persons similarly situated in an entirely different manner is undesirable. Proposed Section 201(h) is particularly undesirable in adopting arbitrary rules to determine who should be taxed and, more importantly, in adopting rules which tax the most desirable forms of charitable gifts and exempt the less desirable forms. As the above examples show, *the transfers which provide the charity with maximum assurance that it will receive the money are those which are taxed. Where the donor retains rights which may allow him to divert to private purpose some of the value for which a charitable deduction has been allowed, he is granted tax exemption.*

(d) To impose reasonable restrictions on the inheritance of wealth

In those few cases where the donor cannot or will not recast the form of the charitable gift, he will undoubtedly retain all or most of the money during his lifetime and give it to his heirs at his death. It is against human nature to expect a person to pay gift or estate taxes to give money to charity when he can avoid that tax during his lifetime by keeping the property and, at his death, can give the money to his family without incurring any greater tax than if he gave it to charity. Proposed Section 201(h) thus has a tendency to encourage the very thing that the estate and gift tax laws seek to discourage.

(e) To produce revenue

Section 201(h) will not raise any significant tax revenue. Section 201(h) *expressly denies the gift tax deduction in the very cases where no income tax deduction is allowed.* No one will pay a gift tax to give money to charity when he gets no income tax deduction for the gift and can avoid the gift tax by keeping the money and spending it himself.

(f) To produce a tax structure that will be regarded as fair

Section 201(h) arbitrarily taxes certain forms of charitable gifts while other forms which are no more worthy escape tax. For example, if a person owns some real property and gives it to his wife and a qualified charity in equal shares as tenants in common, the gift to the charity will be taxed. If a person wills his home, or art objects in it, to charity, but provides that if his elderly wife survives him she can live in the house or can use the art objects during her remaining lifetime, a Federal estate tax would have to be paid on the entire value of the house and art objects even if his wife lived to use them for only one week after her husband's death. Many additional examples could be given. These are not isolated examples of unusual situations. They are specific illustrations of some of the many types of gifts which have been important sources of funds for charity in the past, but which will be eliminated in the future. They are every bit as

worthy as the permitted types of charitable gifts. They are eliminated solely because they do not fit into one of the three neat pigeonholes that Section 201(h) arbitrarily selects as the only permitted forms of gift. The objective of the Federal estate and gift tax laws should be to assure that a qualified charitable organization actually receives the money for which the estate and gift tax deductions are allowed, not to create sheltered preserves which permit certain forms of gifts and prohibit others.

IV. ANALYSIS OF THE CONTENTS OF SECTION 201 (H) OF H.R. 13270

Section 201(h) directly, or by cross reference to other provisions of H.R. 13270 adds over forty pages of complicated new rules to the existing Federal estate and gift tax law. The major thing that it will accomplish is to require many charitably motivated people to hire tax experts to read and analyze Section 201(h) and advise them how they can make the gifts they have in mind.

The changes proposed by Section 201(h) can be summarized as follows:

(a) Federal estate and gift taxes will be imposed on gifts to charitable organizations unless the organization has been exempted by the Secretary or his delegate or the organization's governing instrument has been amended to require that the organization comply with numerous technical requirements relating to distributions of its income, transactions it can engage in, expenditures it can make, and investments which it can hold.

Comment: These changes will cause problems because of their complexity and poor drafting. They will also create chaos for those who desire to make gifts or bequests between the time the law is passed and the time the charitable organizations can comply with the new procedural red tape. The changes will cause serious problems for a few organizations which, although operated in exemplary fashion, have unamendable charters which do not contain the required wording. It is doubtful if this portion of Section 201(h) will have any appreciable effect on estate and gift taxes. The estate and gift tax law has long denied deductions for gifts to charitable organizations which could be diverted to private use. Section 201(h) adds little or nothing of substance to this.

(b) *No estate tax deduction* will be allowed for a charitable gift unless it is in the form of a "charitable remainder annuity trust", a "charitable remainder unitrust" or an outright transfer. Section 201(h) intends to deny *gift tax deductions* in similar cases, but the language used in drafting the statute will accomplish this in some cases and not in others.

Comment: These are the changes which have been discussed at length at earlier portions of this memorandum. For the reasons indicated no amount of redrafting of language could make these proposals into desirable tax legislation. They would substitute complex, arbitrary and unfair rules for the desirable portions of the existing law without improving the existing law in any way.

The undesirable features of Section 201(h) are made worse by subparagraph 7 of Section 201(j) which excepts these provisions from December 31, 1969 effective date applicable to most of Section 201. The Federal estate tax provisions are made applicable to anyone dying after the date of enactment without the grace period for existing wills usually provided in this type of legislation.

The gift tax changes are even worse. They are made retroactive to April 22, 1969. This means that they will impose gift taxes on charitable gifts made between April 22, 1969 and August 2, 1969, which is the first date on which these proposed changes were made public.

CONCLUSION

For five years a distinguished panel of law professors and tax attorneys studied the present Federal Estate and Gift Tax laws under the sponsorship of the American Law Institute. During the same period a distinguished group of professors and economists studied the Federal Estate and Gift Tax laws under the sponsorship of the Brookings Institution. The Treasury Department's own estate and gift tax experts participated in the American Law Institute and Brookings Institution studies and conducted independent studies of their own. These studies have resulted in proposals to Congress for the most sweeping revision of the Federal Estate and Gift laws in their history. *Nowhere is these proposals or in any of the voluminous detailed reports of these studies is there any support for the proposed changes in Section 201(h) of H.R. 13270.*

Section 201(h) is a proposal which violates every rule for sound tax legislation. It is complicated where simpler provisions would be more effective. It fails to close any tax loop-hole or prevent any tax abuses. It does not increase tax

revenues. It arbitrarily allows tax deductions for certain forms of charitable gifts while penalizing other more worthy forms.

One conclusion is inescapable. Section 201(h) should be eliminated from H.R. 13270. It did not belong there in the first place. If anyone feels it has any merit it can be considered as part of the pending Federal estate and gift tax legislation. However, for the reasons indicated in this memorandum, Section 201(h) has so little to recommend it that everyone's time would be better spent in examining the carefully researched proposals which have resulted from the American Law Institute, Brookings Institution and Treasury studies than in searching for any meritorious ideas that might be hidden in Section 201(h).

GEORGETOWN UNIVERSITY,
Washington, D.C., September 5, 1969.

Hon. RUSSELL B. LONG,
Chairman, Senate Finance Committee,
Senate Office Building,
Washington, D.C.

DEAR MR. CHAIRMAN: Certain provisions in H.R. 13270, a bill to revise the income tax laws, would, if enacted, have a serious effect on the fund raising efforts of private institutions like Georgetown University.

Private education, already in serious financial straits, may be permanently crippled if philanthropic support from generous alumni and friends is curtailed by restrictive federal legislation.

Clearly, certain tax laws need reforming but I do not believe that laws governing charitable gifts to private institutions, like schools and churches, are loopholes that need plugging. To the contrary, for the past 30 years Congress has been encouraging such gifts with enlightened tax incentive legislation

Universities and other charitable institutions depend on gifts of appreciated securities and property. In the past, donors have given appreciated securities and property freely because there was an incentive to do so—a gift of appreciated securities to a charitable institution was exempt from the capital gains tax.

H.R. 13270 largely eliminates tax advantages for persons establishing trusts for nonprofit organizations by taxing the appreciated portion of the gift. Trusts and other forms of deferred giving are the most important single source of long-range support for private universities.

In addition, the bill establishes complicated procedures for gift giving, makes some changes retroactive and reduces other incentives. In my opinion, the "allocation of deductions" provisions, if passed, is so wieldy that donors will hesitate to give in the future what they now give freely.

If H.R. 13270 is enacted, I fear that private giving will be curtailed and the government will soon be forced to replace a large amount of philanthropy with tax dollars. This represents a major shift in public policy, designed and written into law by previous Cogresses to encourage private support of a broad range of charitable services.

H.R. 13270 should be closely examined by the Senate Finance Committee and others concerned with the preservation of non-profit service organizations.

In large measure, the success of our society depends upon an efficient and effective system of private higher education which relies upon the philanthropy of a concerned American public for support. Passage of H.R. 13270 would deal severe blows to private education and endanger the survival of private universities already faced with spiraling costs in this inflationary era.

I hope the Senate Finance Committee will give H.R. 13270 the characteristically thorough examination it deserves.

Very sincerely yours,

R. J. HENLE,
President.

RCA,
New York, N.Y., August 12, 1969.

Re Contribution of new advanced computers to educational institutions.

Hon. RUSSELL B. LONG,
Senate Office Building,
Washington, D.C.

MY DEAR SENATOR LONG: We respectfully call to your attention an inequity which will result from a provision in H.R. 13270 relating to the contribution of certain property to colleges and universities. (Sections 201(c) and 201(d)).

In 1968 RCA instituted a program of contributions in connection with the acquisition of new advanced computers by certain institutions of higher learning throughout the United States. These advanced computers are used by colleges and universities in performing their educational and scientific functions for the benefit of scholars and students at both undergraduate and graduate levels of study.

Most often, educational institutions do not have funds to pay the full price for this costly advanced equipment. Under this program RCA contributes to the university the difference between the reduced price to the university and the current selling price of the computer.

It would not be economically feasible for RCA to underwrite this program without the benefit of a charitable contribution deduction. RCA received a favorable ruling from IRS concerning this program. The Revenue Service held that (1) the difference between the fair market value of the computer and the sales price to the educational institution would be deductible by RCA as a charitable contribution; and (2) the sales price would be reduced by the adjusted basis of the computer to RCA in computing any gain on the sale.

H.R. 13270 as presently drafted would abrogate the effect of these Internal Revenue rulings, i.e. section 201(c) with regard to the charitable contribution deduction, and section 201(d) with regard to the allocation of the adjusted basis to the sale portion of the transaction.

We respectfully urge you to seek modification of these provisions to allow RCA to continue to make these contributions to educational institutions. This might be accomplished by stating that sections 201(c) and (d) will not apply to contributions of new computers and scientific equipment to colleges and universities.

Further, January 1, 1970 is the proposed effective date of Section 201(c) relating to the contributions deduction. It seems unfair to require a retroactive effective date May 27, 1969 for section 201(d) relating to the same transaction. Under existing law each of these two rules is of equal validity and longevity. We respectfully urge that both of these related provisions (sections 201(c) and 201(d)) have the same effective date of 1/1/70 so as not to constitute retroactive legislation.

H.R. 13270 as presenlty drafted will severely curtail the ability of institutions of higher learning to acquire this most advanced equipment for use in pursuit of their educational and scientific goals. This loss to our educational institutions would indeed by unfortunate to our nation's educational and scientific progress.

We will be pleased to supply any additional information which you may require in this regard.

Very truly yours,

LAWRENCE M. ISAACS,
Vice President and Controller.

OHIO DOMINICAN COLLEGE,
Columbus, Ohio, July 16, 1969.

Hon. RUSSELL B. LONG,
Senate of the United States of America
Senate Office Building,
Washington, D.C.

DEAR SENATOR: On April 15, 1969, Sister M. Suzanne, O.P., President of Ohio Dominican College, wrote to you and to other members of the Senate Finance Committee, as well as the House Ways and Means Committee, the President, and various other officials. You, along with many others, where kind enough to answer her. I am addressing this letter to you and to many of the same people, simply as a reiteration of our sentiments since suggestions for tax reform have come from the House committee and, as I understand it, the Senate Finance Committee will begin considering these proposals on July 21, 1969. I have written to President Nixon and to Tom Vail, Esq., explaining that it is not possible for the President or I to request to be heard at the meetings and that is the reason for this letter.

I would like to state first that we are in favor of two measures being considered:

1. Taxing organizations on income received from debt-financed investments,
2. Extending the unrelated business income tax to cover all organizations now exempt.

We believe that these two measures will be extremely helpful and equitable.

Our main points of concern are three of the other proposals. I shall list these here, along with a brief word about each.

1. Gifts of appreciated property—The present law, which allows a deduction for the fair market value with no capital gains tax on the appreciation, should be retained. Such gifts have in the past been extremely beneficial to education and to all recognized non profit organizations. In our opinion, it is an incentive to the donor and provides him with a justifiable tax deduction. You will recall that in 1938 the House of Representatives passed a bill calling for the contributor's deduction to be measured by the donor's cost, not in the fair market value at the date of the gift. However, the 1938 bill, as finally passed, did not contain the House provision. The Senate Finance Committee rejected the provision and it was not enacted.

2. Life income gifts—The law as it stands governing charitable remainder trusts and life income contracts provides that there is no capital gain on the transfer of the appreciated property to fund the trust or contract, nor is there capital gain when the property transferred is later sold by the trust or life income pooled fund and the gain permanently set aside for the charity. This should be retained. The present rule governing charity gift annuities should also be retained. All life income plans for the benefit or recognized charitable and publicly-sponsored institutions should continue to be deductible up to 30% of adjusted gross income (or any higher ceiling which may be allowed for outright gifts to these institutions) with a five-year carryover for any "excess."

3. A 3% threshold on deductibility of charitable gifts—We believe that there should be no floor whatsoever on the deductibility of gifts to charity. I realize that the House Ways and Means Committee so far has made no statement concerning this. However, the proposal was made by the Treasury Department under President Johnson and may not be dead. This particular reform would cause hardship to the person unable to make the large gift and hence again would do great harm to charitable organizations.

We are also concerned with any radical changes contemplated regarding the unlimited charitable deduction, two-year trusts, appreciated property gifts which would generate ordinary income if sold, and rent-free use of property. These are additional aids to charitable institutions in their efforts to obtain private support.

We are in the process of preparing a $12 million capital fund-raising effort which, hopefully, will produce five badly-needed buildings, as well as increased endowment, faculty compensation, scholarships, etc. This effort and every fund-raising operation of any consequence, whether it be for education, hospitals, religious organizations, or other, would be seriously injured if the measures proposed by Chairman Mills and his committee are made into law. If institutions which are not publicly supported are hampered in their fund-raising efforts by unrealistic tax reforms, it will leave us no course except additional pleas to the Federal and State Governments for money. The tremendous sums that would be required could not possibly be recovered by the changes being considered now and, without a question of doubt, there would be a necessity for additional taxation someplace along the line on the individual who can least afford it.

I am not sitting in an ivory tower decrying all efforts at tax reform and predicting utter disaster. I must admit that I, like many Americans, have sometimes wondered how it is possible for the extremely wealthy to avoid any payment of income tax or at least an extremely small tax, proportionately, campared to my own. I am by no means a tax expert, nor am I an attorney. I recognize that the programs being undertaken by the Federal Government cost money. I know that our effort in Vietnam is an expensive proposition and that putting a man on the moon requires major resources from all segments of the American public. But I think that the men and women in Congress with the banks of information and resource facilities at their disposal could find ways of correcting many tax problems without hindering the efforts of charity. We cannot exist without public giving, unless we are to become almost completely state-supported. This I am against.

Thank you very much for your kindess in reading this rather lengthy letter.

Respectfully yours,

ANDREW T. JACOB,
Director of Development.

STATEMENT BY HOWARD W. JOHNSON, PRESIDENT, MASSACHUSETTS INSTITUTE OF TECHNOLOGY

SUMMARY

I. *Bill as written will inevitably have an adverse impact on future financial support of educational institutions*

A. Private philanthropy's share of roughly one-half of the total of support of educational institutions will be impossible to meet if Bill is enacted in its present form.

B. We believe it is possible to meet the objectives of the Bill (curbing of abuses) without the damage to genuine charitable giving which would be caused by withdrawing tax incentives and imposing penalties.

II. *Principal provisions adversely affecting educational support*

A. Treatment of appreciation of donated property.

1. 30% limitation whereas 50% limit on other gifts—Limitation applied to total value rather than amount of appreciation.

2. Appreciation as tax preference—This, together with the provision for allocation of deductions automatically reduces incentive for charitable giving, and takes back deductions otherwise granted and makes intelligent planning for future gifts impossible.

3. Appreciation element not deductible in gifts of future interest unless theoretical gain taken into income.

B. Treatment of Charitable Remainder Trusts.

1. Income tax and gift tax deductions are disallowed and gains realized by trust are taxed unless trust qualifies as Annuity Trust or Unitrust—This, in effect, requires charitable remaindermen to guarantee return to life tenant irrespective of yield.

2. *Ex post facto* application to existing trusts would have effect of freezing portfolios or imposing gains tax, which will be borne by the charity, whereas no such tax would have been imposed under the law in effect when the trusts were created.

3. Life income contracts—Ambiguities in the bill which raise so many dangers may eliminate support from this source.

4. Estate tax—Imposes Annuity Trust and Unitrust Rules and retroactively applies rules preventing self dealing, etc., to existing trusts whose governing instruments cannot be changed.

III. *Miscellaneous provisions*

A. Private Foundations—Severe provisions will reduce the substantial support of educational institutions now being received from foundations.

B. Reporting requirements—Disclosure endangers anonymous gifts.

C. Unrelated Debt Financed Income—The Bill should exempt income from low income housing projects or at least exempt income from projects financed or insured by state or municipal authorities.

STATEMENT

Mr. Chairman and Members of the Committee: My name is Howard W. Johnson, President of the Massachusetts Institute of Technology. It is a privilege to submit this statement and to join with many of my colleagues across the country in warning of the dangers of certain provisions of Bill H.R. 13270 which can be extremely hurtful to the future of higher education in the United States.

In commenting on these hurtful provisions, I want to make it clear that I do not stand in opposition to tax reform, and I recognize the formidable task the Congress faces in seeking to accomplish it. I recognize the need to curb tax abuses and to stop any subversion of laws designed to encourage philanthropic giving.

But cannot these objectives be reached without drastically discouraging private philanthropic giving? I think that they can: and I am convinced that they must if our private institutions are to secure the resources they need, not only to grow in strength but to survive.

I want first to underscore the urgency and magnitude of the current financial needs of our universities. Indeed, if you include the problem of finding a basis for

a renewed spirit of concerned citizenship and involvement among the young, there is no problem facing higher education more critical than its financial one. As the head of a large private institution, I am keenly aware of the steadyily rising cost per student and the mounting difficulties in finding adequate resources.

It should be especially clear that the flow of Federal dollars to educational institutions in recent years has not reduced the need for private funds in our private institutions. Private institutions will and do require both public and private funds, and those of us who have responsibilities for the financial integrity of private institutions have counted and planned on increasing amounts of gifts, grants and bequests from private sources. All our forward planning, which we have undertaken with great care, has been done on this basis.

The recent Report of the Carnegie Commission on Higher Education calls for private sources to support the same fraction of the total cost of education as in the past—roughly half. The question before us is whether the private sector will be able to provide its share of the total cost which will rise from approximately $20 billion to more than $30 billion annually by 1976–77. To achieve this will be difficult under even favourable conditions; it will be impossible if we surround philanthropy with harsh constraints and regulations.

Looking at certain provisions of the Tax Reform Bill I am convinced that they are unwise and severely damaging to the future of all our educational institutions. At this time when almost all institutions of higher learning are faced with mounting financial problems and towering capital needs, we must make sure to do all that we can to strengthen and not weaken the support given them to meet these needs and resolve these problems.

The provisions of the Bill which will have most serious and adverse effects on charitable giving—aside from those provisions relating to private foundations, on which separate comment is to be presented to the Committee by my associate, Dr. James R. Killian, Jr., and others—are (i) the treatment of donated appreciated property, particularly in conjunction with the allocation of deductions, and (ii) the provisions relating to charitable remainder trusts.

Due to the tax incentives afforded under the present law, a very substantial part of present charitable giving to private institutions is in the form of appreciated securities. At M.I.T., for example, nearly $31,000,000, or 27 per cent. of all donations received over the past four years have been in securities and approximately 38 per cent of gifts from individuals have been securities. We have no knowledge of the donors' cost basis, but it is a reasonable presumption that all these securities had significantly appreciated in value while held by the donors. The new law presents a clear danger to this important source of giving.

The allocation provision of the new law will also present a serious bar to charitable giving. If there is merit—and, of course, there is—to the policy of encouraging charitable contributions by affording deductions, it simply does not make sense to grant the deduction on the one hand and then limit or take it away with the other under the guise of an allocation. This is inconsistent with the policy which dictates the increasing of the limitation on charitable deductions to 50 per cent of the contribution base. It is inconsistent with the often reaffirmed policy of the Congress as it has evolved over a long period of time.

The Bill's treatment of Charitable Trusts poses an even greater threat and, because of its application to existing trusts, unjustly penalizes them. Charitable remainder trusts and life income plans have been and are a substantial source of contributions. At M.I.T., gifts over the past four years through charitable remainder trusts and life income plans have constituted in excess of six per cent of total contributions; and we had, before this Bill, expected this source of contributions to continue to grow. The Bill would sharply curtail or possibly eliminate future support from this source and would burden existing trusts at the expense of charitable remaindermen.

An equally severe blow to charitable giving would be dealt by the Bill's treatment of testamentary trusts and intervivos trusts, the property of which is includable in the taxable estate. Under present law, an estate is given a deduction for the remainder interest which goes to a charity. Such trusts and bequests are most important sources of contributions. Of total contributions received by M.I.T. from *individual* contributors over the past four years, about two-thirds was derived from these sources.

Clearly, we would be sorely hurt by this Bill, for the combined effects of the various sections relating to charitable trusts and bequests seriously limit deductions for gifts which can take effect only in the future. This strikes a very sensitive nerve in the make-up of private philanthropy because often the only feasible way a gift may be made is by providing that the charity will benefit only after

the death of the donor and/or other persons to whom the donor has a prior responsibility. It is for this reason that such a substantial portion of giving has come through bequests and charitable remainders.

Let me turn now to a more specific and detailed examination of some of the particulars of the Bill. In view of the very wide scope and complexity of the Bill's "charitable provisions" (private foundations, unrelated income, charitable deductions, charitable remainders, tax preferences, allocation of deductions, etc.), I shall deal only with those aspects of these provisions that I deem most hurtful and troubling. I shall present not only a critique but make some suggestions for modifications.

GIFTS OF APPRECIATED PROPERTY

The changes proposed by the Bill with respect to donated appreciated property which we find objectionable are:

1. 30 percent limitation

Whereas other gifts to qualifying charities would be subject only to a limitation of 50% of the "contribution base", the deduction for gifts of appreciated property would be limited to 30% of such base. We feel that there is no necessity for this special limitation in the light of other provisions in the Bill which restrict the use and the abuse of the opportunity to make gifts of appreciated property, such as the provision Section 170(e) (IRC) applicable to property, the disposition of which would result in ordinary income, the provisions relating to tangible property, etc.

Moreover, as written, this 30% limitation appears to apply to the full value of any gift of appreciated property regardless of the amount of appreciation. If the special 30% limitation is to remain in the Bill, it should certainly be applied only to the appreciation element and not to the entire value of the appreciated property. For example, a donor who gives property with a value of $50,000 and a cost to him of $40,000 should get no less tax benefit than one who makes a $40,000 cash gift. Nor should two donors who give property of equal present value be penalized to the same degree where the cost basis to one is $50 and to the other $50,000.

2. Gifts of future interests

No current income tax deduction would be allowed with respect to the amount of appreciation in property given as a future interest (as for example the remainder interest in a trust) unless the donor includes such appreciation in taxable income. In view of the other provisions relating to charitable trusts discussed below, we see no reason for this special limitation.

3. Appreciation as a tax preference

Among the tax preferences over which certain deductions must be allocated is the appreciation on any donated property. We recommend that at the very least such appreciation be eliminated as a tax preference for the purpose of allocating deductions (as in the case of certain tax-exempt interest). Otherwise the appreciation will have a serious effect in reducing the tax value to the contributor, not only of charitable deductions, but of most other deductions and will make it impossible for him to determine before the end of his taxable year the true tax effect of his contribution. This factor is of real concern to substantial givers and would have a particularly adverse effect on extended pledges for contributions to be made over a period of years.

4. Charitable gifts as allocable deductions

The allocation provision will present a serious hindrance to charitable giving. The effect of applying the allocation of deductions provision to the appreciation in charitable gifts of property as a tax preference must automatically reduce the tax benefit of charitable and other deductions even though the appreciation is the only tax preference which the taxpayer has. The greater the appreciation the more the deductions are decreased. If a taxpayer with $130,000 of gross taxable income donates securities having a fair market value of $40,000 and a cost of $10,000, a deduction of $40,000 would be allowed under present law. Under the Bill, the deduction would be prorated between taxable gross income and so-called tax preference income and would thus be reduced by 13.3%.[1] Not

[1] $\frac{\$30{,}000 \text{ (appreciation)} - \$10{,}000}{\$130{,}000 \text{ (gross income)} + \$20{,}000} = 13.3\%$

only would this reduce the charitable deduction but the other deductions, which must also be prorated, would be reduced by the same percentage. Thus, though the taxpaper realizes no economic gain from the gift, the net effect would be a significant increase in his taxes.

Moreover, as noted above, because of its interrelation with the tax preferences, the donor will be unable to compute the tax effect of even a cash gift until the year end when the entire amount of his tax preferences (including such items as capital gains[3] has been finally determined.

CHARITABLE REMAINDER TRUSTS

Under the present law, a donor who creates a trust with income to himself and/or a member of his family for life and the remainder to charity, is entitled to a deduction for the discounted value of the charitable gift for income and gift tax purposes. Also by virtue of Section 642 which affords a trust a deduction for amounts permanently set aside for charity, if the trust sells the corpus, the gain, if any, is not taxed since it is so set aside for charity. These charitable remainder trusts and life income plans (where the charitable institution is in effect the trustee) have been and are a substantial source of contributions.

The particular changes in this area which would be effected by the Bill are:

1. As noted above, no current income tax deduction will be allowed for the amount of appreciation in property given to such a trust unless the donor includes the appreciation in taxable income.

2. Intervivos gifts to such trusts would no longer qualify for a deduction to the grantor for income and gift tax purposes and the trusts themselves would be denied exempt treatment of gains realized by the trust, even though clearly set aside for charity, unless the trust qualifies as an Annuity Trust (one which affords a guaranteed annual amount to the donor) or a "Unitrust" (one which pays to the donor or other life beneficiary, at least annually, a fixed percentage of the fair market value of the assets). The expressed reason for the new concept of the Annuity Trust and the Unitrust is to assure that the charity will ultimately receive its full remainder interest. In fact, the proposed provisions would have the opposite effect. Most existing trusts with charitable remainders provide for the income to be paid to the life beneficiary and the remainder to the charity. Under such trusts, the charitable remainderman bears the risk only of fluctuation in the value of the principal for the duration of the preceding life estate. Under the Bill, the charitable remainderman would bear not only that risk but also the risk of fluctuations in income from the property since it would, in effect, be guaranteeing payments not measured by the yield.

The charity could be required to use other revenues or even its capital to pay the life beneficiaries and, if the yield on the property declines from the rate used in computing the charitable deduction, the charity would net substantially less than it would under a trust created under current law.

By withdrawing the deuction for amounts permanently set aside for charity unless the trust meets the Annuity Trust or Unitrust requirements, the charity would now be presented with the unfortunate alternative of either (i) guaranteeing a fixed return to the life beneficiary, potentially at a loss to the charity in the event that the fixed return exceeds the earnings, or fixing the rate of return so low as to be totally unattractive and thereby making it virtually impossible for the prospective donor to consider a gift, or (ii) bearing the cost of capital gain taxes in the event of a sale to diversify or otherwise improve the portfolio.

3. A very real inequity in these provisions results from their application to existing trusts. Hereafter, deductions for amounts set aside for charity by an existing trust with a charitable remainder would no longer be available unless such amounts are currently paid out to the charity, which in many cases of existing trusts cannot be done under the governing instrument. Thus, though the trust was drawn under a law that gave it freedom from tax on gains, it would hereafter be taxed on the gain on the disposition of the property. The net result will be that either the portfolio will be frozen or the tax will be incurred, in which case *it will be borne by the charity* since the remainder will be reduced

[3] The capital gain is perhaps the most variable factor among the proposed tax preferences, the tax burden on which would be markedly increased by those provisions of the Bill which eliminate the alternative tax, and increase the holding period to twelve months. The treatment of the capital gain deduction as a tax preference imposes a real penalty by reducing other deductions and we submit that the donor should not be doubly penalized by a reduction in the charitable deduction.

by the amount of the tax. We strongly urge that such tax not be applied to existing trusts.

At the very least, if the tax is to be given retroactive effect to existing trusts, the law should provide that the cost basis if the assets should be the fair market value of the property as of 12/31/69 (as the Bill provides in the case of certain private foundations) so that at least gains accrued to date will not be taxed. Unless that is done, the provision as it stands will impose an additional undue burden on the charity or trust, as in most cases it will not have and cannot obtain records from which to ascertain the donor's basis so that it will likely be changed with a basis of zero.

4. One of the many complexities and ambiguities introduced by the Bill is its effect on life income contracts. Under a typical life income contract, the donor merely enters into a contractual arrangement with a university whereby in exchange for a transfer of property, the university agrees to pay the donor for life or a term of years, the income, either from the property or the appropriate percentage of income from a pooled fund in which this property is placed. Under the meaning of the Bill, is this a gift or a sale and, if it is a gift, it is a gift of a future interest?

If the transaction is a trust and a gift of a future interest, then (i) presumably the amount paid to the donor will have to conform to the so-called Annuity and Unitrust standards, i.e. the university would have to guarantee either a certain amount or a certain rate of return irrespective of the actual yield, (ii) no current deduction would be allowed with respect to the amount of appreciation, if any, in the donated property unless the donor elected to include the appreciation in taxable income,[8] and (iii) the university as "trustee" would be liable for taxes on capital gains when and if the property were sold unless the arrangement met the Annuity and Unitrust rules.

If it is not a trust but an outright transfer or sale so that thereafter the property belongs to the university, then (i) does the donor realize a taxable capital gain on such sale, (ii) is it a so-called "bargain sale" so that the bargain sale provisions are applicable, and (iii) is it by chance "debt-financed" property so that income therefrom is unrelated income. The provisions dealing with unrelated income would appear to be sufficiently ambiguous and broad that they could include life income contracts.

5. Not only does the Bill change the rules as to deduction of gifts to these trusts, but, under the heading of "Private Foundations", it would impose many of the same punitive taxes and regulations on trusts with charitable beneficiaries which are made applicable to private foundations. The 7½% investment income tax and the "penalty" taxes (self-dealing, etc.) are imposed on those trusts which have only charitable beneficiaries and the "penalty" taxes are imposed on trusts in which only a portion of the beneficial interests are held by a charity. Like many other provisions of the Bill, some of these rules would be applied to trusts already in existence, even though the trusts were drawn (and in many cases cannot be changed) in reliance upon laws which afforded them freedom from such taxation and penalties.

As in the case of private foundations, the only apparent relief from these penalty taxes is under a provision Section 4947 which provides that the Secretary "may", not "shall", abate the unpaid portion of a tax if the trust distributes all of its net assets to a specified type of charity.

6. *Estate Tax Deductions*

Under present law, an estate is given a deduction for a remainder interest which goes to charity. The proposed Bill would deny that charitable deduction in computing estate taxes for gifts or bequests in trust unless (i) the trust qualifies as an Annuity Trust or Unitrust, and (ii) the governing instrument expressly prevent self-dealing, speculative investments, etc.

These new estate tax rules are applied retroactively to intervivos charitable remainder trusts, the corpus of which is includable in the gross estate for estate tax purposes. Because of the incapacity of testators in some cases and because of the time that would be required to make the necessary changes of wills in practically all cases, many trusts under wills could not be changed to meet the requirements of the new law before death occurs. Also many intervivos trusts, the property of which is includable in the estate of the donor, cannot be changed because they were created under instruments which are irrevocable and unamend-

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[8] If this is the result, the Bill would, as a practical matter, put an end to gifts made under life income contracts.

able. In such cases, though the bulk of the property will inevitably go to the charity, the estate will be denied the charitable deduction, even though such deduction was allowable under the law at the time that the instrument was executed. Again, the burden of this tax will fall on charity except in those cases where the governing instrument provides that the tax is to be borne by noncharitable beneficiaries, in which case it may very well wipe out such beneficiaries even though at the time the trust or will was drawn, the charitable remainder qualified for the charitable deduction.

At the very least, these provisions should be made inapplicable to existing trusts and testimentary trusts which cannot be amended and in addition the statute should extend ample time (perhaps one year after enactment) to permit appropriate changes in wills and trusts which can be amended.

7. Gift tax deduction

As noted above, the Bill would also disallow a deduction for gift tax purposes for remainder interests given to a charity except in those cases where the charitable remainder qualifies as an Annuity Trust or Unitrust and the trust instrument expressly prevents certain acts (self-dealing, etc). This would present a major obstacle to charitable giving. The gift of a remainder interest in property is the most attractive way of making a charitable gift because it does not involve an immediate cash outlay. We believe, however, that there are few donors who could be persuaded to make such a gift if at the same time they were required to make substantial payments of gift taxes to the government, especially when such tax is occasioned by a gift which is irrevocably to go to charity.

MISCELLANEOUS PROVISIONS

Other provisions of the Bill which are of concern to educational institutions include:

1. Private foundations

I understand that the many and complex provisions relating to Private Foundations will be commented upon in later testimony and I will, therefore, not deal with them here to reiterate that institutions of higher learning, such as Massachusetts Institute of Technology, have in the recent past depended to a very substantial extent on contributions from such foundations. The proposed new taxes, particularly the punitive ones, which, if enacted, may well spell the end of such foundations, can only serve to reduce the much needed revenue that has been forthcoming from that source.

2. Reporting requirements

Under the Bill all exempt organizations would be required to file certain returns and reports unless excused from so doing by the Commissioner of Internal Revenue if he determines that such filing is not necessary to the efficient administration of the law. Included in the information required to be filed are the names and addresses of all substantial contributors. In addition, each contributor who transfers income-producing property having a value in excess of $50,000 must file a report of such transfer if the transferee is known by the contributor to be an organization which is subject to the tax on unrelated income.

We have no quarrel with an obligation to file reports that furnish information needed by the IRS to administer the law but we do not believe that such reports should require naming anonymous contributors. The filing and the publication of such information would place yet another hurdle in the path of charitable giving.

3. Unrelated debt-financed income

The Bill includes a provision which would subject income from certain debt-financed property to the tax on unrelated income (Section 514). Due to social pressures, a number of educational institutions, including Massachusetts Institute of Technology, are inaugurating programs for the building of low-cost housing which can be financed only through debt. These projects will not be related directly to the institutions' educational function with the result that the only exemption accorded to this type of income is that debt obligations insured by the FHA are not taken into account in computing debt-financed income. In view of the need for low-cost housing and of the fact that the universities are obliged to undertake this as a *pro bono publico* matter, we suggest that the exemption should be broadened to include all debt-financed projects for con-

struction of housing for low and moderate income groups. At the very least, the exemption should be broadened to include situations where the debt is insured by state or municipal authorities under arrangements similar to those with the FHA.

In sum, all the various items in the Bill which I have discussed impose very real obstacles to continued philanthropic support of education at a time when such support has become more necessary than ever to enable private institutions to meet their growing financial needs. I hope most earnestly, therefore, that the Congress will give proper weight to this concern in its review of the proposed tax bill and seek to achieve a means of reaffirming strongly the traditional role of private philanthropy in our society within a framework of tax reform.

LAW OFFICES OF
KOSTER, KOHLMEIER & GRAHAM,
San Francisco, Calif., August 29, 1969.

SENATE FINANCE COMMITTEE CHAIRMAN,
Senate Office Building,
Washington, D.C.

HONORABLE SIR: I respectfully request your permission to submit the following comments on what appears to me to be most unjust and inequitable results inherent in the provisions proposed in Section 201 of the Reform Bill and the retroactive effect of those provisions.

To pinpoint the purpose of my comments, I submit an actual situation which I believe is typical of a great many similar transactions.

In 1967 two persons, man and wife, age 70, each created an *irrevocable* trust in which each deposited his or her community property estate of gilt-edged securities, respectively. The Trust instrument provides for retention of a life interest in income (exclusive of tax-computed capital gains) until death of one; and then a continuation to the survivor of the life interest in his or her own Trust and a life interest in the decedent's Trust. Upon death of the survivor, the trust property is distributable to a tax-exempt charitable organization. The capital gains are required to be held exclusively for distribution to the charitable organization upon termination of the trusts.

As I understand Section 201 of the Tax Reform Bill HR 13270, this trust will be a taxable trust because it does not qualify as a "Charitable Remainder Annuity Trust" since the income distribution is not a "sum certain" and does not qualify as a "Charitable Remainder Unitrust" since the distributable income is not based upon a "fixed percentage of the net fair market value of its assets". Obviously the Trustors in this case could have estimated the life income fairly accurately and could have provided for distribution of a "sum certain" had they known that this might be important under some future amendment of the Taxing Act, but they cannot make any change now because the trust is irrevocable and cannot be amended.

The Trustors are not concerned about their own income tax deductions or gift tax incidences because the Reform Bill provisions do not relate back to trusts created prior to April 22, 1969 *as to these matters*. But they are concerned about the income tax liability of the trust as to the capital gains being retained for the charitable organization and about the estate tax liability as to their respective estates. The estate tax liability is affected by the new Bill since the estate tax amendments apply in the case of decedents dying after enactment of the bill without any exclusion of the effect of the bill as to estate tax treatment for irrevocable trusts created prior to the enactment of the bill.

If I understand the Reform Bill, the capital gain would be taxed to the Trust only because it is not exempt as a Charitable Remainder Annuity Trust or a Charitable Remainder Unitrust. Also, the deduction for the capital gain permantly set aside for the charitable organization will not be allowed as a deduction because the new bill repeals the deduction for income "permanently set aside" and allows a deduction only for amounts "paid" to the charitable organization. The Trustors will suffer and the charity will suffer if the proposed changes are made retroactive to cover previously created irrevocable trusts in situations such as the one herein described.

As to estate tax, the Trustors recognize that the gross estate of each will include his or her trust because of the retained life interest and under the present law the estate would be entitled to a deduction for the property distributable to the charitable organization in computing the net taxable estate. As I read the new

Reform Bill, this deduction will not be allowable only because this charitable remainder trust does not qualify as an annuity trust or a unitrust. The retroactive effect of the new law which creates these harsh impositions upon taxpayers unable to meet the requirements because of the binding nature of their undertakings entered into in prior years, seems discriminatory and most unfair.

The tenor of the new Reform Bill is to make changes which will correct injustices and provide for equitable considerations. If my understanding of the provisions herein discussed is correct, then it appears to me that some further changes should be made in the Reform Bill to protect innocent people from unjust tax treatment resulting from retroactive application of the new taxing provisions. As to situations herein desribed, the Trustors cannot now comply with the new Bill and unless some remedial provisions is made in the Bill their carefully planned bona fide program for charitable philanthropy put into effect years ago will be frustrated and tax injustices will result.

I respectfully urge further consideration of the new provisions herein discussed, particularly as to the definitions of the Charitable Remainder Annuity Trust and Unitrust and the retroactive application of the provisions to irrevocable trusts already created.

Respectfully yours,

GEORGE H. KOSTER.

SHRINERS HOSPITALS FOR CRIPPLED CHILDREN,
Beverly Hills, Calif., September 23, 1969.

HON. RUSSELL B. LONG,
U.S. Senator, Washington, D.C.

DEAR SENATOR LONG: This letter is being directed to you because of Shriners Hospitals for Crippled Children's grave concern over certain provisions contained in Section 201 of this House-passed Tax Reform Act of 1969, which would drastically curtail the availability of funds to assist many crippled children and burned children at our nineteen orthopedic hospitals and three burns institutes.

Instead of our charity being able to further extend its outreach in behalf of more crippled children, which is our earnest most hope and prayer, Shriners Hospitals would itself be crippled if the tax incentives for charitable giving and deductions were removed or greatly restricted. Does the Federal government really want the alternative of federally controlling and financing these charitable endeavors for the public good at a cost of many times what the government would actually gain in tax revenue through putting into effect these changes in our tax laws?

Since our first Shriners Hospital was constructed in 1922, we have cured or materially helped more than 140,000 children without any charge to the parents. We have likewise substantially aided research and teaching of the medical profession. Our present average cost per orthopedic patient to our charity approximates $2,200, while the treatment of a severely burned patient approximates $16,000, when you include the reconstructive surgery that is involved. Right now we estimate our total operating expenses for the calendar year of 1969 will exceed $22,00,000, which figure is in excess of our projected income.

Generally, our concern centers on three portions of Section 201 of this Tax Bill, as follows:

1. *Charitable contributions by estates and trusts* (See Section 201(f) of the Tax Bill and Section 642(c) of the Internal Revenue Code.)

Under present law, a non-exempt trust (or estate) is allowed a full deduction for any amount of its gross income which it *pays or which it permanently sets aside for charitable purposes.* There is no limitation on the amount of this deduction under Section 642(c) of the Internal Revenue Code. By this new Tax Bill, it eliminates this "*permanently set aside*" charitable deduction.

We are firmly convinced this would have a very profound effect on all charities and educational institutions which are presently designated to receive the corpus or principal of many testamentary trusts or irrevocable living trusts after one or more intervening life estates in individuals. Section 201(f) of the Tax Bill would require the trustees of these trusts each year during the period of these intervening individual life estates to pay federal fiduciary income taxes on all capital gains trust income allocated to principal resulting from trust investment changes. Heretofore, this capital gain income was *untaxed*, since the income was considered to be "permanently set aside" for charitable purposes under Section 642(c) of the Code, and specifically, Regulations 1.642(c)-1 and 1.642(c)-3.

As a sizable national charity, we rely extensively on such charitable remainder trusts in supporting our Hospitals for Crippled Children and Burns Institutes. We envision that this proposed amendment to Section 642(c) of the Code, if enacted into law, would represent *yearly* an ultimate income loss alone to Shriners Hospitals of from a minimum of several hundreds of thousands of dollars to well over a million dollars (depending on market conditions and the amount of gains from the sale of long-term capital assets). Inasmuch as the income has been "permanently set aside" for charity, the tax burden falls directly on the charities, rather than private individuals.

In addition, in *estates* which may run for several years where our charity or any charity may be designated for a residuary interest, this Section 201(f) would require the executor to pay out all charitable income received during each taxable year, before the close of the following taxable year, or the charitable deduction would be lost to the estate. Presently, it is unnecessary that the executor (unless he so desires) pay over this charitable income to the charitable residuary beneficiaries until the conclusion of the probate, since it is considered "permanently set aside" for their use. *We earnestly implore you to leave unchanged Section 642(c) of the Internal Revenue Code as it would have a horrendous effect on all charities and educational institutions, were Congress to eliminate this "permanently set aside" deduction allowed trusts (or estates), as proposed by Section 201(f) in the House-passed bill.*

2. *Charitable remainder trusts* (See Section 201(e), (h) and (i) of the Tax Bill).

A second major concern of our charity involves the very significant changes made in regard to charitable remainder trusts and the new proposed estate tax provisions governing charitable deductions. Under present law, if a trust is created for both a charitable and private purpose, there is allowed an estate or gift tax deduction for the value of the charitable beneficial interest, provided such interest is "presently ascertainable", and thus, severable from the noncharitable interest. As you know, Section 201(h) and (i) would apply a more rigid set of rules and allow no deduction for a charitable remainder in trust, *unless the trust is either a charitable remainder annuity trust or a charitable remainder unitrust, as defined by the Act.*

On Page 58 of the Report on the House Committee on Ways and Means, in discussing the "*General Reasons for Change*" the Committee makes the following statement:

"The rules of present law for determining the amount of a charitable contribution deduction in the case of gifts of remainder interests in trust do not necessarily have any relation to the value of the benefit which the charity receives. This is because the trust assets may be invested in a manner so as to maximize the income interest with the results that there is little relation between the interest assumptions used in calculating present values and the amount received by the charity. For example, the trust corpus can be invested in high-income, high risk assets. This enhances the value of the income interest but decreases the value of the charity's remainder interest.

"Your committee does not believe that a taxpayer should be allowed to obtain a charitable contribution deduction for a gift of a remainder interest in trust to a charity which is substantially in excess of the amount the charity may ultimately receive."

Looking at the Committee's first sentence, it is obviously true that the amount of the charitable remainder deduction will have little, if any, close causal relation to the value of the benefit which the charity actually receives. It shouldn't! In many cases, it could very likely be many years (after one or more intervening life estates) before the charity or educational institution will actually receive its interest, and if recent history can offer any guide, it is that the value of assets eventually passing to charity will have considerably appreciated in value from the date of computation of the charitable remainder. It is rather difficult to comprehend the Committee's particular reasoning in placing so much emphasis on trying to make a close comparison between the value which a charity ultimately receives and the dollar value of the actual charitable deduction taken in the estate, unless the Committee or the Treasury wishes to set the normal investment policies and standards for the trustee.

What the Committee appears to lose sight of in its comments is that when this charitable remainder becomes vested, the amount of the charitable remainder interest deduction is determined by reference to the government's life-remainder annuity tables as set forth in the Federal Estate Tax Regulations. This can be

likened, I suppose, to a person who prepares a Will, not knowing what conditions may be present at the time of his death. He prepares his Will on the basis he may die tomorow. Certainly, if a different annuity factor would now be more appropriate in valuing the charitable remainder, this could be easily accomplished without establishing completely new tax concepts which are not in accord with accepted fiduciary standards of conduct. Under the new tax proposal, every Will or living revocable trust involving a charitable remainder interest would have to be revised or the taxpayer would suffer a complete loss of his charitable tax deduction.

As a reason for making this proposed change, the Committee indicates that ". . . trust corpus can be invested in *high-income, high-risk* assets," (emphasis supplied), thus asserting that the non-charitable income interest would benefit to the detriment of the charity's remainder interest. It would be most unusual, we believe, to find a high-risk speculative equity investment (purchased for capital appreciation), also paying a high income. The opposite is usually the case. In most all instances, the receipt of a higher income by the income beneficiary results from a very conservative investment policy pursued by the trustee. Under this form of investment policy, there is little likelihood of any charitable remainder being enhanced in value. It would thus seem that the government would have less concern if the trustees did in fact follow the investment policies of which it now expresses anxiety.

The examples which have been utilized in the Committee report are not at all representative of the usual charitable remainder factual situations, and it is our belief that one or more of these examples would today not qualify under the present tax laws and rulings for a charitable remainder tax deduction. This section of the report appears to us to be based on supposition and theory, and is not borne out by our own experiences.

We also observe the Committees comments that a charitable deduction would not be allowed for *income tax purposes* unless the probability of a charity receiving an interest met the same standards as under the estate tax law. Here, again, based on our experience in sustaining charitable remainder deductions in estate tax matters, we feel that this tax proposal will only be a litigation-breeder—the cost of which will ultimately be borne by charities and educational institutions and not individuals.

In explaining its tax law provision change requiring either a charitable remainder annuity trust or a charitable remainder unitrust, the Committee on Page 59 states ". . . the requirement will remove the present incentive to favor the income beneficiary over the remainder beneficiary by means of *manipulating* the trust's investments." (emphasis supplied)

As the charitable remainder beneficiary of many trusts, Shriners Hospitals does not find these conditions prevalent, except perhaps in a few isolated situations where the income beneficiary is also the designated trustee and has an obvious conflict of interest. Even in these situations, our concern is not so much that the charitable remainder value will be reduced over the term of the trust, but rather that the value of this charitable interest will not keep abreast of inflationary trends and the preservation of purchasing power. It is a false premise to go on the assumption that a trustee may manipulate the trust investments in a manner favoring the income beneficiary. A trustee's fiduciary duty requires that he act impartially as between the income and principal beneficiaries, and if he does not, any principal beneficiary has a remedy to either seek the trustee's removal or his surcharge through legal process.

As we have briefly alluded to above, we are concerned over the fact that in those situations where a person does not propely revise his Will or revocable living trust, before dying, in accordance with these new rules, there would be no charitable deduction permitted for the charitable trust remainder by this Tax Bill.

The effective date for this change as stated in the Committee's report for income and gift tax purposes would be April 22, 1969, and in the case of the estate tax, this provision would apply with respect to all decedents dying after the date of enactment of the bill. If there are to be substantial and more rigid changes on securing a charitable remainder deduction, it would only appear to be equitable and proper that a transition period be granted so that persons would be allowed reasonable time to make revisions in their Wills and revocable living trusts.

3. *Charitable contributions of appreciated property* (See Section 201(c) of the Tax Bill).

Our third principal concern has to deal with the tax treatment provided by this Act as applied to all charitable gifts of a future interest in property, where there is a retained life income in the donor, and as to those situations where a donor makes a direct gift of appreciated property to Shriners Hospitals which (had it been sold) would have resulted in either ordinary income or a short-term capital gain to the donor. There is little doubt that all charitable giving from the general public will diminish considerably if such giving is not supplemented by other incentives—namely, tax incentives to the donor. Surely, the ultimate cost to the Federal government in making up for such charitable and educational services which will of necessity be curtailed by these organizations because of diminished gifts, must outweigh the revenue to the government from eliminating such tax incentives for charitable giving. We cannot believe that our Congressmen intend this result.

In your State of Louisiana, there exists El Karubah Shrine Temple of Shreveport and Jerusalem Shrine Temple of New Orleans, which have a total membership of 10,627 at the close of 1968. I would very much appreciate hearing from you and being able to report to these Shrine Temple Officers and their members that you are opposed to the tax effects of these particular provisions of Section 201 of the Tax Reform Act of 1969. Would you kindly address all correspondence to me at 323 North Michigan Avenue, Chicago, Illinois, 60601.

Thanking you, I am,

Respectfully yours,

HAROLD LLOYD,
President and Chairman of Board of Trustees.

TRANSYLVANIA COLLEGE,
Lexington, Ky., June 27, 1969.

Senator JOHN SHERMAN COOPER,
125 Old Senate Office Bldg.
Washington, D.C.

DEAR SENATOR COOPER: Chairman Mills of the House Ways and Means Committee has recently announced tentative decisions reached by the Committee with respect to certain tax reform measures.

I know that the Committee has had the benefit of many diverse views and opinions in their progress on the proposed tax reform legislation. Until Chairman Mills' announcement, I had believed that the concerns of private higher education had been expressed well and forcefully before the committee by representative national leaders in higher education.

However, the apparent direction of the committee at this time demands that those of us directly concerned with the potential deleterious effects on higher education make our views known as strongly as possible. Many of us over recent decades have worker hard to persuade persons and organizations of means to better the condition of their fellowman through a vast variety of causes and institutions. Such an effort takes time, but recent years have demonstrated the great progress we have made in this direction.

The Congress traditionally has joined in this effort by providing some tax incentives to those who support philanthropies. While progress has been great, our needs have also grown. Congress, itself, has taken the stand on many occasions that the government is compensated for any loss of revenue by its relief from financial burdens which otherwise would have to be met by appropriations from public funds. This is not a time when the nation can afford to indulge in the curtailment of major support of its philanthropically supported institutions.

Transylvania has just announced a 30 million dollar capital improvement program for the next decade. It is anticipated that 95% of the funds in this major effort must be provided by individuals and organizations who may be encouraged to give generously by the present tax incentives. Possibly most important to us are the retention of present laws relating to gifts of appreciated property and the tax deductability of all gifts up to a ceiling of a certain percentage of adjusted gross income.

At Transylvania and similar institutions, we must take care that we not price a Transylvania education beyond the reach of our students. This necessitates gift income of as much as 20% of our educational budget to meet our annual expenses without raising our tuition beyond the ability of our students to pay. Much of our gift income toward the annual budget is provided by donors of

more modest means. We believe it highly important that the donor of a $100 gift and his fellow contributors continue to benefit from the tax incentive which may have encouraged them to reach that level of giving.

Thus, I am encouraging the Committee to consider retaining the present provisions regarding *gifts of appreciated property*, *gifts of income interest*, *gifts of remainder interest*, the *donation of use of property*, and the *tax deductability of all gifts* to eligible institutions without regard to a minimum standard. I hope that you might concur in this view and make your considered opinion known when the proposed legislation reaches the Senate.

On the other hand, I am encouraging the Committee to continue to give favorable consideration to increasing the limit on individual contributions to qualified charities.

You and your associates have a difficult task in a matter of concern to all Americans, and I trust sincerely that the results of your deliberations will enhance the contributions which Transylvania and similar institutions may make to the welfare of this nation and mankind. There lies, however, in the proposals before the Congress the danger, too, of irreparable harm to all institutions who must in great measure depend on the resources of philanthropy for their survival and continued progress.

You and your work are the subject of our prayers and our very deep concern.

Sincerely,

IRVIN E. LUNGER,
President.

BOYCE THOMPSON INSTITUTE FOR PLANT RESEARCH, INC.,
Yonkers, N.Y., August 22, 1969.

Hon. RUSSELL B. LONG,
U.S. Senate,
Washington, D.C.

DEAR SIR: Before the present session of the Congress adjourns you will be called upon to pass judgment on the tax reform bill recently passed by the House of Representatives. I cannot argue against the need of reform or the constructive nature of many of its provisions. However, the proposal to tax all charitable trusts and private foundations is ill conceived, will do more harm than good, and will operate to the disadvantage of our Society.

Great good has been done for humanity in general, and the American people in particular, because of the generosity of our people in voluntarily supporting charitable causes, promotion of public health, advancement of education, and promotion of research, etc. Our government has wisely encouraged this fine trait of American character by granting tax exemption to charitable giving. Volumes could be written about the good that has resulted but not the least has been the hidden asset of simple enhancement of self respect and purity of character among our people. We can ill afford to forsake this attribute today when weakening of self respect and morality are so rampant. The small contributions of the general public to local charity and the national health associations, the generous giving of philanthropists and alumni to educational institutions, and the establishment of private foundations has each, in its own way, contributed to a richer Society and greater self respect.

We also know that the privilege of tax exemption has attracted the unscrupulous schemer who would escape paying his legitimate share of the cost of government. These must be completely curbed but it will not be done effectively by taxation. The taxes will hurt the constructive sound institutions without necessarily correcting the abuses. A more positive, direct regulation must be found so I urge you to seek this before you make a false move of injuring those that have served our Society so effectively.

Would you be kind enough to spend a few minutes in reading the attached memorandum? I trust you will think deeply, be motivated strongly, and act wisely in securing the support of your colleagues in seeking a better method of controlling private foundations. One need not burn down his home to rid it of vermin.

Yours respectfully,

GEORGE L. MCNEW.
Managing Director.

REINFORCEMENT OF THE PRIVATE FOUNDATION AS A PUBLIC TRUST

The provision in the 1969 tax reform bill of the House of Representatives to tax all foundations and charitable trusts will create grave injustice and can do appreciable harm to our Society. It is neither reasonable nor fair to tax those organizations that have a record of serving well the best interests of the American people—often for periods of several decades. There is no valid reason why the government should not encourage further philanthropy of those who are properly motivated to set up comparable charitable trusts or else reenforce existing ones.

The only question before the Congress should be how to prevent the obvious abuses that now exist. Any fair-minded person is completely aware that too many wealthy people are setting up private foundations as a blatant means of escaping payment of their legitimate taxes. Where such foundations serve no better purpose than to gratify the personal whims of the founder or are so constituted and organized that they promote self dealing between the so-called foundation and its founder, his relatives or his businesses, they should be denied all forms of tax exemption. If an established foundation cannot offer evidence that it is performing the constructive purposes of its charter with reasonable effectiveness, it should lose its privileged status.

A charitable trust must be operated conscientiously as a public trust dedicated to the welfare of all mankind. If it has no charitable, educational, scientific or social-enhancement objectives, it certainly should not expect to seek favor with the American public. Trustees who fail to live up to such ideals are guilty of deception, dishonesty or incompetence, depending upon their motives.

TAXATION IS NOT THE DEVICE FOR REGULATION OF ABUSE

There is no reason to believe, however, that we can correct through taxation the abuses of the privileges of the private foundations. All the taxation will do is to weaken and curb the legitimate, honestly dedicated foundation. These organizations have fought a rear guard action against a bitterly persistent inflation for over three decades. Most of them have seen the purchasing power of the dollars available to them from investment income decline to less than 35% of their original value. Rare indeed are the cases where the trust has been able to replace lost purchasing power by investment so as to enhance its capital assets. Most conscientious trustees avoided high risk investments capable of unusual capital gains. Some, especially in the educational and social welfare fields, have been able to survive only by locating supplementary endowment from interested philanthropy, such as the alumni. In addition to weakening the worthy, taxation of foundations will merely present a greater challenge to the scheming, conniving individual. The end result probably will be to promote further abuse by the unworthy while injuring or destroying the worthy, well established institutions.

ELIMINATION OF CHARITABLE TRUSTS WOULD LEAVE A POORER SOCIETY

An alternative might be to prevent further establishment of tax-exempt foundations or set about to liquidate those now in existence, especially those that cannot demonstrate a clearly established record of worthy public service. As a matter of fact, one of the very probable end results of taxing foundations should be their eventual destruction. If so, the socialistically oriented members of our Society should be deeply gratified because it means that all aspects of public welfare and social progress must come from an all powerful, tax supported central government agency.

The worthy, privately endowed foundation or public trust is the finest expression of the free enterprise system. An inidividual who has achieved much in commerce, industry or finance sees an unfilled need in our Society or dreams of a better way of solving old problems confronting the human race. He is motivated to apply his creative initiative, his energy and/or his material resources to the problem because he believes it is a good investment of his talents. There can be no more noble or progressive stimulation of a citizen, so our government should encourage such impulses. Our whole system of morality is based upon individuals having compassion for their fellow men and a desire to improve all facets of our economic and social development.

There is no need to dwell at great length upon the tremendous good that humanity has reaped from the efforts of private trusts. They are almost uniquely an American institution because free enterprise has fluorished among us and been encouraged by wise government policy. We could give hundreds of examples

to prove that American education outstripped others because of pioneering studies in teaching concepts and establishment of liberal arts colleges by private philanthropy or by the creation of research institutes, social studies, attack on public health problems, enhancement of food and fiber production by scientific study, and many other realms of human need.

The private foundations have served America well as an adjunct to enlightened government in three functions. First, it can move forward into neglected and nebulous areas for exploratory investigation long before public enlightment reaches such a state that it is politically feasible for government to launch a program. For example, the citizen-supported public health programs such those of the TB and Public Health, Polio, Heart, etc. associations have opened people's eyes to the need of concentrated research through their pilot studies at the local level and by educational programs while raising funds. It is doubtful whether the highly constructive program of NIH and NSF would have been made possible today had not these private foundations prepared the ground for government so it would be politically feasible to support such research effort.

Secondly, the private foundations have a unique talent for locating neglected areas for study. Since they are not responsible to direct local pressure or require political acclamation, they can reach into unique areas of service. For example, the Rockefeller and Ford Foundations sensed that improvement of rice could resolve an international need. They may very well have gained the world at least two decades of breathing space in the food-population crisis by their attainments.

Finally, the private trusts also serve to extend or supplement government functions. For example, the private educational institution for extension of knowledge to youth, the research institutions designed to solve special problems by extending the frontiers of knowledge and the social improvement institutions such as hospitals and orphanages, etc. would have to be replaced by—and be entirely supported by—governments at various levels if every one of them was eliminated tomorrow. It is obvious that any effort to relieve government of its burden by supplementary programs or diversification of effort should be cherished and preserved. In having the inevitable diversity of different approaches to similar problems, both government and private institutions should profit from each other's example.

It follows that all of humanity, and the American people in particular, have gained much from the establishment of tax-exempt, charitable trusts and can expect to continue to do so. Then the only question remaining is how to prevent the abuses. We simply cannot believe this will ever be achieved by a taxation that destroys but does not regulate. There must be established some sort of a regulatory agency since regulation of abuse is at least two decades overdue. We suggest this should be done through a licensing system established in the proper government agency such as the Department of Health, Education, and Welfare or the Internal Revenue Service. If our duly elected representatives in Congress would look at the broad problem of making charitable trusts most serviceable, they should fully appraise the following problems raised by the tax reform bill before making any final move.

THERE SHOULD BE NO TAX OF LEGITIMATE CHARITABLE TRUSTS

Those institutions that are honestly dedicated to promotion of human welfare should not be taxed. As discussed above, the tax will perform a disservice by weakening the worthy causes, forcing government to assume additional burdens to be supported by taxation, discouraging a noble trait of human character, and depriving government of the value of exploratory programs that can open up new avenues of service to our citizenry. An enlightened, socially conscious government has more to gain than to lose by encouraging private philanthropy.

The amount of money raised by taxing them will not justify the damage done. If the funds so confiscated are ear-marked for support of grants to worthy institutions—as proposed by Senator Long of Louisiana—the cost of collecting allocation to the appropriate government department, administration of a grant system, and supervision of expenditures and performance will reduce the efficiency by at least 40%. For example, if a privately endowed research institute was taxed $75,000 on a $1,000,000 income it would either have to reduce its research effort by 1.5 senior scientists or go to the appropriate government agency—where it would be lucky to get funds to support one scientist—and that would on a temporary project. Innovations by that one scientist will be further hampered by this being called upon to prepare one or probably more detailed research

proposals and detailed reports each year and by the necessity or adhering to strict fiscal policies not required in direct budgeting by on-site management. Thus we create inefficiency, higher overhead, and less research effort for a worthy institution. The same loss would occur in promotion of social welfare and education.

It is unfortunate that anyone would consider imposing a tax on constructive institutions at a time when they are already weakened by the erosion of a galloping inflation. Furthermore, it is ironic that government should consider taxing them at the very time its own fiscal policies force it to curtail the availability of contract and grant funds. The consequences are obvious—less service to the public welfare.

FORCED EXPENDITURES OF FUNDS AS RECEIVED MAY NOT BE WISE

The provision that every charitable trust should spend its investment income in the year it is received is not wise. Obviously all income of a private trust should be spent for the purposes of the trust. However, the amount of permissible reserve depends upon the character of the trust.

If the foundation raises funds by an annual subscription, the donors obviously expect such funds to be expended as soon as it can be done efficiently—probably within a year or two, except for certain types of long-range sustaining programs. If a charitable trust is endowed primarily to disburse funds from investment income, there should be no delay beyond the time to locate suitable recipients and see that programs are soundly conceived. A delay of one to two years would be in order except for major programs where the foundation is expected to make a massive effort beyond current income or expects to assure a recipient of a certain level of support for a stated period of several years.

In contrast to these non-operating foundations, there are operating trusts such as in hospitals, orphanages, universities and research institutes, that maintain their own facilities and staff. They must make provision for depreciation of facilities and security of staff. It is obvious that a staff of highly trained, skilled employees such as M.D.'s, Ph.D.'s, Engineers, etc. cannot be developed and retained on a hand-to-mouth existence. They must be protected against the vicissitudes of the economic cycles and occasional misjudgment of trustees in making investments. Such a staff cannot be disassembled and reassembled as a working team with every fluctuation in the economy. It would seem only reasonable and fair that such institutions should be allowed to retain a reasonable operating reserve possibly equivalent to two annual budgets.

RESEARCH INSTITUTES SHOULD BE CLASSIFIED AS EDUCATIONAL INSTITUTIONS

The modern University or College has the responsibility of both acquiring and diffusing knowledge. The acquisition of true knowledge through research is just as important to the future of America as the teaching of well established fact. Our Society cannot remain progressive and fulfill its tremendous responsibilities to the free world without innovative, creative enterprise. Therefore, research conducted within or outside of the University should be encouraged wherever possible. A trust established for support of research in a University is no different from one that operates independently, provided both make the results of their investigations freely available to the public through publication.

We, therefore, feel strongly that all research institutitons dedicated primarily to acquisition and distribution of new knowledge or solution of problems of public welfare in medical research, production of food and fiber, study of social systems, etc. should be as tax-exempt as the University that teaches what they learn. This would, of course, exclude the mission oriented laboratories set up to serve private industry by development of new products or processes or to make marketing studies in which the ultimate objective is private profit. The ultimate differentiation would be made according to whether the new knowledge acquired was made freely available to the public within a reasonable period of time.

CAPITAL GAINS SHOULD NOT BE CONSIDERED AS ORDINARY INCOME

If all capital gains from sale of equities are considered as current income that must be directly and forthrightly applied to the purposes of the trust, the inevitable result will be a liquidation of the trust. This leaves the trustees no room for errors in judgment in making investment and it denies them any chance to maintain the purchasing power of their investment income. The end result will be a gradual attrition of the program of the foundation. If it is serving an honest,

worthy function, as so many are doing, this is a direct loss of service to mankind.

A foundation should be given the right to build up a reasonable capital reserve so capital losses may be covered by previous or subsequent capital gains. Furthermore, it would seem reasonable to permit some reinvestment of capital gains according to the rate of depreciation in purchasing power of the dollar through inflation. The government should not insist on any trust operating on a fixed dollar value unless it can guarantee a fixed purchasing power of the dollar. Unfortunately, our government has had to follow policies through pressure of current events that led to deterioration of the value of its currency for the past 30 years. It would be grossly dishonest to say that this trend is going to be reversed in the next decade. It may accelerate.

We suggest, therefore, that every foundation be allowed to reinvest capital gains to the extent required to maintain a constant *real* worth of its assets as measured by the capacity to purchase goods and services. It would be logical to let each one use a 10-year moving average based upon some yardstick of the value of the dollar such as the Department of Commerce's Cost of Living Index to keep its purchasing power more or less constant.

We do not believe, however, that any foundation should be given the privilege of creating an ever-expanding bureaucracy of its own by speculative investment policies. Once the foundation's capital gains exceed the established tolerances defined by regulations, the excess could very well be considered as current income. As such it should be applied directly to the purposes of the foundation. If the trustees elect otherwise, the excess should be taxed at the standard rate for capital gains of ordinary individuals. After the foundation has paid its fair tax the residual funds could be invested so as to provide a more sustained form of revenue extending over a period of time. If some provision such as this is not made to discourage excessive reinvestment, the trustees will be tempted to enter into speculative investment over the decades and thereby extend the control over American capital by the dead hand of the donor.

A SELF-SUPPORTING LICENSING SYSTEM IS NEEDED

No matter how valuable the private charitable trusts may be, they cannot be encouraged if they are to be perverted to personal gain by unscrupulous schemers. Since it is unlikely that they can be properly controlled by simple punitive taxes, a just and equitable regulatory device must be created. A licensing system could be established by the U.S. Government for all private foundations that expect to be granted income-tax exemption, regardless of where they are incorporated.

It should not be too difficult to establish certain categories for foundations and the regulations to be applied to each as discussed above. A substantial staff would be required to receive applications, study the objectives and operating methods of each, and certify them for tax exemption. It would be necessary for the staff to follow up on performances by studying annual reports on financial disbursements, capital structure, and operational activities.

The cost of such a regulatory agency should be borne by the applicants on some sort of license fee system graduated according to the scope of activities and diversity of expenditures. The endowed institutions might very well have their fees based on the total volume of capital assets so the giant foundations would pay more than the more modest ones, but the small ones undoubtedly would have to pay a larger percentage of their investment income so as to pay their fair share of the cost of the licensing arrangement. This might very well serve to discourage many of the small family foundations that do serve a real purpose but a graduated license fee would seem more proper than payment of the expense of regulation from general government revenue. It would be neither fair nor constructive to force the ordinary taxpayer to pay any substantial part of the cost of supervision of a privately chartered enterprise unless he is given a voice in its operations.

Any foundation that fails to fulfill the objectives of its charter or to disburse its income primarily in implementation of its goals, should be called to public accounting by the licensing agency. If corrective measures are not made or the trustees show persistent incompetence, the assets of the trust could be diverted to the appropriate government agency for reallocation as grants to one or more effective operating institutions in the area of enterprise selected by the donor in his original trust instrument. No foundation should be allowed to function indefinitely when the purposes of its establishment no longer exist or its method of operation proves totally ineffective.

CONCLUSION

The charitable trusts of the United States have proved their worth to our Society on a hundred fronts. They have provided seed money to start new enterprises and generate new concepts in human welfare. They reflect the best in the dignity and honor of mankind so charitable giving should be encouraged by granting tax exemption.

This privilege must be extended only to those who are willing to create a public trust that will be fully subject to supervision and review. There is no room for the donor to use the device as a means of extending the use of his own capital assets for his own personal gain. To assure there is no abuse of privilege, the private foundations—we admit reluctantly—must be licensed on an annual basis to qualify for exemption from federal income taxes. The trust itself should bear the cost of its supervision by paying an annual license fee based roughly on the cost of auditing its accounts and reviewing its operations.

Such supervision can never be achieved rationally by taxation. Certain rather simple rules regarding use of investment income must be established and any appreciable deviation therefrom should be taxed so the funds can be reoriented toward its proper use in social progress. We sharply differ, however, with the spirit and much of the detail in the recently adopted tax reform of 1969 passed by the House of Representatives wherein it applies to foundations so indiscriminately. The plan will not achieve full reform and certainly will not encourage enterprise and worthy philanthropy among our citizens. We urge the whole problem be restudied and, if at all possible, be divorced from the revenue raising objectives in the tax reform instrument. The problem goes much deeper than simple taxation because it is fundamental to the exercise of personal initiative in a Society of free people.

AUGUST 22, 1969.

MEMORANDUM OF MACALESTER COLLEGE SUBMITTED BY THOMAS R. MULCAHY, GENERAL SECRETARY

IMPACT OF THE TAX REFORM ACT OF 1969 ON GIFTS TO EDUCATIONAL INSTITUTIONS

Macalester is a private, coeducational, liberal arts college serving 2,000 students from all parts of the United States and many foreign countries. Macalester College, like all educational institutions, would be adversely affected by the proposed changes in the rules for charitable contributions. The proposal would drastically alter many tax incentives to philanthropic support. The major adverse changes are:

(1) *Gifts of Appreciated Property.*—Present law allows a deduction for the full present fair market value of the property with no tax on the gain. This should be retained. It is the most important source of substantial gifts. For example, over $1,000,000 annually comes to Macalester College in the form of appreciated property, usually common stock. The bill would reduce this incentive and hurt us greatly.

(2) *Allocation of Deductions.*—The charitable deduction should not be subject to the proposed allocation rule which reduces the deduction by treating the gift of appreciated property as a "tax preference". (This complex provision is harsh. Ostensibly, the appreciation on gifts of appreciated securities and real estate [held more than one year] is not to be taxed when the donee is a church, school, hospital, or is publicly supported. However, the Allocation of Deductions provision indirectly taxes appreciation on gifts of appreciated securities and real estate.)

(3) *Life Income (Deferred) Gifts.*—Present tax treatment of appreciated property contributed to fund these plans should be retained. Almost without exception, donors set up life income plans with appreciated property, not with cash. The bill would impose incalculable burdens on the operation of pooled fund investments already in existence. Capital gains earned by the pooled fund would be taxed even though permanently set aside for the College. Allocation and inventory valuation among the many life income participants in the pooled fund are unspecified.

(4) *Bargain Sales.*—Some donors wish to recover the cost of appreciated property and donate the increment to the College. Present law allows a charitable deduction for the amount of the increase in value. The bill would tax a part of this appreciation under the allocation rule. Bargain sales of furnishings and

equipment, especially of high mark-up items, are very attractive to the College and to the donor.

(5) *Retroactive Application*.—A number of provisions are retroactive to April 22, May 27 or July 25 of this year—affecting gifts already made this year. It is extremely unfair to rewrite the tax consequences of completed gifts, of which the following are but two examples. Two sisters, alumna of Macalester, both over 70, have set up life income contracts funded with 3M stock. Another alumnus has just given the College a 35 acre tract in Tucson which will fund a gift annuity.

(6) *Gifts of the Use of Property*.—If a donor allows the College the use of property rent-free, such as a building or house, present law allows him a charitable deduction for the fair rental value of the property. The bill eliminates this charitable deduction.

The College has been the recipient of gifts of homes, usually near the campus, from retired faculty, staff and friendly neighbors. In order to make the gifts during his lifetime, the donor frequently reserves a life estate. This arrangement generates very favorable relationships and present law allows a charitable deduction to the donor based on his life expectancy. The bill denies a deduction to a donor who gives "less than his entire interest in property."

(7) *Gifts of Works of Art, Antiques, Collections of Papers*.—The bill evidences a bias against these gifts. Such items are part of the cultural treasure of the nation or the locality. Valuation problems should not be exaggerated to deny an incentive for the donation of collections of merit, such as the Lewis and Clark papers or the Edouard Manet painting, "Le Fumeur," (The Smoker) valued at about $1,000,000, recently given to the Minneapolis Institute of Arts.

(8) *Information Returns*.—Present law exempts colleges and similar organizations from filing information returns. The bill would require such returns and constitute a burden on most institutions because of the amount of data demanded. The annual information return would require a statement of the institution's gross income, expenses, disbursements for exempt purposes, accumulation's, balance sheet and the total amount of contributions and gifts received by it during the year. In addition, the information return must show the names and addresses of all substantial contributions, directors, trustees, other management officials and of highly compensated employees.

(9) *Foundation Income Tax*.—The bill would impose a 7½% tax on net investment income. This provision would divert funds from private charitable causes to the U.S. Treasury without any offsetting income source to which we can turn. To the extent that any college has received foundation grants, a tentative projection of the effect of a 7½% reduction in future grants can be made. Macalester College has over the last ten years received $27,144,791 from private foundations. Obviously we count heavily on this source of funds to sustain and expand our educational efforts.

MACALESTER'S BUDGET SITUATION

Macalester's 1969-70 budget involves expenditures of more than $10,000,000 an increase of 25% over last year, continuing a ten-year trend of 17% annual increases. These increases are projected to increase at 14% for the next five years.

Of the annual budgeted expenditures, about 26% is normally supported by gifts for current use, such as alumni annual fund and other unrestricted annual gifts.

In the case of gifts for endowment, gifts of securities play an important part. The income from Macalester's endowment is budgeted to meet another 17% of 1969–70 expenditures.

In the aggregate we estimate 43% of Macalester's annual income depends on giving by Macalester's alumni friends. Given this situation and given a budget which can be balanced only with wholehearted efforts on our part, the proposed legislation poses a serious obstacle to the attainment of both short and long-range objectives.

Finally, we submit that contribution to a publicly supported institution should not be considered a tax loophole. It is not a Congressional oversight that a contribution of appreciated property entitles a donor to a deduction for the property's full present fair market value with no capital gains tax on the appreciation.

August 29, 1969.

ARTHUR ANDERSON & CO.,
Chicago, Ill., September 10, 1969.

Re: statement regarding H.R. 13270 Tax Reform Act of 1969—Charitable Contributions.

Committee on Finance,
New Senate Office Building,
Washington, D.C.

SUMMARY OF COMMENTS AND RECOMMENDATIONS

DEAR SIRS: As tax practitioners, it is our opinion that many of the contemplated changes are unnecessarily complex. We believe that simplifications should be made which would neither materially affect the revenue, nor prolong present abuses which might currently exist. Therefore, consideration should be given to the following:

1) The myriad of effective dates for the separate provisions of Section 201 of the Bill should be eliminated, and one effective date imposed on the entire Section.

2) There should be an elimination of the present proposal allowing a taxpayer to elect whether to report a contribution of certain appreciated property at its adjusted basis, or at its fair market value with a corresponding increase in income for the appreciation. In view of the other complex provisions of the Act, allowance of an election with respect to this Section will unjustifiably complicate many taxpayers' planning and return preparation.

3) New provisions relating to charitable income trusts and charitable remainder trust should be completely revised, to eliminate the emphasis on the structure of the trust instrument.

BASIS FOR COMMENTS

1) Effective dates

In an overall review of H.R. 13270, one discovers that there are 86 separate effective dates of applicability of the new law. Ten separate effective dates are provided for in Section 201 of the Bill, and another related item in Section 121, relating solely to charitable contributions. However, when reviewing Tables 5 and 6 of the Report of the House Ways and Means Committee, it is apparent that the overall revenue effect of the charitable contributions section is one of the smallest in the proposed reform. The complexity of effective dates seems completely out of proportion to the benefits to be achieved from such complicated legislation. To emphasize this point, we have attached Exhibit I outlining these various dates, and the Sections to which they are applicable. We realize that each separate date has particular significance, and is designed to protect the revenue. However, in view of the overall complexity of H.R. 13270, the complexity of Section 201 itself, and the contemplated small annual gain in revenue, it seems unreasonable to impose additional hardship on the taxpayers and their advisors with such a variance of effective dates in one particualr section. Unlike industry and other special interest groups, most of the millions of individual taxpayers do not attend the Committee hearings to obtain first-hand warnings of impending legislation. In fact, most taxpayers did not learn of the effect or dates of this proposed legislation until several weeks later, and, at this writing, it is fair to say that many affected taxpayers and their advisors are still uninformed of its applicability and far-reaching changes. Also, it seems reasonable to surmise that, because of uncertainty as to the passage or modifications of this Section or other parts of the Bill, prudent, informed taxpayers will probably adopt a "wait and see" attitude toward immediate tax planning. Therefore, most of the effective dates inserted as "stop-gaps", to prevent last-minute measures to take advantage of disappearing loopholes, will be unfair or of little consequence, and thus should be deleted. We suggest a standard effective date of "for taxable years beginning after December 31, 1969."

2) Alternative treatment of certain gifts of appreciated property

Section 201(c) amends Section 170(e) of the Code, to provide that where a taxpayer contributes certain appreciated property, he may elect to deduct the adjusted basis of such property, or he may include the contribution at its fair market value and, under new Section 83, report the appreciation as income from the sale of the asset. We realize that the availability of such an election will be of advantage to some taxpayers in specific instances. However, it

appears that, generally, it will be advantageous for the taxpayer to elect to deduct the fair market value of property where the resultant appreciation will be taxed as long-term capital gain. In cases where the appreciation results in ordinary income, there would, generally, be little consequence to the election one way or another. However, because of the availability of the election, it must be considered in planning for each taxpayer, and in computing each individual liability. Standing alone, this section still would present no insurmountable problem. But when considered with the other contemplated revisions, the effect of the alternatives available under this particular Section create the effect of a geometric progression in evaluating the choices available. For instance, if a taxpayer contributes a capital asset held over twelve months to a private foundation, any appreciation will be taxed as a long-term gain, if the taxpayer so elects. His alternatives must be considered in the light of their effect on other proposed revisions:

a) The contribution of appreciated property is subject to a separate limitation of 30% of his contribution base, which may include the entire amount of the capital gain for the appreciation. His election could determine whether or not he exceeds the limitation.

b) In determining the taxpayer's limitation on interest deductions (Section 221), the long-term gain on appreciation would be a factor in determining the allowable interest deduction. If he elects to increase gain, his allowable interest deduction will be increased.

c) In computing the limitation on tax preferences (Section 301), one-half the elective gain will have to be considered.

d) In allocating deductions (Section 302), the amount of gain and the amount of the contribution would cause the numerator, denominator and multiplier in the required computation to vary, depending on the taxpayer's election, and also would be dependent on the results achieved in a), b) and c).

e) In determining averageable income under Section 301, each of the above factors have a direct bearing on the computation for any given year. The effect of averaging cannot be determined until the effect of a) through d) is determined.

Therefore, we have concluded that the mere availability of the election under Section 170 would unjustifiably compound the already complex computations under the proposed reform. It seems obvious that elimination of the election would not impose a hardship on any particular group or class of taxpayers; rather, availability of an election would only serve to decrease tax liability in isolated circumstances for various taxpayers. To protect an isolated, unidentified minority at the expense of imposing additional expense and complexity on all taxpayers from the outset does not seem logical. Yet, this is the present contemplated result from this available election. The present requirements for unreasonably complex calculations will probably be best handled on sophisticated computer programs, but certainly not by the taxpayer himself. To require taxpayers to avail themselves of additional outside advice solely because of mechanical alternatives imposes an unwarranted hardship.

In the interest of simplicity and practicality, we propose that the election be removed and provision made that all such gifts of certain appreciated property be treated as sales of the property at fair market value, with a corresponding charitable deduction for such fair market value.

3) Overall revisions relating to charitable income and charitable remainder trusts

Separate provisions have been enacted for each of these type trusts. However, each provision has, in part, attempted to rectify situations where there is a material difference between the claimed contribution upon the creation of the trust, and the ultimate benefit received by the charitable organization. In most of the differences, charity receives substantially less than contemplated at the time of the gift, mainly through original design or subsequent manipulation.

We agree that such distortions were not the original intent of Congress, and where practical, such occurrences should be minimized or eliminated. However, the remedy proposed by the House has been directed mainly toward the structure of the trust instrument itself, requiring that, for any gift in trust to qualify for a charitable deduction, the instrument must provide that the income beneficiary receive either a fixed amount of dollars annually or a fixed precentage of the fair market value of the assets (determined annually). These types of arrangements are quite inflexible, both for the potential donor and the trustee. In both instances, an artificial tax concept of "income" and "corpus" is being created by statute, since real income accumulations and corpus segregations

will have no relationship to the tax result. In either type trust, it is impossible to guarantee that corpus will be preserved intact, although preservation of corpus is a prime consideration in normal business and investment concepts. There does not appear to be sufficient justification for forcing an inflexible trust structure on the taxpayer, if alternative remedies exist. Finally, it would appear that there is still no guarantee that the actual benefit to charity under the new provisions will approximate the computed deductions at the date of the donation. Fluctuations in market value and earning capacity will still be subject to variation; decreased earnings of an annuity trust due to market conditions will still reduce further a charitable remainder, and decreased market values of corpus will serve to reduce the income to charity where a noncharitable remainder exists.

Since one of the prime considerations is the establishment of the value which ultimately inures to the charitable organization, a more simplified and yet more flexible approach would be to provide for an extension of the statute of limitations on such contributions in trust, to allow the Commissioner a period for measurement of the benefit accruing to the charity, through a five or ten-year "lookback." *De minimis* rules could be established to minimize the possibility of adjustment, and manipulations of investments which previously were used to the taxpayer's benefit could now be used to insure that value was ultimately transferred to charity in the amount originally contemplated. Such provisions would leave the taxpayer much more flexibility in the creation of the trust from a business and economic standpoint, and at the time be better assurance that charitable deductions are not overstated.

We would also suggest that in any case, the Regulations be revised to provide for a more realistic discount rate, rather than the 3½% now being used. Continued use of a 3½% rate automatically produces a distortion, since it does not measure the true discount rates which exist in our present economy.

SUMMARY

The foregoing objections are not intended to indicate an approval or disapproval of the remaining portions of the Act, but are only indications of technical and mechanical areas which obviously need simplification. This statement is submitted as part of a series of letters, each dealing with a particular area of the proposed legislation. It is intended that the comments and suggestions contained herein be made part of the record of testimony relative to the legislative changes contemplated for charitable deductions. We shall be pleased to discuss these matters further with you or the Committee, either in person or by telephone. Please call us collect at 312-346-6262 if necessary.

Very truly yours,

JOHN MENDENHALL,
Director of Taxes.

Attachment

EXHIBIT I.—TAX REFORM BILL OF 1969—EFFECTIVE DATES

Tax provision subject	Effective as to—	Bill section
Charitable deduction, gifts of income or partial interest.	Gifts made after Apr. 22, 1969	201(a), 201(h).
Charitable contribution deduction limit increased	Taxable years beginning after Dec. 31, 1969.	201(a).
Unlimited charitable deduction repealed	Contributions paid in taxable years beginning after Dec. 31, 1969.	201(a).
Charitable deduction denied, gifts to certain private foundations and organizations making political campaign expenditures.	Contributions paid after Dec. 31, 1969	201(a)(7), 201(b).
Charitable contributions of appreciated property limited.	do	201(c), (d).
Charitable deduction limitation on bargain sales	Sales made after May 26, 1969	201(d).
Split interest and charitable remainder trusts	Gifts made after Apr. 22, 1969, for income and gift tax purposes; and to estates of decedents dying after date of enactment, for estate tax purposes.	201(e), (h), (i).
Repeal of nonexempt trust's or estate's deduction for amounts set aside for charity.	Amounts paid after date of enactment	201(f).
2-year charitable trust rule repealed	Transfers in trust made after Apr. 22, 1969.	201(g).
Charitable income annuity trusts and "unitrusts"	Transfers in trust made after date of enactment.	201(l).
New information return, gifts of income-producing property.	Taxable years beginning after Dec. 31, 1969.	121(e).

JOHN D. MILLER,
Long Beach, Calif., July 21, 1969.

Re pending tax bills—charities.

Hon. GEORGE MURPHY,
Washington, D.C.

HONORABLE SIR: I would like to express the following views concerning those pending tax bills which pertain in various ways to the *charitable deduction*. The approaches of the Administration appear to be in three general categories: namely, *one*, those that would put some kind of limitation on the amount of any charitable deductiaon available to an individual who itemizes his deductions; *two*, those that apply to charitable foundations in some degree controlled by a single person or group of family donors; and *three*, those that would deprive the donor of the tax advantages of certain kinds of bequests that have theretofore been sanctioned.

It appears to me that as has so often been the case, a legitimate grievance against some specific and notorious abuse, or alleged abuse, of the tax laws (the Fortas and Douglas matters come quickly to mind) is seized upon by the "planners" as a platform from which to mount an attack. Such attack, while ostensibly to correct an abuse, goes far beyond what would be necessary to accomplish this result. The ultimate goal is not articulated but is sensed. In this instance, it is my firm belief that the ultimate goal of the "planners" is based on their assumption that they can determine best in Washington what are *the* charities to be supported.

Having determined this, they can then disburse the tax revenues from Washington. In order to do this, however, it is of course necessary to obtain an ever-increasing amount. If the charitable deduction can be reduced in a substantial degree throughout the country, then the tax revenues resulting from such reduction can be funneled through Washington and spread back to the charities selected by those in Washington rather than by the individual donors.

The current attack which denies a charitable deduction for amounts donated *below* a certain floor is to me most vicious. One such proposal is that individuals should not be allowed to deduct charitable contributions below $300 where they itemize deductions. That is, in effect, an invitation to the great mass of our population to turn their back on charity, to take the attitude that "I am not my brother's keeper" and to let Big Brother decide what is and is not worthy of charitable support.

Another companion suggestion is that the charitable deduction should parallel the medical deduction and that no individual itemizing deductions should be permitted to deduct charitable bequests below 3% of his adjusted gross income The effect on the private educational institutions, hospitals, Community Chest, Boy Scouts, Red Cross, WMCA, YWCA, Boys Clubs, churches, and all manner of charities that depend on a broad base of public support can well be imagined.

Those proposals which are directed at charitable family foundations perhaps should be most closely scrutinized. Here, there has been demonstrated abuse. The temptation therefore may well be, under the guise of reform, to take a meat-ax approach. Such, I do not feel is desirable.

I have had the opportunity of working to establish several of these family foundations, and I have not found any desire to abuse the tax laws under the guise of a charitable undertaking. Rather, it has been the desire of these families to instill in their members a sense of social responsibility and charitable orientation. It seems, to me, desirable for the State to encourage the altruistic and donative inclinations to its individual members. There is in the history of our tax laws, relating to charitable deductions, a clear past government policy of encouraging individuals to help charitable organizations directly. This policy, I believe to be a good one and hope that it will not be changed under the guise of tax reform to correct certain limited abuses, no matter how odious the particular abuses may seem. The abuses should be corrected, but the underlying philosophy should remain intact.

There is really no basis in logic for a 5%, or any other, tax on the income of these foundations where the income is, as it must be for them to qualify, irrevocably committed to the various charitable undertakings recognized by the tax statutes as worthy of support.

The third category of tax reforms relates to the denial of deductions for certain gifts that have been previously allowed. Among these are charitable remainder trusts, the short two-year trust with income going to charity, the ability to take a deduction for the fair market value of appreciated property

without being taxed on the appreciation, etc. The policy question on these items would appear to be the extent to which the government wishes to encourage and promote independent charitable giving by individuals and other taxable entities. If one assumes that the government can best determine what is worthy of charitable support, then all the tax "reforms" reducing the incentive to individual charitable donations could be endorsed. On the other hand, if the basic philosophy is to encourage individuals, regardless of high or low incomes, to support the charities which are individually convinced are worthy of their backing, then these programs attacking charitable deductions, under the guise of reform to correct abuses or to simplify tax collection procedures, should be eschewed most carefully; and I believe they should be rejected unless clearly shown to attack an existing abuse.

The gift of appreciated property and a charitable deduction for its fair market value, the bargain-sale, the charitable remainder trust, etc., have a long history of acceptability. One must concede, however, that the past consistent liberal congressional policy of promoting and supporting individual charitable giving (which clearly appears in the statutes and acts of Congress) has not always been followed by the Internal Revenue Service. The IRS quite frequently adopts a most technical position to defeat the deductibility of charitable remainders, to mention but one example. These incentives should be retained and expanded to encourage our citizens to take active part in helping to solve our nation's many problems in the areas where charities, schools, hospitals, etc. have traditionally operated.

IMMEDIATE ATTENTION REQUESTED

One important feature of the current tax program which is raising havoc with charities in general is the effective date on most of the Bills which have been introduced. Some carrying effective dates of January 1, 1969; others carry an effective date of April 22, 1969; and in either case, for those transactions occurring after the proposed effective date involving charitable donations, the public is in a complete quandary. If they make their plans and donations according to the law as it currently exists, they may wake up on January 1, 1970 to find that the law has changed radically and retrocatively to wipe out the tax consequences which were in effect and contemplation at the time the transactions took place.

This unsettling of the law is a most unhappy state of affairs for those engaged in charitable undertakings such as hospitals, schools and churches. For example, I represent a local Hospital administered by a religious order. It has, for several years, been planning a major capital funds campaign. That drive got under way in March. Many donors, some considering amounts in excess of a million dolars, had made plans to give to the Hospital to support the new much-needed facility. On April 22, 1969, the Administration's Bills were introduced to limit charitable deductions, wipe out charitable remainder trusts, destroy the benefits of giving appreciated property to charities, etc. The effects on the drive have been catastrophic. We must advise any potential donor of the pending Bills, not knowing whether they will be passed, but knowing that we will have a very unhappy donor if they are passed and he wakes up to find out that the tax law existing on the date of his donation has been retroactively changed by a later enactment of Congress.

Anything you can do to get Congress to announce that such changes in the tax laws, particularly those pertaining to charitable giving, as may be enacted will be prospective only, will be a great service to the people of the country, will settle the undecisive state of affairs that currently exists, and will promote the smooth operation of the thousands upon thousands of charities throughout the nation.

This has been a long letter, but it is in connection with a subject which I feel is most important to the people of this country and one concerning which I have strong feelings.

Very truly yours,

JOHN D. MILLER.

[Telegram]

SENATOR FONG, *Senate Office Building,*
Washington, D.C.:

Tax reform package strikes hard at financial support of Honolulu Academy of Arts. Most detrimental is reduced deduction donors can take for gifts of appre-

ciated art and property. Another blow is possible 5 percent tax on our investment income. Please do not undercut our sources of direct public support.
Mahalo and aloha.

J. SCOTT B. PRATT III,
President, Board of Trustees, Honolulu Academy of Arts,
JAMES W. FOSTER, *Director.*

HONOLULU ACADEMY OF ARTS,
August 5, 1969.

The Honorable HIRAM L. FONG,
U.S. Senate,
Washington, D.C.

DEAR SENATOR FONG: We are deeply concerned about some of the tentative decisions reached by the Congressional Ways and Means Committee in its current study of certain tax-reform measures, as they relate to charitable contributions and private foundatons.

As you know, the Honolulu Academy of Arts has been chiefly an educational institution since its founding in 1927. Its collections, classes and other operations are supported by endowments and private contributions and gifts.

Certain aspects of the tax-reform legislation strike directly at the base of our financial support. If passed into law, they could seriously curtail both the future building of the art collections as well as the educational activities the Honolulu Academy of Arts now provides to the people of this State.

The most detrimental proposal of the Committee is the provision that would significantly reduce the amount of deduction an individual can take for donating art objects and other property that have appreciated in value.

Present tax laws encourage donors to give appreciated property, tangible or intangible, to us for public enjoyment and instruction. Contrariwise, the legislation now being considered would jeopardize our efforts to collect and exhibit the arts that represent our rich and diverse cultural heritage here in Hawaii.

The new tax-reform measures raise another question of major concern. In spite of public support of and participation in the many educational services this Academy provides for our people, we are not certain whether the Academy qualifies under the highly complex definition of a "publicly supported charity." If it does not, another provision would impose a 5% tax on our total investment income, including capital gains.

During recent years the federal government has considered various proposals for aiding museums, but so far the amount of federal support to museums is less than one percent of their operating expenses.

We do *not* propose that the federal government assume the burden of supporting American museums. What we ask is that the federal government *not* undercut the very sources of direct public support that has built, housed and staffed the great museum collections of the United States.

We ask that you give serious consideration to the far-reaching and grave consequences that the present tax-reform bill would have on this and all museums throughout the country.

Thank you for your most able representation of the people of Hawaii in the United States Senate.

J. SCOTT B. PRATT, III,
President, Board of Trustees.
JAMES W. FOSTER, Jr.,
Director.

STANFORD UNIVERSITY,
Stanford, Calif., September 12, 1969.

The Honorable RUSSELL B. LONG,
Chairman, Committee on Finance, U.S. Senate, Senate Office Building, Washington, D.C.

DEAR SENATOR LONG: I write to enter testimony for hearings on H.R. 13270, the proposed Tax Reform Act of 1969. In accordance with instructions in your August 12 press release, my associates and I have cooperated with sister institutions to present consolidated testimony, and our substantive analytical comments will be entered by representatives of the American Council on Education and certain university and college officers now scheduled to appear before your Committee.

While I will not here repeat these substantive comments, I feel that I must testify to the genuine alarm with which I view certain features of the Bill. As we have studied the proposed reforms, my colleagues and I have realized the Bill's consequences would be nothing short of disastrous for the high quality and broad opportunity of American higher education.

Tax incentives to private philanthropy are a keystone to the remarkable development of our healthy pluralistic system of higher education in the United States. Visitor after visitor from foreign university systems, including those systems which we formerly considered superior to ours, has come to our campus to study the financing of this university. They have left impressed more than anything else by the wisdom and the importance of the American policy of tax incentives to gifts. Certain provisions of H.R. 13270 cut at the very heart of those incentives.

We have long believed that an appropriate federal role in aid to higher education included acts which helped colleges and universities to help themselves. The incentive to gifts is perhaps the best example of this role and provides enormous leverage which channels untold private energy and substance to the public good.

Stanford University has for many years used 10-year financial forecasts as a part of its planning and budgeting process, and I would like to indicate briefly the relevance of such forecasts to the tax *dis*incentives included in H.R. 13270. We have set ourselves a target of increasing gift receipts from the present $20 million per year to over $50 million per year by 1979—and in spite of other estimated increases in income (tuition, endowment income and federally sponsored research and training) we see a deficit of over $4 million per year in 1979 for an unacceptable minimum program and many times that size deficit if we carried out the educational program we really should. Now, facing this situation, we believe that one of our strongest hopes is to increase gift receipts even more than our ambitious forecast. We need *more* incentives to gifts for higher education, not less.

Our gift history indicates that well over one-half our receipts from individuals are in appreciated property, and our forecasts are based on this assumption. We are already making commitments against over $14 million of gift pledges, and there is no doubt in my mind that many of those future payments are expected to be made in gifts of appreciated property. Furthermore, deferred income trusts represent a significant part of our long-term future reliance on gifts. These are reasons why H.R. 13270's treatment of appreciated property gifts in respect to Limited Tax Preference and Allocation of Deductions and the treatment of Charitable Remainder Trusts would have tragic consequences for us at Stanford—and, I feel sure, for our sister institutions throughout the country.

Please do not conclude that I oppose all changes which might affect tax incentives to giving. Tax reform, in my opinion, is needed, and I applaud the efforts of Congress to grapple with this difficult problem. In our consolidated testimony we accept certain provisions of H.R. 13270 which attempt to avoid potential abuses even though these provisions may reduce gift support: these include repeal of the unlimited deduction, treatment of valuation of intangible assets and "bargain sales", and repeal of the short-term trust. But I must record my opinion that those provisions to which our consolidated testimony objects carry the potential death blow to the United States' world leadership in higher education and research.

Finally, I would like to comment on that portion of the reform proposals dealing with philanthropic foundations. Let me emphasize that I do not want to give the impression that in defending the most useful of the foundations and their activities I am also defending those who have misused the privileged tax status conferred on philanthropic foundations. Stanford is on record as endorsing in substance the corrective proposals of the Treasury Department's Report of February 2, 1965.

The major well managed foundations have been a singularly important factor in making possible Stanford's development from the status of a good regional institution to that of a major national resource. In the past ten years, gifts from foundations constituted roughly 36 percent of all private giving to Stanford. More importantly, these foundation gifts most often provided the venture funds for innovation in education and research; and I think the need for such funds has never been so critical as at this very time. Therefore, I urge the Committee not to accept the proposed 7.5 percent tax on foundation income and other provisions of the Bill which practice "overkill" on the responsible foundations. Rather, I

hope the Committee can concentrate on perfecting those provisions which will clearly prevent abuses such as self-dealing, personal gain and inordinate withholding of distributable capital and income—but do so without penalizing the "not guilty" along with the "guilty".

I appreciate this opportunity to present my concerns to you and the Committee and I am anxious to respond in any further way which may assist you in your deliberations.

Yours very sincerely,

K. S. PITZER.

LOUISIANA BAPTIST FOUNDATION,
August 21, 1969.

Committee on Finance, Washington, D.C.

DEAR SIRS: The following written statement is respectfully submitted for consideration by the Senate Finance Committee in its hearings scheduled to begin Thursday, September 4, 1969 on H.R. 13270, the Tax Reform Act of 1969.

The Louisiana Baptist Foundation is a religious non-profit corporation established, owned, operated and supported by the Louisiana Baptist Convention, representing 1301 cooperating Southern Baptist churches in Louisiana, with a total membership of over 450,000. The purpose of the Foundation is to encourage and secure endowment and capital gifts for the support and maintenance of our Baptist college, hospitals and benevolent institutions, and to administer these funds for the benefit of the causes so designated by respective donors. These religious institutions and agencies depend almost entirely upon such gifts for their support and continued operation.

It is our opinion and belief, based upon Acts of the Congress itself, dating back to 1916, and opinions rendered by the courts, that our Federal Government has consistently encouraged gifts to educational, religious, social welfare and other philanthropic institutions by providing tax incentives therefor.

It is not a Congressional oversight, for example, that a contribution of appreciated property entitles a donor to a deduction for the property's full present fair market value with no capital gains tax on the appreciations. In 1938 the House of Representatives passed a bill calling for the contribution deduction to be measured by donor's cost—not the fair market value at the date of the gift. However, the 1938 Tax Act as finally passed did not contain the House provision eliminating the added tax benefit on the donation of appreciated property to charity. The Senate Finance Committee rejected the House provision. The Senate Finance Committee stated:

Representations were made to the Committee by officials of educational and charitable institutions that the effect of such a provision would be to discourage the making of charitable gifts in property. The Committee believes that charitable gifts generally are to be encouraged and so has eliminated the provision of the House Bill. (S. Rep. No. 1567, 75th Cong. 3rd Sess. 1938).

We are convinced the House Bill's provisions which deal with charitable contributions both directly and indirectly are extremely complex. Religious and charitable organizations presently obtain support by being "easy to give to." House Bill 13270, by its very complexity, discourages such giving and support.

While there are admitted abuses and inequalities in our federal tax structure, we do not believe good and proper tax incentives for charitable giving (churches, denominational schools, childcare, missionary causes) should be repealed or diminished to correct some problems.

We do support and favor taxing qualified charities (churches) on unrelated business income. Also, we have no objection to requiring annual reports by private foundations.

We respectfully request the Senate Finance Committee to retain the present law containing no minimum or floor on charitable giving. We strongly oppose the provisions of H. R. 13270, TITLE II, repealing and/or changing tax advantages with respect to gifts of appreciated property, Charitable Remainder and Life Income Trusts, Gift Annuities, Short Term Trusts and Bargain Sales for support of churches, church related schools, hospitals, children's homes and missionary work.

Very truly yours,

LOUISIANA BAPTIST FOUNDATION,
HERSCHEL C. PETTUS,
Executive Director.

IVINS, PHILLIPS & BARKER,
Washington, D.C., August 13, 1969.

Hon. RUSSELL B. LONG,
Chairman, Committee on Finance,
Senate Office Building,
Washington, D.C.

DEAR SENATOR LONG: I am writing as a Trustee of Oberlin College, Oberlin, Ohio, to register strenuous objection to certain of the provisions relating to charitable contributions contained in the Tax Reform Act of 1969. The provisions objected to will seriously affect the College's ability to raise funds in the future and will result in tax effects on past donors wholly contrary to the assumed effects at the time the gifts were made.

For many years Oberlin College has sought gifts from its constituency, principally alumni, under a reserved life income plan. Under this plan donors have contributed cash or securities to the College under an agreement calling for the payment of the income on the value of such securities to the donor for his life with remainder to Oberlin College. In many cases a donor has reserved the income for his life and then for the life of his spouse. Cash or securities donated under this plan have been placed in a common trust fund maintained by the College, which also contains a large block of securities owned outright by the College as part of its endowment, and donors have been assigned the number of units in this fund which reflect the relative value of his contribution at the time it is made. Each year the donor receives his pro-rata share of the income from this common fund.

Several million dollars have been raised for Oberlin under this plan and it is an extremely important part of its development program. It is my understanding, moreover, that a great many colleges and universities throughout the country have similar or identical plans. They are particularly suitable for elderly donors who cannot afford to lose the income from their investments but who wish to make a current gift.

The new provisions relating to charitable remainder trusts would not only make necessary a radical revision in Oberlin's retained life income program, but would destroy the tax assumptions on which past irrevocable gifts have been made. While Oberlin's retained life income plan differs to some extent from the average individual trust administered by a bank or individual, it certainly does not qualify as a "unitrust" under the new provisions. Accordingly, it would be necessary, in obtaining future gifts to guess at the time a gift is made as to the probable yield which the College could obtain on its common trust fund in order to fix an appropriate percentage of income to be payable to the donor. It would be impossible to make a guess which would not be unfair to either the donor or the College.

More important, however, is the effect of the new provision on past gifts irrevocably made. Where a donor has transferred property to Oberlin, retaining a life interest in himself and his spouse, the assumption on both sides has been that the property would not be taxable in his estate. Under the new provision, because of the interest of a surviving spouse, this would apparently not be true. Thus, the new provision changes the rules of the game after the game is over.

Another problem raised by the new provision relates to the handling by the College of the common trust fund used in connection with its reserved life income program. The College has always assumed that gains derived from the sale of securities in this common trust fund did not and could not attract tax. It is my understanding that under one of the new provisions (section 201(f) of the Act) the College itself would have to pay tax on a portion of the gains derived from sales of securities in its common trust fund. This would cause a great deal of confusion and would reduce the value of the pool from which the donor had expected to receive a life income.

In the House Ways and Means Committee report explaining the new provisions relating to charitable remainder trusts it is stated that:

> Your committee believes that this requirement will provide a better means of assuring that the amount received by the charity will accord with the charitable deduction allowed to the donor on creation of the trust. This is because the requirement will remove the present incentive to favor the income beneficiary over the remainder beneficiary by means of manipulating the trust's investments.

This statement could not possibly be applicable to the reserved life income plan at Oberlin or for that matter at any established college or university. The College handles the investments and is the remainderman. If there is any incentive

to "manipulate," the incentive would be to invest in such fashion as to benefit the College rather than the income beneficiary. The College attempts to be fair to the beneficiary in the matter of income but it has been the College's experience that, in the long run, it receives far greater value from gifts of this sort than were contemplated and allowed to the donor at the time the gift was made.

I appreciate that there have been some areas of charitable giving where abuses have occurred and I am in favor of making changes in these areas. However, I do not believe that abuses have existed in the charitable remainder area, particularly where established colleges and universities are involved, sufficient to warrant the confusion and inequities which would result if the new provisions in this area are enacted. At the very least, the effective dates of the various provisions should be placed sufficiently far in the future to permit an orderly adjustment to the new rules and should certainly not result in changing the rules on transactions already completed.

Very truly yours,

JOHN C. REID.

CITY OF LINCOLN, NEBR.,
September 26, 1969.

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

GENTLEMEN: This statement is submitted in opposition to those provisions of H.R. 13270 which would impose a federal tax on the income derived from state and municipal bonds.

It is inconceivable that serious consideration should be given any proposal which imposes a great burden upon the local taxpayers in the name of federal tax reform. The citizens of this city have at a city election voted their approval of city general obligation bond issues to permit new city fire stations, new city libraries, new city street improvement facilities, and new city storm sewers. These bonds have not been sold. From the testimony which has been presented, it is obvious that the proposed federal tax will make it necessary to raise our local property taxes to pay the increased costs of these bonds if the tax is approved. The arguments against such federal taxation and the resulting burdens presented to local governments are so persuasive that we cannot believe that the distinguished members of this committee will permit favorable consideration.

The city also has a position of responsibility to the citizens of Nebraska. The Nebraska Legislature has enacted and the Governor of Nebraska has approved legislation providing that the City of Lincoln, by the issuance of its revenue bonds, will construct a state office building, a state game commission headquarters building, and a state educational television building. The State of Nebraska will lease these facilities, and pay the rental costs by appropriations made possible by sales and income taxes imposed on Nebraska taxpayers. The City of Lincoln will not receive any financial gain from this construction, and recognizing its responsibility to the taxpayers of Nebraska, wishes to finance this construction at the lowest possible cost. Again, if the United States intervenes by the imposition of a tax on the interest from local bonds, there will be increased cost to the Nebraska taxpayers.

For all of the reasons presented by those similarly situated, I submit that any attempt to levy a federal tax on local bonds should be rejected.

Respectfully submitted,

SAM SCHWARTZKOPF, *Mayor.*

BOARD OF NATIONAL MISSIONS,
New York, N.Y., October 6, 1969.

The Honorable RUSSELL B. LONG,
Chairman, Senate Committee on Finance,
Senate Office Building,
Washington, D.C.

DEAR SENATOR LONG: The Senate Finance Committee is presently holding hearings on H.R. 13270, the tax reform bill. Certain features of the bill, as it was passed by the House of Representatives, are beneficial to philanthropic organizations such as the one of which I am a member—the Board of National Missions of the United Presbyterian Church in the United States of America.

On the positive side is the proposed increase in the limit of contribution deduc-

tions from 30% to 50% of a person's income for one year. Also, the continuation of the five-year contribution carryover is helpful.

There are, however, certain features of the bill which will discourage potential donors from contributing toward the support of charity.

1. Under the provisions of the bill dealing with the "limit on tax preferences" and "allocation of deductions", charitable gifts would be singled out for harsh treatment that would discourage many potential donors. The appreciation portion of property gifts would have to be considered as "tax preferences", which could result in the appreciation being taxable to the donor. Moreover, contributions would have to be allocated in part to a donor's total "tax preference" items, with the result that a donor must reduce not only his charitable deductions but also his deductions for taxes, interest, medical expenses, etc. The complex computations necessary under the bill would, of themselves, make the planning of gifts very difficult and would deter many donations.

2. Another ill-advised feature of the bill would require that in the common case of gifts of appreciated property in which the donor has reserved a temporary present interest (such as a retained life income), the donor will be held responsible for capital gains tax even after the gift is in the hands of and under the control of the recipient of his charity. This restriction would be most unfortunate in discouraging a continuation of this type of giving, which organizations such as ours have come to rely upon more and more.

3. The so-called unlimited charitable deduction would be phased out over a five-year period. While their total number is not large, the individuals who qualify under the present law for the unlimited deduction, by reason of their very substantial charitable gifts over a period of many successive years, are counted upon by charities for their generous continued support. Removal of the unlimited deduction would, therefore, be an adverse factor in reducing future gifts to charity.

The Federal Government has, over the years, continually liberalized the tax benefits for those who voluntarily contribute to our nation's philanthropies, each time stating that the liberalization was designed to further aid charities to meet rising costs and the increased needs of society. At this time when the Government finds it necessary to curtail many of the programs designed to augment the work of charitable organizations, it is important that tax incentives be increased rather than decreased for those who contribute to legitimate and clearly-beneficial charitable causes.

Anything you can do to assist in this matter will be greatly appreciated by us.

Sincerely,

FRED G. SECREST,
Chairman, Development Committee.

TORGAN, SMITH AND CHRYSLER,
Denver, Colo., September 18, 1969.

Committee on Finance,
Senate Office Building, Washington, D.C.

DEAR SIRS: Regarding the impact which the new Tax Reform Act of 1969, which is presently pending in the Senate, might have upon the fund-raising and the resultant research which is conducted by the American Cancer Society, I enclose herewith Certification of Resolution adopted by the Board of Directors of the Colorado Division of the American Cancer Society. We earnestly request that you circulate this resolution among members of the Senate Finance Committee so that each will be aware of the effect which certain parts of the Act might have upon the fund-raising activities of the Society.

Very truly yours,

KENNETH L. SMITH,

CERTIFICATION OF RESOLUTION

I hereby certify that I am the duly elected and presently acting Secretary of the American Cancer Society, Inc., Colorado Division, and that at a duly held regular meeting of the Board of Directors of said Society held on September 10, 1969, at which a quorum was present, the following resolution was unanimously adopted by the Board of Directors of the American Cancer Society, Inc., Colorado Division:

Whereas, the American Cancer Society, Inc., Colorado Division, is affiliated with the American Cancer Society, Inc., and as such is charged with the conduct of the activities of the American Cancer Society in the State of Colorado, and one of such activities is the solicitation and acceptance of funds for cancer control and for research for the cause and hopeful eventual eradication of this dread disease; and

Whereas, a major portion of the funds received from legacies, from gifts of appreciated property and from deferred donations is utilized in such research; and

Whereas, in the past a considerable amount of property which has appreciated in value has been received for which the donor thereof has obtained certain income tax advantages; and

Whereas, under the present Tax Reform Act of 1969 which is to be considered by the Senate of the United States Congress, the tax advantage to donors of gifts of appreciated property will be to a large extent destroyed, which, in turn, will materially decrease the incentive for such donations; and

Whereas, the result thereof will materially reduce the funds which have heretofore been, and which will in the future be, devoted to the research for the cause and cure of cancer; now, therfore, be it

Resolved, that the American Cancer Society, Inc., Colorado Division, is opposed to any tax reform provision which would materially curtail the fund-raising activities of this Society and the devotion of such funds to the objects and purposes of the American Cancer Society and particularly the curtailment of any tax advantages to donors in the giving of appreciated property to the American Cancer Society; be it further

Resolved that any tax imposed on the income of the American Cancer Society would be contrary to the public interest and the health and welfare of the people of the world; be it further

Resolved, that this Society respectfully submit this resolution to the Committee on Finance of the United States Senate and to the Senators and Representatives of the United States Congress for the State of Colorado, urgently petitioning that this resolution be carefully considered in the deliberation and the action concerning the Tax Reform Act of 1969, since the purposes, objects and activities of the American Cancer Society would be materially affected.

Dated at Denver, Colorado, this 11th day of September, 1969.

KENNETH L. SMITH, *Secretary*.

STATEMENT BY THE CHICAGO SOCIETY OF FUND RAISING EXECUTIVES

The Chicago Society of Fund Raising Executives is an organization of 150 men and women professionally engaged in raising funds for the Chicago Metropolitan Area's leading private health, welfare, educational and civic organizations and institutions.

As citizens, we favor a tax system based on ability to pay—a progressive rather than a regressive program. Tax reform to reduce the disproportionately high taxes required of low- and middle-income families is long overdue and should be enacted.

But the Tax Reform Bill of 1969, as passed by the House of Representatives and now pending before the U.S. Senate Committee on Finance, contains several provisions which will be seriously harmful to philanthropic giving while contributing little or nothing to progressive tax reform or to increased governmental revenue.

The Bill would impose taxes on appreciation in securities and property donated to charities if the securities or property had been held by the donor less than one year; and on property and securities held a year or longer if the tax-payer came within the "limitation on tax preferences" or "allocation of deductions" proposals. These gains are not taxed now when given to charities. They should not be taxed in the future.

The desirable purpose of the "limitation on tax preferences" can be achieved without including appreciated property donated to charity as a tax preference; similarly, the desirable purpose of "allocation of deductions" can be achieved without including charitable contributions among the allocable items. We are pleased to note that on these two points we are in agreement with amendments proposed by Secretary of the Treasury, David M. Kennedy, in testimony given last month before the Senate Finance Committee.

Gifts of appreciated property are vital to charities. For a number of the voluntary, charitable, educational and similar organizations, one-fourth to three-fourths of their income is in the form of gifts of appreciated securities and property. Any deterrent to such gifts can have most serious effects. The donors involved are among the largest contributors.

Charities have nothing in common with the list of "tax preferences" with which they have been lumped in the House bill—such as excess depreciation, hobby farm losses, tax free interest on municipal bonds, untaxed capital gains. Charitable gifts should therefore be deleted from that list. The other items can be dealt with on their own merits.

The beneficiaries of the gains in securities and property given as charitable donations, rather than the taxpayers, are the people who depend on these gifts. They are the aged and the sick, families in trouble or already broken, emotionally disturbed and retarded children, and others.

The Senate Finance Committee in the past has recognized the harm in the House proposals. In 1938 the Committee eliminated such tax proposals from a House bill because "the Committee believes charitable gifts are to be encouraged". That position is equallly valid now.

Charities are not a "loophole"—they are a life-line to human needs. With one exception, exclusions and deductions of particular items from income effect only the personal economic welfare of the taxpayer and the receipts of the government. The exception is the tax deductible charitable contribution, which vitally affects the income of a third party—he charitable organization. Unlike other items, tax deductibility of a charitable gift provides an incentive to the taxpayer for making the expenditure (as intended by the law); were tax deductibility removed from *all* items currently covered (such as state and local taxes, interest, medical expenses, etc.) it is doubtful that the taxpayer would actually reduce his expenditures for these items, with the sole exception of his charitable contributions.

Throughout our history, it has been the policy of the government to encourage voluntary philanthropy to meet health and welfare needs. The charitable contributions deduction was first enacted in 1917, almost simultaneously with the imposition of the income tax. The incentives for charitable gifts have been consistently increased by the Congress in revising the tax laws. Now for the first time, that policy would be reversed by the House bill. The House action comes at the very time that the Administration is emphasizing a larger role for voluntary citizen responsibility in welfare and health services. The House bill undercuts that purpose. The human problems met by voluntary philanthropy will still have to be met—and a result of the House measure will be to press these problems upon the government to be financed with larger tax funds, and thereby would be self-defeating.

Tax equity can and should be achieved without harm to the charities.

The principal changes needed in H.R. 13270 to avoid adverse effects on charitable giving are:

1. Delete section 201(c) dealing with charitable contributions of appreciated property. This section sets forth the general principle that when an individual makes a charitable contribution in the form of property which has appreciated in value, the amount to be reported as a charitable contribution by the taxpayer shall be either (a) the fair market value of the property (in which case the tax payer would pay the appropriate tax on the amount of the gain in value) or (b) the cost of the property to the taxpayer (in which case the capital gains tax would be avoided but the taxpayer, of course, would get credit for a smaller charitable contribution), whichever he chooses.

2. Delete section 201(d) pertaining to bargain sales to charitable organizations. This section provides that when a bargain sale is made to a charitable organization, the amount counted as a charitable contribution shall be (as at present) the difference between (a) the value received by the charity from the sale of the donated property and (b) the amount returned to the taxpayer in his bargain sale; but the taxpayer would no longer (as at present) be able to avoid the capital gains tax on that portion of the money he receives back which can be prorated as a gain. The taxable portion of the money returned to the taxpayer would bear the same ratio to the total amount returned as the gain in value of the property bears to the price at which the charity sells it.

3. Delete that portion of section 301(a) which includes a charitable contribution of appreciated property in the list of disallowed tax preferences, namely, the added section 84(c)(1)(A). This sets forth the principle that charitable

contributions of appreciated property together with other tax preferences (like accelerated depreciation or interest on bonds) may not under any circumstances be greater than one-half of the total amount of income derived from all sources (those which are presently taxable and those which are presently exempt from taxation).

4. Delete that portion of section 302 pertaining to the allocation of deductions which includes charitable contributions together with other deductible items (like interest payments, State and local taxes, etc.) as an item which is to be apportioned between taxable income and presently nontaxable income. The amount of disallowed deductions would bear the same ratio to the total deductions subject to allocation as the amount involved in income from tax preferences bears to total income from all sources.

Submitted by Committee on Legislation.

SIDNEY SCHONBERGER, *Chairman.*

STATEMENT OF ALAN SIMPSON, PRESIDENT, VASSAR COLLEGE, POUGHKEEPSIE, N.Y.

TO THE HONORABLE RUSSELL B. LONG,
Chairman, Committee on Finance,
U.S. Senate.

My name is Alan Simpson, and it is as the President of Vassar College in Poughkeepsie, New York, that I make this statement to you and to the other members of the Senate Finance Committee on the deleterious effects H.R. 13270 would have on the financial operation of our college.

Vassar College, a private, non-denominational, four-year fully accredited liberal arts college, is financially supported by and dependent upon student tuition and income from charitable contributions. During the 1968–69 fiscal year, income from endowments established by earlier charitable contributions amounted to $997 per student, and current outright gifts made to the college were $435 per student. Thus, total income from charitable contributions was $1,432 per student or 37.2 percent of the total income received by the institution.

These gifts were used for current general operating expenses, including the operations of academic departments and scholarships and other student aid. I want to emphasize that 33 percent of Vassar students require some financial aid, and a large percentage of this necessary aid comes from charitable contributions from alumnae and friends of the college.

During that same fiscal year, 1968–69, Vassar received gifts from private sources totaling $3,965,525. Included in this total were 181 gifts of securities with a market value of $1,424,918, which is 36 percent of the total. Gifts in the form of annuities and life income contracts amounted to $575,052 of which $426,355, or 74 percent, were gifts in the form of securities. At the present time, we have 669 life income contracts and annuities on our books, with a total book value of $4,973,407. Obviously this type of deferred giving is particularly appealing to our alumnae since it assures them of income during the remaining years of their lives and then makes it possible for their Alma Mater to benefit from their personal generosity upon their death.

Despite this kind of generosity over the past years, Vassar College now finds it essential to embark upon a major effort to raise $50,000,000 to help meet ever-increasing operating expenses and to provide for long deferred plant rehabilitation and for sorely needed additional scholarship funds. The ravages of inflation on the college are best demonstrated by the fact that although Vassar had a balanced condition in 1967–68 and only a minor deficit in 1966–67, our operating deficit for the past year was $1,289,000. Our long-range projections show annual estimated deficits of well over $1,500,000, without the additional support from charitable contributions expected from our new fund drive.

Clearly, then, our financial problems are severe and growing. Any tax legislation that discourages gifts of securities with appreciated values will only make our fund-raising efforts more difficult. Moreover, removing many of the tax benefits from life income contracts and seriously reducing the tax benefits of annuities would be another severe blow to our college. As I have said, such forms of giving are highly favored by those of our alumnae who need life-time income but also hold their college in such high regard that they wish it to receive their financial stake after they no longer require it.

I should like to close this statement with a formal request to you that our present tax laws be amended in such a way as to keep the avenues for charitable

contributions for support of education simple, clear and forthright. Such private support is chiefly for the benefit of the students of today and of the future. To remove or seriously alter the tax benefits of such contributions will only make private institutions dependent upon the support of the State and the Federal Governments. In the end, education will suffer and the burdens upon the ordinary taxpayer over the long run will be increased.

Respectfully submitted,

ALAN SIMPSON, *President.*

BREED, ABBOTT & MORGAN,
Washington, D.C., September 24, 1969.

RE H.R. 13270

Honorable RUSSELL B. LONG,
Chairman, Committee on Finance,
U.S. Senate,
Washington, D.C.

DEAR SENATOR LONG: I am taking the liberty of enclosing a memorandum concerning a situation which has come to our firm's attention in connection with the proposed amendment to I.R.C., Section 642 (c), respecting taxability of capital gains of charitable remainder trusts and estates.

I believe many trusts and estates would be affected by what may well be an unintended result of the language of the House Bill as presently written.

I trust the situation and the proposed remedy for it may be of sufficient importance to warrant my bringing it to your attention.

With personal regards, I am

Sincerely yours,

JOSEPH P. TUMULTY, Jr.

MEMORANDUM

Re: Section 201 (f) of H.R. 13270 (proposed Tax Reform Act of 1969), amending Section 642 (c) of the Internal Revenue Code.

Section 642 (c) of the Internal Revenue Code 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 House bill would, effective on enactment, delete the words, "or permanently set aside," with the result that, if enacted in present form, the charitable remainder beneficiary would stand to lost 25% (or more if the capital gains tax is raised) of term appreciation currently reflected in the value of trust estates, later realized as capital gain, which amount would be paid in Federal income tax rather than go, eventually, to charity.*

This memorandum suggests inclusion in Section 201 (j) (6) (prescribing the effective date of the proposed amendment in section 201 (f) of the House bill), of a provision for stepup in basis for existing charitable remainder trusts and estates, to values as of the enactment date of the Bill.

The amendment, as proposed, is unfair in its application to existing trusts and estates, with current appreciation in value of assets, sometimes very substantial whose provisions do not authorize the trustee currently to pay out capital gain income that, under present law would eventually be paid to charity. In such cases, to tax realized capital gain because not paid out currently would impose a direct tax on the charity and serve no useful tax reform purpose.

Accordingly, a step-up in basis to the date of enactment should be included in the Bill, which as now drawn would tax all capital gains realized and set aside for charity after the date of enactment of the Bill (Section 201 (j) (6)). This would, of course, impose tax on future gains realized on past appreciation of assets in existing trusts and estates.

Such a step-up provision would be consistent with the policy behind Section 101(a) of the Bill (which would enact Section 506 of the Code) with respect to the 7½% (2% under the Administration proposal) tax on the income of private foundations. Thus, proposed section 506(b)(4) of the Code 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."

The sense of fairness which prompted the provision for a step-up of basis for the purpose of the 7½% rate for private foundations indicates similar treatment

for the much more burdensome 25% or a higher capital gain rate that would henceforth apply to charitable remainder trusts and estates under the proposed amendments to Section 642(c).

The step-up provision here proposed would relieve trustees of what may well be a positive fiduciary duty to insulate current capital appreciation in existing trust estates from future capital gains tax by engaging wholesale in sales and repurchases of securities to anticipate possible enactment of amended Section 642(c) of the Code, with resulting market activity that would benefit brokers, but no one beneficially interested in the trusts. On the other hand, trustees who may fail to act to protect current appreciation may, in the future, find important investments "locked in," incapable of disposition or diversification without causing substantial shrinkage of the trust estate.

The proposed amendment would not relieve from tax any gains that accrue after the effective date of the amendment. It would simply eliminate a retroactive and punitive consequence of the amendment, as presently proposed.

JOSEPH P. TUMULTY, Jr.

STATEMENT BY FEDERATION OF PROTESTANT WELFARE AGENCIES, INC. TO THE SENATE FINANCE COMMITTEE REGARDING H.R. 13270, THE "TAX REFORM ACT OF 1969"

For nearly a half century, the Federation of Protestant Welfare Agencies, Inc. has been the central coordinating and planning body for voluntary Protestant and nonsectarian health and welfare agencies serving the Greater New York area. Our membership includes 232 such agencies, whose annual operating expenditures exceed $100,000,000 and whos services reach more than 1,000,000 individuals.

In company with the Federation of Jewish Philanthropies of New York, Catholic Charities of the Archdiocese of New York, Catholic Charities of the Diocese of Brooklyn, and many other philanthropic organizations, the Federation of Protestant Welfare Agencies is greatly concerned over some of the provisions of the proposed Tax Reform Act of 1969. The reasons for our concern and the importance of rejecting some of the proposed changes have been clearly spelled out in the testimony of George H. Heyman, Jr., president of the Federation of Jewish Philanthropies of New York, to your committee on September 18, 1969. The Federation of Protestant Welfare Agencies wishes to associate itself with Mr. Heyman's statement in its entirety.

There is no need to repeat the points which Mr. Heyman has made with such compelling force and clarity. We do, however, wish to underscore his statement that "If the Congress enacts this bill in its present form, it will in effect propound a distorted view of private philanthropic giving as a form of tax shelter with no greater social importance than the other tax payer preferences with which it is grouped". As he points out, the enormous investment of time, skill and energy which men of goodwill are giving to charitable activities in addition to the wealth they donate, is persuasive evidence that personal gain is not their primary motivating force. By and large, existing inducements to charitable giving should properly be regarded as enabling measures which make it possible for charitably disposed persons to give more generously than would otherwise be possible.

The Federation of Protestant Welfare Agencies does not oppose tax reform. It favors appropriate safeguards against questionable practices on the part of foundations, but it considers the provisions of the Tax Reform Act of 1969 with respect to foundations inappropriate for such purpose. It heartily commends the objective of distributing the burden of public expenditures in far closer conformity with the ability to pay. Our plea is that this objective be sought through means which will not tend to inhibit support of constructive non-profit endeavors in the private sector. Philanthropy is not a loophole; it is the source of an important and costly public service.

WILLIAM F. TREIBER, *President.*

MEMORANDUM OF UP WITH PEOPLE INCORPORATED

Up With People Incorporated, a nonprofit, educational, and charitable organization incorporated July 23, 1968, depends on its ability to develop philanthropic support from the general public. Its experience this past year has shown that it is

necessary for at least 50 percent of its overall financial income to come from contributions, the balance to be realized from revenue-type of income. The development of a deferred giving contribution program is also a major backbone to the future growth, expansion, and existence of Up With People.

There are a number of provisions contained in the present Tax Reform Bill as passed by the House of Representatives which cause the elimination of several tax incentives which, we believe, will be detrimental and create an adverse effect on the above-needed sources of financial support for Up With People. With the many problems facing our country, we believe now is the time, more than ever, for increased, and not decreased, tax incentives for people who want to contribute to organizations such as Up With People. Therefore, we hope that serious consideration will be given toward retaining the following long-established tax incentives.

1. Gifts of Appreciated Property. Present law allows a deduction for the fair market value with no capital gains tax on the appreciation. We believe this should be retained.

2. Allocation of Deductions. The charitable deduction should not be subject to the allocation rule and thus should not be reduced because a donor has capital-gain income, tax-exempt income, etc.

3. Life Income Deferred Gifts/*Charitable Remainder Trusts.* The present law provides there is no capital gain on the transfer of appreciated property to fund a charitable remainder (life income) trust; nor is there a capital gain if the property transferred is later sold by the trust and the gain permanently set aside for the charity. These rules should be retained. Further, we believe the very complicated provisions for the charitable remainder annuity trusts and charitable remainder uni-trusts should not be substituted for the widely-used and understood charitable remainder trust.

However, should the Congress decide to eliminate the charitable deduction on existing charitable remainder trusts (substituting the annuity trusts) the law should not be retroactive to April 22, 1969, but be effective with the passage of the tax reform act, the reason being that donors will not make gifts because of the uncertainty of the tax consequences. This will impose a hardship on Up With People. In any event whether a new trust format is adopted or the present type of trust is retained, 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 gain if he elects to compute his deduction based on the fair market value. Further, captial gains incurred by the trust and permanently set aside for charity should nto be taxed.

Life Income Contracts. Present law governing these contracts (no capital gain on transfer of appreciated property, nor capital gain when the property transferred is later sold by the life income pooled fund) should be retained. As with the charitable remainder trust, (1) the deduction should be based upon the full fair market value without imposition of capital gains tax; (2) capital gains incurred by the life income pooled fund and permanently set aside for charity should not be taxed.

4. The Tax Reform Act makes it difficult for donors to give to Up With People because of the complexity of reporting requirements. Just as IRS makes it easy for taxpayers to pay their income tax on the short form return, could not the Tax Reform Act make it easy to give charity instead of making it difficult for even tax experts?

Congress has continually liberalized the tax benefits on those who sponsor philanthropies and organizations such as Up With People—each time stating the liberalization was designed to further aid charities to obtain additional funds to meet rising costs and the increased needs of society.

Congress has also reiterated that the Government is compensated for any loss of revenue by its relief from financial burdens which otherwise would have to be met by appropriations from public funds and by the benefits resulting from promotion of the general welfare.

We again belive that tax incentives are essential to the future support and existence of Up With People and its role in the future of our country.

HARVEY MUDD COLLEGE,
SCIENCE AND ENGINEERING,
Claremont, Calif., September 12, 1969.

SENATE FINANCE COMMITTEE,
Senate Office Building, Washington, D.C.

GENTLEMEN: This letter is in regard to the harmful effects on non-tax supported colleges if certain provisions of the Tax Reform Bill (HR 13270) now under consideration by the Senate Finance Committee are enacted.

These proposed changes would be serious blows to the strength of privately supported colleges. Moreover, they threaten the very survival of these colleges. The specific proposed tax changes I am referring to concern: Gifts of appreciated property, life income contracts, two-year charitable trusts, foundations.

To illustrate the effect these four proposed changes would have on private colleges, let me cite specific examples at Harvey Mudd College. Since Harvey Mudd College was founded in 1955, a total of $19,515,538 has been received in gifts and grants. Ninety-two percent has come from private sources and eight percent from government. Seventy-one percent came from the four methods of giving which the proposed taxes would severely limit or entirely eliminate. A breakdown follows:

	Amount	Percent
Appreciated property	$4,025,276	20
Life-income trusts	2,427,674	13
Short-term trusts	2,347,480	12
Foundation gifts	4,912,217	25
Government grants (primarily for faculty research and summer institutes)	1,435,909	8
All other gifts	4,366,982	22
14-year total	19,515,538	100

Numbers are abstract, students are not, and students after all are what colleges are all about and the end to which those dollars are the means. For example, of $19,515,538 in gifts and grants, approximately $9,000,000 has paid for that part of the cost of education of our students which their tuition did not cover. Much of the remainder has gone into physical plant-gifts made through short term trusts have essentially built one building and part of another; two other buildings have been built from foundation grants; three more from gifts of appreciated property.

Gifts of appreciated property given in trust with reservation of life income represent our most viable means of building endowment and endowment income is the principal means of holding down tuition as educational costs spiral.

Had the proposed tax rules been in effect in 1955, I doubt that this college would have been founded. Had they been introduced after our founding, we would not have our present strength in the education of scientists and engineers.

As Provost of the six Claremont Colleges, I know that each of the other five colleges could provide similar facts. Of these six colleges, three have been founded since 1945 and an essential condition has been the Congress' wisdom in providing tax incentives. These incentives are now in jeopardy.

The proposed changes affecting appreciated property, life income trusts, short-term trusts, and foundation giving would clearly be a deterrent to the maintenance of quality and strength of private colleges and universities. These institutions are barely making ends meet now. Restrictions such as proposed in HR 13270 would entirely eliminate some gifts and discourage others. Even a slight reduction in gifts of this type would pose a grave financial threat. The proposed tax regulations would probably necessitate future substantial state and federal support of private higher education.

I urge your committee to eliminate from the proposed tax bill these measures which would have serious adverse effects on non-tax supported colleges.

Sincerely,

JOSEPH B. PLATT, *President.*

Presented on behalf of the Associated Colleges of the Midwest:

Beloit, Carleton, Coe, Colorado, Cornell, Grinnell, Knox, Lawrence, Macalester, Monmouth, Ripon, St. Olaf; and Great Lakes Colleges Association: Albion, An-

tioch, Denison, DePauw, Earlham, Hope, Kalamazoo, Kenyon, Oberlin, Ohio Wesleyan, Wabash, Wooster.

STATEMENT SUBMITTED BY SHARVY G. UMBECK, PRESIDENT, KNOX COLLEGE

STATEMENT

We commend and support those positive efforts of the Congress to improve tax administration and to support equity in application of the laws of the land. We support the idea that some type of minimum tax be levied on the income of all individuals who share the bounties of America. We support legislation designed to prevent the manipulation of the tax laws regarding tax exemption and charitable contributions for the sole purpose of achieving tax benefit. No one should achieve greater wealth by such use of the tax laws.

1. We support elimination of the unlimited charitable deduction coupled with raising the general limitation on all contribution deductions to 50% of the contribution base provided that the severe restrictions proposed as to gifts of appreciated property are removed as explained below.

2. We support the provision which would eliminate abuses in the gifts of short-term income interests and in the gifts of the use of property and in the gifts of inventory or other property which, if sold, would give rise to ordinary income.

3. We support provisions which would eliminate the possibility of a taxpayer realizing more actual dollars by means of making a charitable gift of a short-term capital asset than he would realize by the sale of such an asset.

However, in the efforts at tax reform contained in H.R. 13270 we see measures of critical adversity to the long established policy of encouraging, by means of tax incentive, private philanthropy to support charitable and educational enterprises in the providing of essential public services which must otherwise be paid for by increased taxes.

There is no question that the demand for the provision of higher education to our citizens will continue to escalate. If private philanthropy is seriously curtailed, those colleges and universities independently supported will suffer erosion in their effectiveness; many will disappear.

The long established policy of tax incentive to private higher education has been often reinforced by the United States Congress. The Senate Finance Committee in 1938 vigorously recognized this:

Representations were made to the Committee by officials of educational and charitable institutions that the effect of such a provision would be to discourage the making of charitable gifts in property. The Committee believes that charitable gifts generally are to be encouraged and so has eliminated the provision of the House Bill.[1]

Likewise, later revisions of the Internal Revenue Code raised the limitation on the deductibility of such gifts from 20% to 30% of adjusted gross income.

This national attitude has helped the private sector and many nominally public institutions to grow with the nation, to provide a multi-faceted system of higher education which has greatly benefited our people individually and the nation as a whole. Additionally, this encouragement of private philanthropy has forestalled additional costs in the public sector. Were it not for the privately supported institutions, the tax supported public colleges and universities would have to provide the facilities and programs to accommodate an additional two million students expected to enroll in private schools this fall. Enrollment in the 24 colleges of our associations has climbed from 28,100 to 40,100 in the past ten years.

In place of easing the tax burden, the opposite effect will prevail if private charitable giving is curtailed. Had these 24 colleges not existed, to provide the programs offered by them during the past decade would have required, *in addition* to endowment income, tuition and fees, at least $842,000,000 in tax revenues to supplant private gifts received.

It should be emphasized here that for a century and a half the role of the 24 colleges listed above has been higly significant in the broad spectrum of American life. Our graduates have provided leadership in public and private life, in the professions, in the arts and letters, and in the sciences. Exhibit 2 illustrates this point. Hence, from the point of view of national self-interest, to discourage voluntary private philanthropy to such institutions is self-defeating.

In particular, we oppose the inclusion of the appreciation in value of property donated to charity in the "Limit on Tax Preferences" and "Allocation of Deductions."

[1] (S. Rep. No. 1567, 75th Cong., 3d sess. 1938).

In our judgment, two aspects of the attempts of the House of Representatives to levy some minimum income tax would, if adopted, have immediate and probably disastrous effect on charitable giving to colleges and universities, and especially to those privately supported.

The "Limit on Tax Preferences" in drawn to foster the fair distribution of our taxes. The language of the section treats the means by which some individuals exclude a large portion of their economic "*income*" from tax. (We italicize the word "*income.*") The tax preferences as listed in H.R. 13270 are:

1. Tax-exempt interest on State and local bonds.
2. The excluded one-half of net long-term capital gain.
3. Depreciation of real property beyond straight line depreciation.
4. Excess farm losses.
5 Appreciation in the value of property donated to a charity.

It is to be noted that Items 1–4 above are truly cash producing to the taxpayer. They add untaxed dollars to his cash flow. They are income items related to property producing income or to property sold and exchanged for dollars. They are excluded income. For the purpose of allocating deductions, an additional "non-taxed" item is listed in the form of certain drilling expenses and depletion allowances. Obviously, Items 1–4 are designed to deal with the imposition of a minimum tax on all forms of income.

However, Item 5 above is *not* income. It should not be treated as a "non-taxed" item of income in the "Allocation of Deductions" nor as an item of prerefential income in the "Tax Preferences." Giving away appreciated property produces no economic income. True, the tax laws provide charitable contribution deductions for the market value of property given to charity. Such tax posture should be maintained. Controlling the tax incentive should be handled solely within the 50% limitation on charitable contributions proposed by H.R. 13270, and the 50% limitation should include the appreciated value of donated property—including tangible personal property where valuation is reasonably acceptable.

Genuine philanthropy to colleges and universities has produced none of the serious abuses to which the two new proposals are directed. The very illustration used in the "Report of the Committee on Ways and Means . . . to Accompany H.R. 13270 . . ." clearly demonstrates the areas where major abuse occurs—the exclusion of real economic items such as the non-taxed one-half of long-term capital gain and the allowance of interest deductions for capital used to finance such capital gain. (See Page 80 of the Committee Report, House Report No. 91-413, Part 1.)

Gifts of appreciated property constituted in excess of 20% of total private gifts to our 24 colleges. The actual volume of such gifts has been $66,610,000 over the past ten year period. (See Exhibit 8.) As presently cast, the "Limit on Tax Preferences" and "Allocation of Deductions" proposals will severely affect this important source of voluntary giving in support of our educational programs.

We are also in opposition to the harmful effects of the provision regarding "Charitable Contribution of Appreciated Property."

Adverse proposals regarding the treatment of appreciation in value of property donated to charity are found in Sec. 201 (a), (c) and (d) of the bill and Secs. 170 and 83 of the proposed code revisions under the board title of "Charitable Contributions of Appricated Property." We appreciate the recognition of the House of Representatives that this matter is of vital concern to colleges and universities which, along with certain other charities, were excluded to a degree from the treatment proposed in this section. However, if the "Limit on Tax Preferences" and "Allocation of Deductions" sections do not also exclude gifts of appreciated property to colleges and universities (and the other named charities), their exclusion under Sec. 201 (c) will be largely illusory! As indicated above, gifts of appreciated property are highly significant to our 24 colleges.

Furthermore, with regard to gifts of future interests, the beneficial exclusion in Sec. 201 (c) was not extended. We speak now of the ordinary life income contract reserving a legal life estate in property to the donor with the remainder going to the college or university.

These gifts are highly significant to the development of college endowments and resources. They are most likely funded by gifts of appreciated securities or real estate—both property with readily ascertainable market values!

To deny the deductibility of the appreciation in value in these cases is not consistent. It would also practically foreclose this area of "deferred giving development" to colleges and universities. Ten-year summaries indicate that the 24 colleges have received in excess of $20,000,000 in the gift value of remainder

interests under life income contracts.[1] The full market value of the properties transferred exceeds this gift remainder value. It is this total value which will be eventually available to the colleges at the expiration of the life income interests involved. If there are areas of abuse regarding these gifts, such abuse can be corrected by tightened appraisal requirements.

Sec 201 (a) (8) likewise is excessively restrictive because it would limit a charitable contribution deduction for an ordinary remainder interest after a life estate in property to such an interest conforming to the sections governing gifts in trust. Where the college or university is the trustee or in the case of legal life estates and remainder interests (and their counterparts in personal property), the actuarial value of the remainder to the institution based on market values of the property involved should be retained *in its present form* as a charitable contribution.

These gifts, upon the decease of the donors, will provide scholarship endowment and other program support, thanks to the generosity of these donors who have parted voluntarily with a share of their wealth. Problems of valuation of the charitable remainder interests can be successfully attacked primarily by means of correct property appraisals and by means of periodic modification of actuarial and discount tables.

We strongly oppose the effective dates for the various sections of the Tax Reform Act of 1969 as proposed therein.

For the convenience and fairness to taxpayers and donee institutions, all effective dates in the Tax Reform Act of 1969 should be the date of the final enactment of the law. Gifts made prior to that date should not be affected by any type of retroactivity. Philanthropy has already been adversely affected by the confusion of the proposed effective dates. Provisions of the law should be prospective in application and should not disturb the gifts already established under gift agreements entered into prior to the effective date of enactment.

We oppose, in their present form, the provisions of the Tax Reform Act of 1969 which require the filing of annual returns.

Sec. 101(d) of H.R. 13270 would require the filing of annual returns. With regard to such filing by privately supported colleges and universities, there is no basic objection. We encourage fair and efficient administration of the tax laws. However, we vigorously oppose the idea that information contained in such returns should be made public. We receive many anonymous gifts. The public disclosure of such a donor's name would require the college to break an article of trust between it and the donor. Additionally, the disclosure of the salaries paid to faculty and others would break a long-standing principle of confidentiality regarding these matters. As far as colleges and universities are concerned, we see no worthwhile objectives to be gained by such disclosures. In our opinion, there has been no abuse in gifts to colleges and universities to warrant disclosure of donor lists and salary schedules. Required information is already available in taxpayer returns. As to institutional returns, the basic doctrines regarding the right to privacy should prevail.

We find the following matters of smaller direct significance, yet needful of revision:

1. Bargain Sales.—It is now doubtful that the proposed law would exclude the discounted cash value of a gift annuity contract as the bargain sale price of securities or real estate used to find an annuity. The additional treatment of bargain sales to a charitable organization (Sec. 201 of H.R. 13270) should expressly exclude from its purview the gift annuity.

2. Unrelated Debt-Financed Income.—Sec. 121(d) of H.R. 13270 contains the commonly called "Clay-Brown" provisions. An obligation to pay an annuity is excluded from the definition of "Acquisition Indebtedness." This exclusion must be broadened so that it applies to the contractual obligation of an institution to pay a donor the income from property under a life income agreement. So long as the life tenant continues to live, all income under such contracts is paid to the life beneficiary who then pays income tax thereon. The college acts solely as a conduit it its position as charitable remainderman. There should be no tax consequence to the college under these circumstances.

[EXHIBIT 1-A]

1969–1970 ACM Academic and Service Programs of the Associated Colleges of the Midwest:

[1] See Exhibit 4.

URBAN

THE URBAN STUDIES PROGRAM

This program gives the student academic and first-hand knowledge of many of the monumental problems of the city: its politics, economics, and racial strife; its metropolitan, suburban, and inner city dilemmas; its problems of city planning, urban renewal, and educational development; its crises in transportation, pollution, crime and delinquency. The students live in the city against the background of Chicago's ric[illegible] cultural resources, landmark architecture, and museums. Formal class work includes the Core Course, an intensive examination of the city; the Seminar on "Power and Justice"; and an individual study project. Each student also works part time in a social agency, community organization, business firm, or government office.

Length of Program: One semester.
Prerequisites: Students who will be sophomores, juniors, or seniors may apply.

THE URBAN TEACHING PROGRAM

Conducted in cooperation with the Chicago Public School System, this program gives ACM undergraduates the opportunity to student-teach in inner city schools and to study in seminars concerned with the education and sociology of an urban environment. The Urban Teaching Program provides the student with two teaching experiences, to permit contrasts between socio-economic levels of student populations, and ethnic origins of school neighborhoods. In addition to the teaching program, the student is involved in two seminars in Urban Education and Urban Sociology. These include field trips, lectures by urban specialists, and discussions with visiting scholars.

Length of Program: Fall or spring semester, or winter quarter.
Prerequisites: The usual for practice-teaching.

ARTS AND HUMANITIES

THE NEWBERRY LIBRARY SEMINAR

Advanced students in the humanities join a community of scholars in the humanities as "Student Fellows". They live in Chicago and study at Newberry, one of America's great research libraries, the holdings of which include some 850,000 volumes and more than four million manuscripts in the history, literature, philosophy and music of Western civilization from the Middle Ages to the present. Each year the Seminar is devoted to a selected historical period; in 1969-70 it is the Renaissance. Students meet with other scholars and faculty members carrying on research at the Library to discuss their research activities. The students work with close guidance from two ACM faculty members.

Length of Program: One semester.
Prerequisites: Working background in history or literature; junior or senior status.

THE NEW YORK ARTS PROGRAM

An apprenticeship with an individual artist or in an arts organization forms the core of this program originated by the Great Lakes Colleges Association. Students live in New York City and view the visual and performing arts in this great art center. Participants will have ready access to a vast number of original works of art, to a variety of dramatic and musical events, and to special research collections. A weekly seminar focuses on exhibits, performances, and collections which the students have viewed during the week. A student may elect a supervised independent study project. Each student is individually placed in his apprenticeship, where he may expect to spend twelve or more hours weekly.

Length of Program: One quarter or one semester.
Prerequisites: Most students will be upperclass majors in the arts, although this is not required.

THE INDIA STUDIES PROGRAM

Students participating in this program are exposed to the culture, the contemporary issues, the social strata, and the political parties of India. Participants receive their initial training in India Studies during a quarter spent at Carleton College. They then travel to Deccan College in Poona, India, a cultural and educational center about 120 miles from Bombay. While living abroad each student continues his language instruction in the Marathi dialect, pursues an independent research project, and participates in a seminar. In the course of the seminar, students will meet with politicians, academicians, and local officials. Students will have the opportunity to travel to other areas of India during their study there.

Length of Program: Nine months.
Prerequisites: All students enrolled at ACM colleges are eligible.

THE ARABIC STUDIES PROGRAM

Students with an interest in the history, culture, and contemporary events of Egypt and the Middle East study for one or more semesters at the American University in Cairo. The formal curriculum includes a Core Course in Modern Abrabic Studies, History of the Middle East, Colloquial Arabic, and two elective courses. ACM students live in university quarters with others in the AUC student body. A series of field trips and meetings with local experts acquaint the student with the people and the cultural background of his immediate environment—Cairo, and Egypt. Students are encouraged to spend two semesters at AUC since one semester will give them only a broad overview of this vast field of study.

Length of Program: One or two semesters.
Prerequisites: Students who will be sophomores, juniors, or seniors at ACM colleges may apply.

INTERNATIONAL

THE CUTTINGTON COLLEGE PROGRAM

A small, private, coeducational, liberal arts college on the western coast of Africa (in Liberia) provides the setting for one of ACM's most unusual programs. Recent graduates and faculty of ACM colleges teach students from many African countries. In addition to their teaching responsibilities, faculty and ACM graduates frequently do research, advise, and carry on administrative duties. Participants receive a stipend and termination allowance for their work in much the same manner as Peace Corps volunteers. Cuttington has a student population of 250. Its graduates serve as teachers and principals in Liberia's growing elementary and secondary schools, as nurses, and in important governmental and business positions.

Length of Program: Two years for ACM graduates; one year for faculty.
Prerequisites: College graduation or faculty status.

CENTRAL AMERICAN FIELD STUDIES

This program offers undergraduate students the opportunity to make an interdisciplinary study of the rural tropical society of Costa Rica. Research teams consisting of faculty members and students carry out investigations of social and biological problems. Topics may include the problems of tropical food production, a study of rural political activity, international trade relating to agriculture, and Mesoamerican archaeology, including excavation at a selected site in Costa Rica. The main headquarters for the program are in San Jose, although students normally spend considerable time in the field.

Length of Program: Usually five and one-half months.
Prerequisites: Completion of two years of college work; knowledge of Spanish language recommended.

SERVICE

THE PERIODICAL BANK

Located at ACM headquarters in Chicago, the Periodical Bank contains backfiles of 1,500 scholarly journals and periodicals, as many as possible in microform. The service provides a paper-printout of microform holdings which is put in the mail on the day the request is received via teletypewriter at the Bank. The journal availability of each of our libraries is thereby considerably extended. The Bank is an effort to resolve cooperatively a common problem which none of our ACM libraries is able to accomplish satisfactorily on its own: the unpredictable needs of current and changing programs in the face of proliferating knowledge, publications, and student individual study programs.

THE SINGLE APPLICATION METHOD (SAM)

Students interested in being considered for admission at more than one ACM college may take advantage of this unique admission procedure. The student files only one application with his first choice college, his secondary school provides only one copy of his high school transcript and record form, and he pays only one application fee. If the student is not accepted by his first choice college (in past years nearly 70 per cent of SAM applicants were), his application is immediately forwarded to the admissions office of his second choice college, and so on. SAM is recommended only for candidates who are prepared to state which of the ACM colleges is his first choice and to list other colleges in order of preference.

SCIENCE

INTRODUCTORY GEOLOGY IN THE ROCKY MOUNTAINS

To unravel the geologic history of the area around Bozeman, Montana: that is the goal of students participating in this program in cooperation with Montana State University. Students are introduced to geology in a field setting which stretches from the Tetons to Glacier, and from the Crazy Mountains to the Craters of the Moon. Students spend about three days a week in the field. Three trips of about four days each are taken during the summer program. Participants live in campus facilities and use Montana State geology lecture rooms and laboratory facilities.

Length of Program: Eight weeks.
Prerequisites: High school graduation and admission to an ACM college; or completion of one year at an ACM college.

THE WILDERNESS FIELD STATION

Students interested in pursuing independent study in science live and work in the Boundary Waters Canoe Country of northern Minnesota, twenty miles from the nearest road. Operating from a base camp, students of botany, zoology, aquatic biology, and geology explore the wilderness region by foot and canoe, learn basic techniques of field research, and carry on individual study projects. The field station is located on Basswood Lake, an area containing a great variety of plant life; over 700 distinct species have been collected. Zoology students have experiences in trapping, in bird observation, and in preparing mammal specimens. The lakes are rich in aquatic flora and invertebrate fauna; and regional rock types are varied in this area.

Length of Program: Five or nine weeks in the summer.
Prerequisites: At least an elementary course in the discipline to be studied.

THE ARGONNE SEMESTER

Students majoring in biology, chemistry, geology, or physics study in a research-oriented environment and assist research scientists on the staff of the Argonne National Laboratory, located 25 miles southwest of Chicago. The Argonne Semester makes it possible for undergraduates to work with scientists who are doing research on current problems, using the most modern scientific instruments. The student spends about one-quarter of his time working in a disciplinary seminar in biology, chemistry, or physics; one-quarter time working in an interdisciplinary seminar; and about one-half time working on his own research project as a student aide to a research scientist. ACM students are housed together in facilities on the laboratory site.

Length of Program: Students, six months; faculty, fifteen months.
Prerequisites: Junior or senior status, majoring in a science.

ARTS AND HUMANITIES

CHILDREN'S THEATRE AND CREATIVE DRAMATICS

Students interested in speech, drama, acting and directing, and in producing and writing plays for children, work and study in a unique educational theatre program in Evanston, Illinois. The semester-long program has five components: two courses in Children's Theatre and Creative Drama; a practicum internship in "Theatre 65 of Evanston", a children's theatre; a practicum serving as a teacher aide to a creative dramatics teacher in the Evanston public school system's elementary and junior high schools; the preparation and touring of scenes from plays; and the seminar, which includes an independent study project. This program serves as excellent preparation for teaching dramatics or working with children in community centers, youth groups, or settlement houses.

Length of Program: One semester.
Prerequisites: All students enrolled at ACM colleges are eligible.

OTHER PROGRAMS

ACM faculty members are encouraged to pursue study and research into the cultures and civilizations of Asia, Africa, the Middle East, Latin America, Eastern Europe, and the Soviet Union through **The Non-Western Studies Program.** The three major aspects of this program are: provision of grants for faculty study and research; seminars; and the strengthening of library holdings.

Through **The Science Education Study**, ACM is making a comprehensive summation of practices, developments, and trends in science teaching at its colleges. It will investigate innovations in curricula and teaching technique; it will seek to determine science faculty problems.

Through **Institutional Research** ACM seeks to know more about its students, alumni, faculties and facilities at all twelve colleges. As systematic data collection increases, answers to many questions—from cost analysis to the impact of the college on the student—will be possible.

The Video Tape Program has made available almost 400 hours of unrehearsed and spontaneous classroom activity for use in teacher education. For the teacher trainee this program is an invaluable aid in filling the gap between academic theory and actual practice. Student-teachers have the opportunity to see and learn by actual observations of different teaching-learning situations.

The Washington, D.C. Office is maintained to interpret the nation's capitol and federal activity to our colleges and its programs. The director of this office provides us with reports from the Washington scene and expedites ACM and member college proposals. She provides administrative services for ACM staff and faculty in Washington.

[EXHIBIT 1-B]

THE GREAT LAKES COLLEGES ASSOCIATION

Incorporated in 1961, the Great Lakes Colleges Association remains composed of its twelve charter members: Albion, Antioch, Denison, DePauw, Earlham, Hope, Kalamazoo, Kenyon, Oberlin, Ohio Wesleyan, Wabash, and the College of Wooster. Located in three states, varying in size, and manifesting diverse campus tones, the member institutions nevertheless share qualities which have made their collaboration especially fruitful. Each is fully committed to quality undergraduate education in the liberal arts; each believes in the value of the comparatively small, cohesive academic community; each is open to forms of experimentation and innovation which will wed the enduring and traditional values of the liberal arts tradition to patterns of education which will have meaning and impact in these revolutionary times. And each accepts the axiom that associative activities can and do provide educational opportunities for faculty and students that the members cannot provide singly.

The Association has developed and now administers international education programs in Africa, Colombia, India, Lebanon, Japan, and Yugoslavia. There is a GLCA Arts Program in New York City and an Urban Semester in Philadelphia. In the summers of 1968 and 1969, GLCA and the University of California at Santa Barbara administered an NSF supported program in marine biology at Santa Barbara. Further, GLCA has standing committees on teaching and learning, the sciences, the humanities, and aspects of administrative cooperation.

The presidents of the twelve member institutions comprise the GLCA Board of Directors. The Associations fiscal support comes from annual assessments of the member institutions and from grants. The assessments provide for the GLCA Central Staff, located at the Detroit Metropolitan Airport, Inkster, Michigan. A portion of the assessments is also used to develop projects and conduct special investigations. Grants from federal and private sources have and are continuing to support special projects.

The GLCA Central Staff is composed of: Henry A. Acres, president; A. Paul Bradley, assistant to the president; Mrs. Eve Mouliso, executive secretary; Mrs. Billie Cuddeback, secretary.

While educational achievement and contribution to the national welfare are measured by many indices, the following statistics indicate the heavy impact of the colleges in the Associated Colleges of the Midwest (A.C.M.) and in the Great Lakes Colleges Association (G.L.C.A.). This impact is fostered by the voluntary support of private philanthropy.

PRODUCTION OF M.D. DEGREES

Of the 100 undergraduate colleges having the highest percentage of male graduates receiving M.D. degrees from 1950–59, we find A.C.M. and G.L.C.A. having nine institutions represented. Three were in the top 50.[1]

PRODUCTION OF COLLEGE TEACHERS

Turning to the production of college teachers, we find A.C.M. and G.L.C.A. colleges effective in proportion far beyond their numbers. In a study of 17,749 faculty members[2] 14 A.C.M. and G.L.C.A. colleges were among the top 50 institutions in the number of college teachers produced per 1,000 full-time undergraduates.

This study also pointed out that of 14,550 college teachers surveyed, 80.8 per cent received their undergraduate degrees at private institutions.

PRODUCTION OF PH.D DEGREES IN SCIENCE

The A.C.M. and G.L.C.A. colleges know themselves as comparatively smaller, privately supported institutions.

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[1] William A. Manuel and Marion E. Altenderfer, *Baccalaureate Origins of 1950–1959 Medical Graduates*. Public Health Monograph No. 66 (Washington: U.S. Government Printing Office, 1961), pp. 18–19.

[2] Allan O. Pfnister, *A Report on the Baccalaureate Origins of College Faculties* (Washington: Association of American Colleges, 1961), pp. 30–31.

[Exhibit 2]

Yet, the production of scholars among their graduates is comparatively very high.

Looking at 6 G.L.C.A. colleges in Ohio[1] during the period 1960–66, we find 352 of their baccalaureate degree graduates receiving the Ph. D. in Science (Biology, Chemistry, Physics, and Mathematics). The average combined enrollment of these six colleges totaled 11,003 annually.

"During the same period three larger universities[2] having an average combined enrollment of 56,688 annually, produced 302 baccalaureates who received the Ph.D. in the above sciences.

PRODUCTION OF SEMINARY STUDENTS

In a Lilly Endowment study[3] of pre-seminary education, excluding Roman Catholic seminarians, privately supported institutions produced 75% of seminary students enrolled in 1960–61. One A.C.M. college ranked in the top 15 of such institutions.

PRODUCTION OF WOODROW WILSON FELLOWS

Without regard to the number of students enrolled and without regard to source of control (public or private), there were 12 A.C.M. and G.L.C.A. colleges among those 65 colleges and universities having 10 or more graduates elected Woodrow Wilson Fellows in the period 1945–60.[4]

PRODUCTION OF DANFORTH FELLOWS

Again, without regard to the number of students enrolled and without regard to source of control, there were 12 A.C.M. and G.L.C.A. colleges among those 53 colleges and universities having 5 or more graduates elected Danforth Fellows in the period 1952–62.[5]

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[1] Antioch, Denison, Kenyon, Ohio Wesleyan, Oberlin, Wooster.

[2] Ohio State University, Ohio University, University of Miami (Ohio).

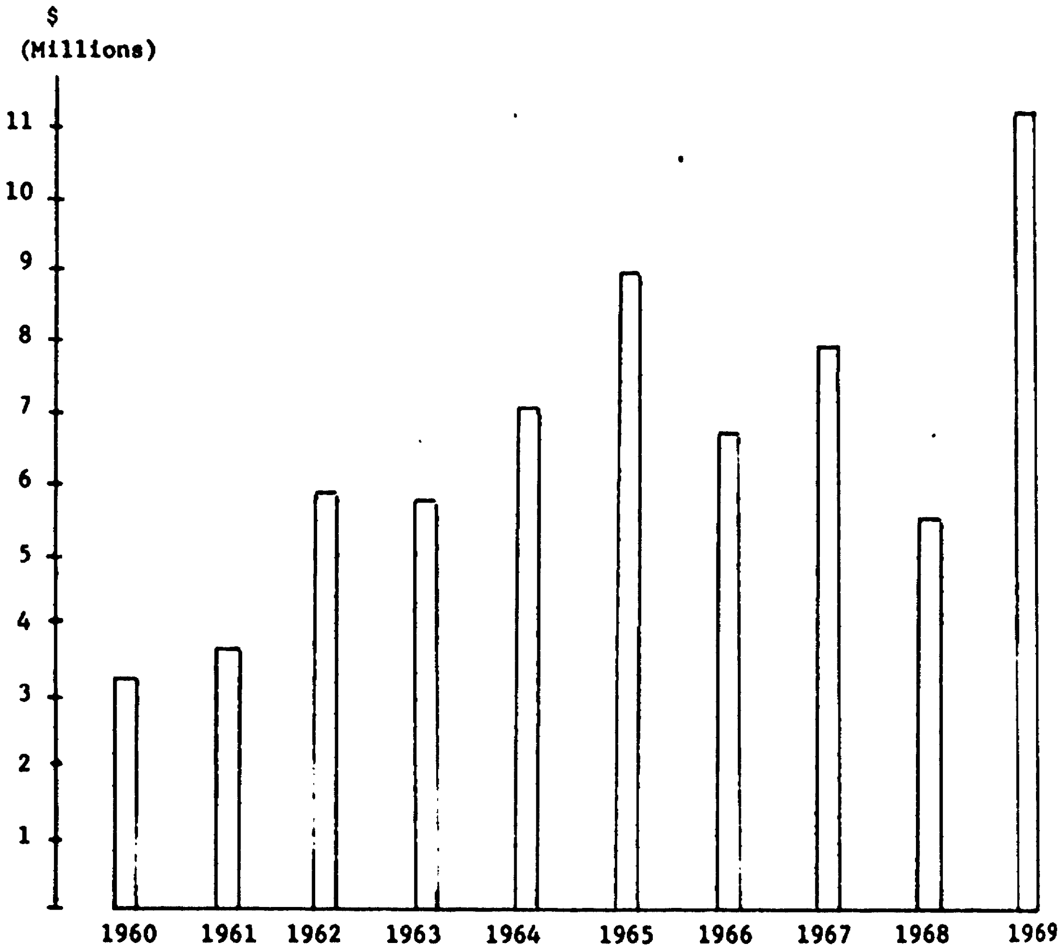
[3] Keith R. Bridston and Dwight W. Culver, *Pre-Seminary Education* (Minneapolis: Augsburg Publishing House, 1965), p. 204.

[4] Data tabulated from *Directory of Fellowship Awards for the Academic Years 1945/46–1960/61* (Princeton, New Jersey: Woodrow Wilson National Fellowship Foundation, 1960), pp. 476–83.

[5] Data obtained from *The Annual Report of the Danford Foundation, 1961–62* (St. Louis: The Foundation, 1962), pp. 25–66.

EXHIBIT 3

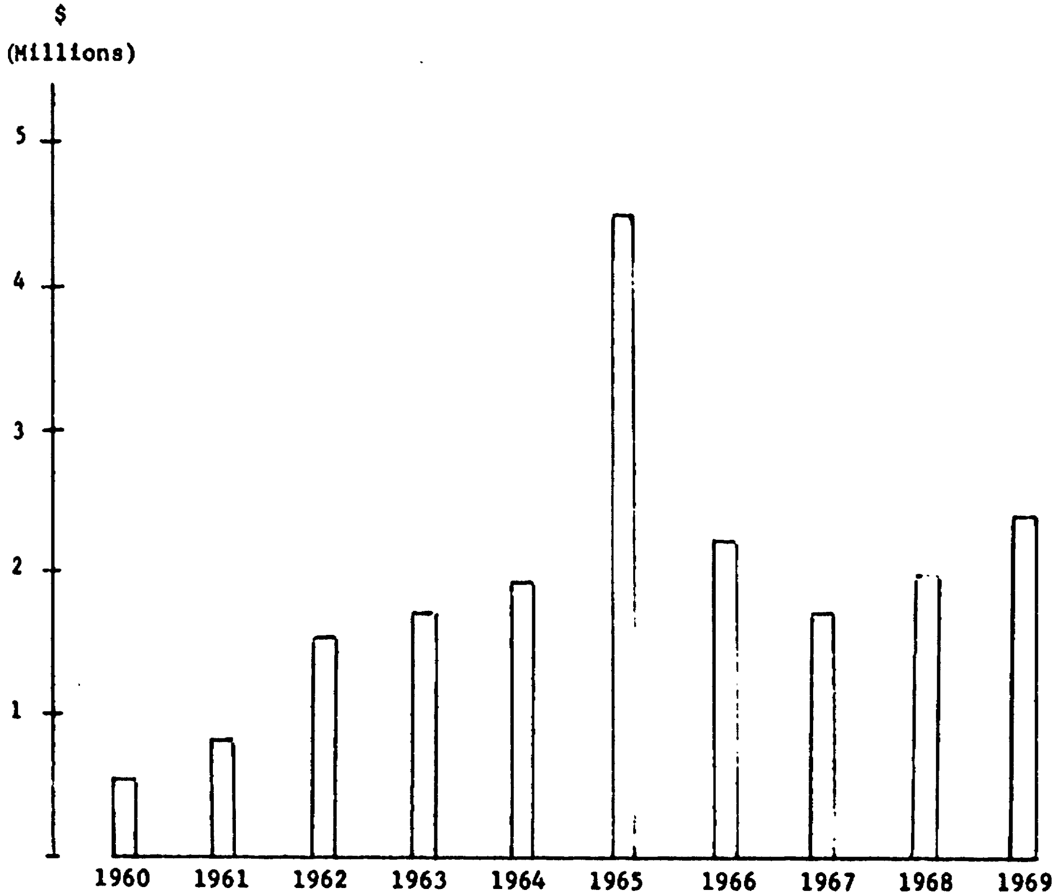
VALUE OF GIFTS OF APPRECIATED PROPERTY TO A.C.M. AND G.L.C.A. COLLEGES 1960 - 1969[1]



[1] Total value of gifts of appreciated property for the ten-year period: $ 66,610,000.

EXHIBIT 4

VALUE OF FUTURE INTEREST GIFTS RECEIVED
BY A.C.M. AND G.L.C.A. COLLEGES
1960-1969[1]



[1] Total value of future interest gifts received during the ten-year period: $19,572,000.

BOARD OF NATIONAL MISSIONS,
New York, N.Y., September 24, 1699.

The Honorable RUSSELL B. LONG,
Chairman, Senate Committee on Finance,
Senate Office Building,
Washington, D.C.

DEAR SIR: The Senate Finance Committee is presently holding hearings on the Tax Reform Act of 1969, Bill H.R. 13270. Certain features of this act, as it was passed by the House of Representatives, are beneficial to philanthropic organizations such as the one I represent.

On the positive side is the intention to lift the limit of contribution deductions from 30% to 50% of a persons income for one year. Also the continuation of the five-year carry-over plan is helpful.

There are, however, certain features of the bill which will discourage potential donors from contributing toward the support of charity.

1. One of the strongest deterrents is the provision in section 201(1), page 135, line 3 which repeals the unlimited charitable deduction for appreciated gifts.

2. Another ill-advised feature is that bill, as it is now written, will not allow charitable deduction on capital gains for life income contracts. Thus the donor will be held responsible for capital gains tax on a life income gift even after that gift is in the hands of and under the control of the recipient of his charity.

3. A third feature of the law with which we are in disagreement is Section 302, page 173, line 4 in which charitable and other deductions are reduced by allocation of deductions between taxable and non-taxable incomes. Therefore, because of his generosity, a donor must reduce not only his charitable deductions, but also his deductions for taxes, interest, medical expenses, et cetera.

The Federal Government has, over the years, continually liberalized the tax benefits for those who voluntarily contribute to our nation's philanthropies, each time stating that the liberalization was designed to further aid charities to meet rising costs and the increased needs of society. At this time when the Federal Government finds it necessary to curtail many of the programs which are designed to augment the work of charitable organizations, it is important that tax incentives be increased rather than decreased for those who generously contribute to causes that materially benefit mankind.

Anything you can do to assist in this matter will be greatly appreciated by us.

Very truly yours,

The Reverend DOUGLAS S. VANCE,
Associate Director of Development.

GARLAND JUNIOR COLLEGE,
Boston, Mass., September 8, 1969.

Hon. RUSSELL B. LONG,
Chairman, Committee on Finance, U.S. Senate, Senate Office Building, Washington, D.C.

DEAR SENATOR LONG: The Trustees, the Faculty and the Administration of Garland Junior College in Boston wish to communicate to the Committee on Finance of the United States Senate their profound concern over certain provisions in the Tax Reform Act of 1969, H.R. 13270, as reported out by the Ways and Means Committee of the House. These provisions, if passed into law, would cut off the major sources of the private gifts that support so large a segment of higher education in this country. They would be a disastrous blow to Garland Junior College and to every institution in the nation, public as well as private.

Two provisions in the proposed act are the most damaging. They are:

(1) the imposition of new limitations on tax deductions for *Gifts of Appreciated Property* to qualified charities, and

(2) the curtailment of tax deductions for *Gifts of Remainder Interests—Life Income Contracts.*

Gifts in these two categories are of vital importance to educational institutions, and we therefore urge the committee not to pass measures that will curtail them, but rather to encourage and facilitate them in every way.

While we fully appreciate and applaud the intention of the Congress to put an end to abuses of the tax laws, we reaffirm our faith in the thoroughly American way of private support for independent institutions and we believe it should

continue unhampered. This system has given the United States the greatest universities and colleges in the world.

Sincerely yours,

FREDERIC B. VIAUX, *President.*

STATEMENT OF DR. J. ROSCOE MILLER, CHANCELLOR AND PRESIDENT, NORTHWESTERN UNIVERSITY

My name is J. Roscoe Miller. I am Chancellor and President of Northwestern University, and have been President and Chief Executive Officer of the University since 1949.

I have prepared this statement because of my deep concern over certain provisions of H.R. 13270 as they bear upon the tax treatment of charitable contributions. I do not pretend to be a tax expert, but I do know the considerations that must, in common sense, govern the philanthropy of even the most generous donor and believe that I am in a positon to tell the Committee of the seriously adverse impact particular features of the House Bill would have upon private educational institutions generally and Northwestern University in particular.

Northwestern University, founded in 1851, now has a total enrollment of 21,737, including students from all 50 states and 66 foreign countries. Our full-time undergraduate enrollment is 6,510, and the balance of the students are in our expanding graduate programs and in our Evening Division in Chicago. Northwestern has a faculty of 2,297, and spends $72 million a year in conduct of its educational and research programs.

Twenty years ago, when I became President of Northwestern our expenditures were about $16 million per year for all operating costs. That amount, which then seemed so large, is today scarcely sufficient to underwrite the annual operating costs of our College of Arts and Sciences alone. The prime factor in the five-fold budget increase has been the cost of improving the quality of our programs and of providing support services and facilities.

I think I need not justify the statement that America has a powerful national resource in a system of higher education that is made up of both public and private institutions. No one fails to recognize the importance to the country's strength and prestige of the great private colleges and universities—among which I of course place Northwestern. And nearly everyone knows that tuition and endowment income do not meet the cost of education. Private gifts are, therefore, essential to the survival of private schools. Indeed, substantially increased volume of private giving is needed if existing programs are to be continued, new programs designed to meet changing needs, and new facilities constructed to expand on or replace those that are inadequate.

It is because of the pressing need for encouraging more giving by individuals that I urge this Committee to review carefully and to reject those provisions of H.R. 13270 which would discourage the most important kinds of gifts to private universities—most particularly those provisions that operate, in a variety of ways, to eliminate the existing tax incentives for large gifts of appreciated property.

As a preclude to a discussion of the distressing features of H.R. 13270, it is important to convey an understanding of the realities of philanthropy.

Each year the University seeks and receives support from many individuals, corporations, and foundations. These gifts come from thousands of donors and in the aggregate provide the essential difference between strength or mediocrity in our educational endeavor. It has been our experience that while many will participate, a relatively small number of donors will provide most of the money. At Northwestern one percent of the donors account for 60 percent of the gifts. Even more noteworthy, in the past fiscal year three individual donors accounted for over 12 percent of total gifts from individuals. This, I am certain, is a fact of philanthropy repeated in greater or lesser degree among all private colleges and universities. We need and must continue to seek gifts at all levels, but the major gifts from the few are crucial both for their substance and for their leadership example.

Another significant factor is the large proportion of gift income received in the form of property other than cash. Since 1960, more than 50 percent of total gift income from individuals has been in the form of property other than cash (largely in appreciated securities). Substantially all of the major gifts are in the form of appreciated securities. This background of dependence upon large gifts of appreciated property from a relatively few major donors is not, I believe, at all unique to Northwestern.

1. REDUCTION OF THE INCENTIVE TO MAKE CHARITABLE GIFTS, PARTICULARLY OF APPRECIATED PROPERTY

We do not feel that the House in its proposal for tax reforms intended to discourage charitable gifts. Whatever the intention, however, the unfortunate reality is that H.R. 13270 would operate in such a way as seriously to discourage gifts, particularly appreciated property, to colleges and universities.

I have consulted with University tax counsel and conclude with them that H.R. 13270 contains three proposals which have a direct impact on individuals who provide a substantial portion of the financial support of private universities. First, under the LTP proposal, a donor may have to increase his gross income by a portion of the appreciated value of property he contributes to charity. For example, if Donor A had $100,000 of taxable income and $100,000 of untaxed income (e.g., tax-exempt bond interest) and made no charitable contributions of appreciated property, the LTP proposal would not have adverse tax consequences. However, if Donor A were to give $30,000 worth of appreciated property to Northwestern, he would have to increase his gross income by as much as $15,000.

Second, under the allocation of deductions proposal, a donor must allocate his non-business deductions between taxable and untaxed income. For example, if Donor A were to make his contribution in the form of cash rather than appreciated securities, approximately one-half of his $30,000 contribution would be allocated to his untaxed income and therefore be rendered non-deductible. The net effect of this would be to almost double the cost to the donor of making his contribution.

Third, the formula used to compute the allocation of deductions not only includes appreciation in the value of property donated to charity, but is also applied to all non-business deductions, with the result that there is a double impact on many donors. For example, if Donor B had $100,000 of taxable income, $70,000 of interest on municipal bonds and $15,000 of non-business deductions other than charitable contributions, the allocation of deduction formula would permit him to deduct approximately 60 percent of his non-business expenses. Thus his taxable income, before personal exemptions, would be approximately $91,000. Now let us say that Donor B made a charitable gift of $30,000 of appreciated securities. The denominator of the allocation of deduction formula would be increased so that approximately one-half of all non-business deductions would be lost—including deductions which would have been allowable if the gift were not made. Donor B would thus lose an additional $1,500 of his non-charitable deduction and approximately $15,000 in deduction allowed for his charitable gift. Thus the $30,000 gift would produce a net deduction of only about $18,000. In other words, the combination of including appreciation in the value of property donated to charity in the formula used to compute the allocation of deductions plus the application of that formula to charitable gifts would almost triple the cost of making the gift.

Even more startling, if Donor A (with $100,000 of taxable income and $100,000 of untaxed income) made a charitable contribution of $30,000 of appreciated property, the $15,000 increase in his gross income under the LTP proposal coupled with the disallowance of almost one-half of the gift under the allocation of deductions proposal would eliminate virtually all of the deduction for the gift.

We feel it is indefensible for purposes of the LTP and the allocation of deduction formula to treat the appreciation in the value of property donated to a university as though it constitutes "untaxed income." A taxpayer who gives $100,000 in appreciated securities to a university does not have an additional $100,000 of economic income from those securities *out of which he can pay* for items that constitute non-business deductions. It is wrong in principle to regard a gift of stock as a realization of "untaxed income" in the same category as items which do in fact increase a taxpayer's net worth and his cash but which are excluded from taxable income, such as tax-exempt interest and capital gains.

As the examples given above illustrate, treatment of a gift of appreciated stock as a realization of "untaxed income" for the purpose of allocation of deductions would operate not only to reduce substantially the charitable deduction for the gift of appreciated assets, but would also reduce the taxpayer's other personal duductions (such as non-business interest, state taxes, medical expenses, theft losses and charitable gifts of cash). Such a proposal, if enacted, would operate as a very real deterrent to charitable giving.

Moreover, we believe that the policy underlying the granting of tax incentives to charitable giving requires the exclusion of charitable gifts from the allocation

of deduction formula. Deductions for medical expenses, mortgage interest, state taxes, etc., represent a Congressional decision that these items affect an individual's ability to pay tax and therefore should be taken into account in determining his tax liability. Accordingly, where an individual has untaxed income in the form of tax-exempt interest and realized long-term capital gains, it may be appropriate to take this other income into account in determining his tax liability.

The charitable contribution deduction, however, differs substantially from other types of deductions. It represents a Congressional policy to grant an incentive for donors to part with their assets without receiving any economic benefit in return. This incentive has proven to be necessary to stimulate gifts to charity. Since *donors are under no obligation to make any gift at all*, if the current tax incentive is substantially curtailed by applying the allocation of deduction formula to charitable gifts, the spring of this critical source of financial support for private universities will soon run dry, forcing us to request financial assistance from the Congress if we are to continue the work we have been doing in educating the nation's youth.

In summary, we believe that in order to maintain the present level of charitable giving, it is essential that H.R. 13270 be amended to eliminate appreciation in value of property donated to charities from the list of "tax preference" items and the "allocation of deduction" formula, and to delete charitable gifts from the list of items which are to be allocated between taxable and non-taxed income.

2. REPEAL OF THE UNLIMITED CHARITABLE DEDUCTION AND THE TERMS OF SUCH REPEAL

Since 1954, the tax laws have provided that the usual 30% limit on deductions of charitable contributions shall not apply if in the tax year and eight out of ten prior years the annual charitable contribution plus tax exceeds 90% of taxable income.

The Treasury Staff, under the last administration, proposed that the unlimited charitable deduction be repealed. However, recognizing that persons qualified for the unlimited deduction had made nondeductible contributions in past years in reliance on this provision, this Treasury proposal provided a ten-year grace period to make contributions without limitation on deductions. This proposal also provided that the unlimited deduction would not be subject to allocation and that the appreciation element in such deduction would not be included in the proposed allocation of deductions.[1]

H.R. 13270 would repeal the unlimited charitable deduction effective with 1975 returns. The total "non-business" deductions (such as charitable contributions, state taxes, interest, etc.) of taxpayers who avail themselves of the unlimited deduction would be limited to 80% in 1970, 74% in 1971, and so on until 1975, when the generally applicable 50% ceiling on charitable gifts would apply. Further as discussed below, the effect of H.R. 13270 on the present unlimited deduction would be far more abrupt than this phase-out schedule would suggest. *This is particularly so for a qualified taxpayer who contributes appreciated securities.* This is of the greatest importance to Northwestern University since three donors who account for 12% of our total individual gifts are qualified for the unlimited deduction *and donate appreciated securities.*

Unlike the initial Treasury proposal, H.R. 13270 would not exempt a taxpayer qualified for the unlimited deduction from the "allocation of deductions" provisions. For qualified taxpayers who contribute appreciated securities, the practical result would be to make the unlimited deduction immediately useless. This is inconsistent with the recognized need for at least a gradual phase-out of the unlimited deduction.

Also unlike the initial Treasury proposal, H.R. 13270 would further stultify the phase-out of the unlimited deduction by making immediately applicable a 30% limitation on contributions of appreciated property without any relief provision for taxpayers qualified for the unlimited deduction. The only explanation given for this provision was that "contributions of appreciated property would continue to be subject to the present 30% limitation."[2]

Even accepting the idea that the present generally applicable 30% limit should be continued with respect to appreciated property despite the general provision increasing the limit to 50%, the application of this 30% limit to the taxpayers

[1] Tax Reform Studies and Proposals, U.S. Treasury Department, Committee Print, February 5, 1969, Part 2, p. 205.
[2] Staff Summary of H.R. 13270, August 18, 1969, p. 31.

qualified for the unlimited deduction and making gifts in the form of appreciated property would immediately deprive the unlimited deduction of any practical significance. The application of the 30% limit to such taxpayers may well have been inadvertent in view of the stated purpose to "continue" the existing limits. But whether inadvertent or not, the application of the 30% limit to taxpayers qualified for the unlimited deduction will create an immediate deterrent to these important gifts.

These several features of H.R. 13270 directed at the unlimited charitable contribution deduction lose sight of the very significant difference between that deduction and other methods used by high-bracket taxpayers to reduce payments of federal taxes. Unlike capital gains, municipal bond interest and other so-called "tax preference" items that increase net worth, an individual who gives an amount equaling substantially all of his income to charity reduces his net worth. Since charity and education benefit from such gifts in an amount substantially greater than the reduction in taxes paid, the Government also benefits. Such gifts reduce the amount Government might otherwise be obligated to furnish through scholarships and grants.

The large loss that the nation would incur as a result of decreased financial support to charity and education is an excessive price to pay for the small increase in tax revenues which would result from repeal of the unlimited deduction. This is especially true where, for the eight years in which a taxpayer is qualifying, charity and education benefit from gifts far in excess of the amounts a taxpayer-donor can deduct.

If Congress nevertheless decides to repeal the unlimited charitable deduction, a reasonable transition period is essential. In fairness to the qualified taxpayer who committed himself to long-range philanthropic programs extending over eight to ten years, an equal grace period is required (including exemption from the "allocation of deductions" provisions with respect to charitable contributions). The Treasury Department staff, under Professor Surrey, propose such a 10-year grace period. Congress should not reduce the length of efficacy of such a grace period.

I make this plea not only in the interest of fairness to the qualified taxpayer but, more directly, because private universities simply cannot afford the immediate diminution of gifts that would result. Even after a 10-year grace period, I do not know how or where Northwestern would replace the important funds presently supplied by the few major donors now qualified for the unlimited deduction. But, at the very least, we desperately need such a transition period within which to search for substitute sources of funds as the alternative to a cut-back in educational programs.

3. RETAINED LIFE INCOME AND CHARITABLE REMAINDER GIFTS

Colleges and universities have benefited significantly through life income plans, under which the donor retains the income for life and the university receives the remainder. At Northwestern we have many examples of large outright gifts and bequests made by donors who originally become interested and committed to our university because of a life income program.

H.R. 13270 would, in effect, eliminate this program of giving by treating the gift of a future interest in appreciated property as a taxable transaction unless the deduction is limited to the donor's cost.

There is no sense in the distinction drawn by H.R. 13270 between outright gifts of appreciated securities (the appreciation generally is not included in gross income) and gifts of less than all of a donor's interest in the same securities (the appreciation is included in gross income unless the donor limited his deduction to his cost of securities). Gifts of remainder interests do not constitute an abuse of the contribution deduction warranting the drastic action taken by the House of Representatives.

A prospective donor, having a choice between (1) retaining his appreciated property and the income therefrom without paying a tax on the appreciation and (2) retaining the income from the property and paying a tax on giving the remainder to charity will refrain from making the gift of the remainder interest. Thus, the revenue likely to be gained under the proposal under discussion is negligible. However, the effect on colleges and universities would be most harmful.

H.R. 13270 also proposes that if property comprising part of the corpus of an existing trust in which charity has a remainder interest is sold, a tax would be imposed on the realized gain. This proposal, in effect, would place an indirect

tax on the charity, since the value of the remainder is reduced through the payment of the tax. We believe that this proposal would generate little additional revenue but would create difficult administrative problems. Perhaps more important, the fiduciaries of such trusts may decide not to make alterations in the trust portfolio, even though such alterations would, in the absence of tax considerations, protect the interests of all the beneficiaries.

For the reasons described above we urge that these changes in the treatment of retained life income and charitable remainder gifts be deleted.

4. CHARITABLE INCOME INTERESTS

H.R. 13270 would, in effect, remove the present income and estate tax deductions for income interests given to charity.

We believe that as long as income interests can be valued with reasonable accuracy, there is no logical reason for treating the gift of an income interest to charity differently from any other charitable gift.

If there are objectionable features to allowing income tax deductions for so-called "short term" charitable income trusts, the way to meet these objections is not in effect to deny the charitable deduction altogether for income interests, but to require a term of ten years or longer.

I have also been advised that there is a technical defect in H.R. 13270 that could have serious repercussions for charities. I refer to Section 201(b)(2) of H.R. 13270, which, in amending Section 2055(e)(2) of the Internal Revenue Code, disallows estate tax deductions for all gifts of income interests to charities. Since there is no income tax benefit where the gift is made in a decedent's will and since the valuation problem can be solved, there is no reason (and no reason was suggested by the House) for disallowing an estate tax deduction in this situation. This may be an omission in drafting the Bill. Whatever the source of this defect, it should be amended.

5. PHILANTHROPIC FOUNDATIONS

In situations where the privilege of foundation status has been used as a mask for self-dealing operations, controls to prevent such abuses are clearly desirable. My concern is that the transgressions of the few will jeopardize the proven philanthropic capacity of the many.

Our country has a great debt to the private foundations. In the area of medicine and public health, they have saved uncounted lives, prevented much suffering, and returned to productivity many who would otherwise be charges upon society. They have enriched our cultural life, adding to our prestige among the nations of the world. They have shared with government the support of education in the last twenty years when pressures of population and change have given schools a national and international significance.

In dollar value of grants, foundations continue to rank second among all sources supporting higher education. The 1967–68 Council for Financial Aid to Education survey of 861 colleges and universities reveals that grants of $311 million from foundations accounted for 24% of all gifts received by these institutions.

At a time when we are deeply concerned about the need to maintain and to increase the levels of support from all private sources, the great contributions of foundations should be remembered and no legislation should be enacted to limit their grant-making capacity. The controls which are needed to cure abuse by the few in the main may be achieved by tighter legislation governing reporting and review. The proposed 7.5% tax on the net investment income of foundations would go beyond the intention to control abuse and would, if enacted, divert a significant level of grants from private education and other charities. The price of such a restriction on foundations would be greater in the long run than any tax revenues such a proposal would produce.

The foregoing deals with several features of H.R. 13270 which would have a retarding impact on Northwestern and other private colleges and universities. If this Bill is not amended, particularly in the areas discussed above, contributions will be adversely affected at a time when increased gifts are urgently needed.

I should also note that the Secretary and Assistant Secretary of the Treasury, in their appearances before this Committee on September 4, 1969, have proposed some modifications in H.R. 13270 affecting the treatment of charitable gifts. Recognition of the problems of the private universities and charities is gratifying, but I regret that the Treasury did not go far enough. Even as modified by the Treasury proposal, H.R. 13270 would seriously deter gifts, particularly by the

relatively few large donors upon whom we depend for such a large portion of our needed gift income.

There are no assurances of perpetuity for private colleges and universities. Our programs and the planning for future service are undertaken with explicit expectancy of a continued and increased commitment of gift support from private sources.

While donors are primarily motivated in furthering the programs of the institutions they support, it is clear that curtailment of tax incentives would be detrimental to overall contributions. In the absence of such support, the Federal Government would itself have to fill this need as the alternative to the decline of these institutions. Considering the relatively small amount of tax revenues affected by these proposals and the very great loss to the nation if private colleges and universities were deprived of the funds necessary to their vitality, reduction in the tax incentives to private giving would constitute a most short-sighted and unwise reversal of Congressional policy.

STATEMENT BY ROBERT W. MORSE, PRESIDENT, CASE WESTERN RESERVE UNIVERSITY, CLEVELAND, OHIO

From the time of its origins nearly a century and a half ago, Case Western Reserve University has strived to be a leading center of quality education. It has a long history of providing that quality to its students through all of the economic, social, technological and political changes that have swept this nation since 1826.

As an independent university, Case Western Reserve has depended upon both the generosity and the commitment of private citizens to support its growth. This private support has had great consequence for the public good. Its faculty and graduates have contributed markedly to their country as Nobel Prize winners, scholars and researchers, statesmen, business founders and educators. Its Medical School is internationally known for its curriculum innovations and its many contributions to new concepts in medical education and health care.

The independent university traditionally has set the educational standards of the country. It has been a citadel of free and independent thought. It has been, in a sense, the intellectual bedrock of the country.

Over the years, independent universities have accepted responsibilities far beyond their commitment to academic excellence. Since the end of World War II, especially, they have faced up to the tasks of accepting increasing numbers of students and carrying forward more comprehensive programs of research in many fields. Federal funds, of course, have played a major role in supporting these efforts, but, private universities in addition, have expended much time and effort in seeking gifts and grants to enable them to assume their share of this public responsibility. This has not been an easy task. It has been fraught with continual crises which still threaten a diminution in the universities' ability to maintain quality in the face of accelerated demands.

Independent universities are also confronted with the impact of severe inflation and a recurring necessity to increase charges to students with the knowledge that we may soon reach a point where our institution may be beyond the financial reach of well-qualified students. This is happening at a time when we are actively trying to enroll increased numbers of disadvantaged youths, with a resultant need for ever-increasing levels of financial aid.

Over the past two years, we have seen levels of federal funds of many kinds diminish. At Case Western Reserve this decreased support amounts to $8 million since 1967 which is almost equal to our current annual deficit of slightly more than $8 million.

With the foregoing as a preamble it is not difficult to understand a university president's deep concern with the pending tax reform bill (H.R. 13270). It is important that the Congress appreciate the impact such legislation will have on all sectors of our national life. Independent universities constitute an important sector.

I feel that the draft bill, if enacted into law, will gravely threaten the future of the independent university.

Of particular concern is the bill's handling of life income trusts, which have been a major source of endowment and a key element in future planning; and gifts of appreciated property, which represent a large measure of operating in-

come. Appreciated stock particularly is a major source of income for capital fund campaigns.

Case Western Reserve University is now completing a total of $60 million in capital campaigns for new health sciences, law and engineering facilities. The entire $60 million has been committed to these projects and much of it has already been spent. In many cases, the facilities have been constructed and are in use. A large share of these gifts and pledges are from private foundations.

However, of the $60 million, some $13.2 million are in the form of pledges from private sources for future gifts. If H.R. 13270 is passed in its present form, the University may fail to receive as much as $3 million.

This would not only be a major blow to the completion of facilities now under construction, and the expanded educational programs they support but it could force the university to take extreme financial measures to the severe detriment of our educational program.

Our situation in this respect is by no means unique; rather, it is typical of what you might find at any independent university. I am reluctant to speak for other institutions, but it seems reasonable to anticipate that many private colleges and universities, under the pressures of inflation, increased costs and decreased levels of federal support, could not survive even a modest reduction of funds from private sources.

The proposed law is extremely technical, difficult to interpret, and fears of its consequences tend to discourage the philanthropic motive. Where the prior law had, in some ways, rewarded people for charitable support of higher education, the proposed law tends to exact a penalty for that support. There is certainly an urgent policy decision to be made by the Congress: Whether or not to reverse the nation's philosophy of giving.

In the national interest, my plea here is that the Congress not reverse this philosophy.

THE LIBRARIAN OF CONGRESS,
Washington, D.C., September 17, 1969.

Hon. RUSSELL B. LONG,
Committee on Finance,
U.S. Senate,
Washington, D.C.

DEAR SENATOR LONG: I am writing in reference to H.R. 13270, the bill to reform the income tax laws.

The Library of Congress is especially concerned with the provision on page 123 of H.R. 13270 that relates to charitable contributions and the gift of tangible personal property. Under this new provision, donors of rare books, manuscripts, works of art, and other library materials which have appreciated in value since they were purchased would not be credited for tax purposes with the fair market value of their gifts. They would be credited only with the original purchase price of the material, or if they used the fair market value deduction they would have to pay capital gains tax on the difference between the purchase price and the market value. Since its beginnings, the Library of Congress has received for the nation from public-spirited citizens gifts of rare books, manuscripts, and other valuable library material. Heretofore, these individuals have been able to deduct the market value of their gift as a charitable contribution. The proposed provision with respect to tangible personal property will, I believe, have a very adverse effect on libraries and museums with respect to gifts of such property. It would, I am convinced, in many instances keep valuable library and museum resources out of public institutions and in the hands of private collectors.

During recent years the Library of Congress has received as gifts, to name only a few, the Lessing J. Rosenwald collection of over 2,200 rare books and manuscripts, many of them books printed before 1500; a rare 16th century illuminated manuscript Book of Hours; musical scores and manuscripts of such noted composers as Aaron Copland, George Gershwin, Oscar Hammerstein, Leonard Bernstein, and Samuel Barber; and the personal papers of James G. Blaine, John Glenn, Felix Frankfurter, Edna St. Vincent Millay, and Owen Wister. Donors also recently made it possible for the Library to acquire an incomparable collection of Walt Whitman materials. Gifts such as these have made the collections of the Library unrivaled in this country and in many instances abroad. They would literally have cost millions of dollars for the Government to buy and it is highly unlikely that public funds for that purpose would have been made available.

As you know, university and other libraries throughout this country also depend in large measure on gifts of such library materials in order to serve their constituencies. Through interlibrary loan and photoreproduction techniques this material is available to scholars throughout the country. It would be tragic if significant items of importance to research remained in private hands and, consequently, virtually unknown to the library and museum world and inaccessible to the scholarly community. It is entirely possible that this would in many instances be the case if individuals are penalized by the tax structure in making gifts of such personal property to a public institution. I therefore urge that your committee give careful consideration to the deprivation to institutions and to research that would result from this provision in the tax reform bill.

I should also like to point out that the Library of Congress, as well as other libraries in this country, has been the recipient of many foundation grants to investigate the feasibility of and to initiate new and often experimental programs of national significance We are therefore concerned that taxation of foundations will limit the amount of funds available for public purposes. I recognize fully that a small number of foundations have acted outside of the intent of the tax laws approved by the Congress in respect to their activities, but I do not believe that foundations that have long served the public interest and scholarship should be penalized because of such activities. I am sure that your Committee will recognize this fact in its deliberations.

Sincerely yours,

L. QUINCY MUMFORD,
Librarian of Congress.

STATEMENT OF POSITION BY 52 NEW YORK COLLEGES & UNIVERSITIES

As Presidents of public and private institutions of higher education, we are deeply concerned over certain features of the program of Federal tax reform now pending. We recognize that the present system requires reform, but we question the need for changes that will drastically limit our ability to meet the urgent and ever-increasing demands for more and better educational facilities and programs.

A single example suggests the degree to which private colleges and universities are dependent on the large individual gifts that would be curtailed by proposed changes in the tax law concerning gifts of appreciated property. Listed below are five buildings under construction or recently completed at Syracuse University. Though the buildings were sorely needed, not one of the projects would have been undertaken without the major individual contributions of appreciated securities that provided crucial incentive for additional private support.

Building	Cost	Major individual donation
1. The Ernest Stevenson Bird Building	$13,100,000	$3,095,349
2. The William Bayard Heroy Geology Building	2,867,000	1,000,000
3. The Ruth Van Arsdale Henry Health Center and Hospital of the Good Shepard	1,000,000	400,000
4. Dr. Perle B. Brockway Hall	2,030,000	629,000
5. Ronald K. Lawrinson Hall	4,090,000	600,000
	23,087,000	5,724,349

You will note that Syracuse was able to initiate a building program, in this case, of $23,087,000 on the strength of major gifts in the amount of $5,724,349. Assuming a cost basis of zero for the appreciated securities comprising these gifts, the maximum tax revenue to be realized would be $1,431,087.25. There is substantial evidence to indicate a loss of revenue in the amount of $350,000 was more likely.

The benefit to society in this case is $23,000,000 in educational physical plant. Congress must weigh the total social benefit justly against the individuals' tax savings benefit.

More is at stake than buildings, of course. The privately supported educational institutions can venture imaginatively into unknown and untested areas of research, development and experimentation. They can explore new areas of study, areas which, though not of immediate public interest, may prove with

time to produce the greatest benefits to society. Much of the daring to find "a better way to do it" in this country has been generated by the private support of higher education.

Obviously the private colleges and universities would be hardest hit by tax reform that curtailed private contributions, but public education is threatened as well. All colleges and universities, not only the private ones, receive financial support from alumni and friends. Furthermore, if the private institutions are rendered less able to meet their responsibilities, the already heavy demands made upon the public will increase accordingly. Without substantial private gifts to higher education, in other words, public colleges and universities will require appreciably increased tax support.

Because of the crucial role that philanthropy plays in the financing of higher education in the United States, Federal legislation has long recognized the wisdom of granting tax incentives for contributions to colleges and universities. Gift-supported institutions require these incentives if they are to meet the needs of society. They have always depended upon the contributions of individuals, and now they depend on them more heavily than ever. Campaigns for annual operating expenses today are on a scale previously reserved for "once-in-a-lifetime" capital campaigns. And, as the representative figures set forth in the appendix to this document demonstrate, gifts in the form of securities are crucial to any successful campaign.

The costs of government must be met; so must the costs of higher education. It is respectfully submitted that the development of human resources provided by our institutions of higher learning should continue to be strengthened through tax incentives to privae donors. To undermine those incentives at a time when the youth of our nation will be called upon to assume heavy burdens of leadership in a rapidly changing world may prove disastrous. The financial pressures on the private sector of higher education are severe already, and the possibility of a massive educational deficit is distinct and threatening. The need for better teaching and training, for increased educational innovation and research, and for greater service from our institutions of higher learning must be met.

While each of our institutions has different constituencies and resources upon which it relies for support, together we submit the following conclusions for your consideration:

GIFTS OF APPRECIATED PROPERTY

We urge that donor-tax payers not be taxed on unrealized gains to charities, either directly or indirectly.

Under the Tax Reform Act of 1969, H.R. 13270, the unrealized gains are indirectly and partially taxed because the appreciation on the charitable gifts reduces the donor's itemized deductions under the "allocation of deductions" provision and may be taxed under the "limit on tax preference" provision. The tax under the allocation of deductions provision would reduce a donor's itemized deductions for interest, taxes, medical expenses, and charitable contributions. By indirectly taxing the appreciation on property gifts, such a provision would greatly inhibit important support from the private sector. We see no reason why this incentive should not be retained in the case of all gifts of tangible property and future interests.

LIMIT OF TAX PREFERENCE AND ALLOCATION OF DEDUCTIONS

We urge that unrealized gains not be regarded as "tax preference" income and that charitable contributions not be included under the "allocation of deductions" provision. Unrealized appreciation is, by its nature, not income received by the donor as is true of the other preferences. Giving is a voluntary act, and one which results in actual net costs to those who make gifts to charities. Inclusion of unrealized gains as a preference is really a further limitation on the deductibility of the charitable contribution of appreciated property.

Including charitable contributions under the allocation of deductions provisions places the contributor in the position of decreasing all other deductions by making gifts, as well as decreasing charitable deductions. A contribution should not be considered in the same context as payments of mortgages, state and sales taxes, and medical expenses.

The computations required by these provisions are so involved as to make it virtually impossible for a donor to plan major gifts. The effect, in fact, would be to discourage substantial gifts, which are so important in the support of colleges and universities, public and private.

GIFTS OF REMAINDER INTERESTS

We urge that the present laws governing charitable remainder trusts and life income contracts be continued. The present law provides that there is no capital gain on the transfer of appreciated property to fund a charitable remainder trust or life income plan; nor is there a capital gain if the property transferred is later sold by the trust and the gain permanently set aside for the charity. H.R. 13270 would require payment of a fixed percentage of the principal or a fixed dollar amount on an annual basis and, thus, would almost certainly lead to an invasion of the principal to the detriment or the college or university. With respect to irrevocable trusts, no tax should be imposed on subsequent gains which under the current law escaped taxation as being "permanently set aside" for the benefit of the college or university.

RETROACTIVE LEGISLATION

We urge Congress make all new tax law prospective. The possible retroactive effect of the proposed legislation has already caused serious loss of support to charitable institutions.

The Presidents of the following institutions are signatories to this statement.

Alfred University, Alfred
Canisius College, Buffalo
Clarkson College of Technology, Potsdam
Colgate Rochester Divinity School, Rochester
Colgate University, Hamilton
College of New Rochelle, New Rochelle
Cornell University, Ithaca
Dowling College, Oakdale
D'Youville College, Buffalo
Eisenhower College, Seneca Falls
Elmira College, Elmira
Finch College, New York City
Good Counsel College, White Plains
Hamilton College, Clinton
Hartwick College, Oneonta
Hobart and William Smith Colleges, Geneva
Ithaca College, Ithaca
Iona College, New Rochelle
Keuka College, Keuka Park
Kirkland College, Clinton
LeMoyne College, Syracuse
Manhattan College, Bronx
Manhattanville College, Purchase
Marist College, Poughkeepsie
Mills College, New York City
Mount Saint Mary College, Newburgh
Nazareth College, Rochester
Niagara University, Niagara
Pace College, New York City
Paul Smiths College of Arts & Sciences, Paul Smiths
Polytechnic Institute of Brooklyn, Brooklyn
Pratt Institute, Brooklyn
Rensselaer Polytechnic Institute, Troy
Rochester Institute of Technology, Rochester
Rosary Hill College, Troy
Russell Sage College, Troy
St. Bernard's College, Rochester
St. Bonaventure University, St. Bonaventure
St. John Fisher College, Rochester
St. Lawrence University, Canton
St. Rose College, Albany
Sarah Lawrence College, Bronxville
Siena College, Loudonville
Skidmore College, Saratoga Springs
State University of New York
Syracuse University, Syracuse
Union College, Schenectady
University of Rochester, Rochester
Utica College, Utica
Vassar College, Poughkeepsie
Wagner College, Staten Island
Wells College, Aurora

STATEMENT OF POSITION BY NEW YORK COLLEGES, UNIVERSITIES

APPENDIX

An average of 46.5 percent of gifts received from individuals by 23 New York colleges and universities during the past 6 years consisted of securities. In dollar value, the total is $94,709,000

Institution	Years involved	Value of securities donated by individuals	Ratio of securities to total gifts from individuals (percent)
Alfred	1968-69	$138,000	29
Canisius	1964-69	136,000	25
Clarkson	1968-69	518,000	45
Colgate	1964-69	6,236,000	66
Cornell	1963-69	39,500,000	49
Eisenhower	1967-69	768,000	24
Elmira	1964-69	1,977,000	50
Hamilton	do	5,759,000	79
Hartwick	do	2,348,000	64
Keuka	do	730,000	76
Kirkland	1968-69	412,000	54
Le Moyne	1967-69	115,000	51
Rensselaer Polytechnic Institute	1968-69	1,290,000	70
Rochester Institute of Technology	1963-68	3,963,000	25
Russell Sage	1964-69	1,050,000	66
St. John Fisher	do	623,000	46
St. Lawrence	do	4,100,000	66
Skidmore	do	1,516,000	23
Syracuse	do	14,951,000	38
Union	do	601,000	17
University of Rochester	1968-69	6,863,000	81
Utica	1964-69	75,000	3
Wells	1965-69	1,040,000	29
Total		94,709,000	46.5

UPHAM, MEEKER & WEITHORN,
New York, N.Y., September 5, 1969.

Re comments and suggestions *re Tax Reform Act of 1969*

COMMITTEE ON FINANCE,
U.S. Senate,
Senate Office Building,
Washington, D.C.

GENTLEMEN, This letter comments upon several aspects of H.R. 13270 (as passed by the House on August 7, 1969) 91st Cong., 1st Sess., i.e., Sections 201(h) (disallowance of estate and gift tax deductible in certain cases), 201(f) (charitable contribution by estates and trusts), and 201(a) (disallowance of charitable deduction for gift of use of property).

Section 201(h)

Section 201(h)(1) amends I.R.C. § 2055(e) to cover a number of situations. One such situation is the disallowance of the estate tax deduction presently available for the charitable remainder interest in a trust where such trust is not either a charitable remainder annuity trust or a charitable remainder unitrust, as described in the amended version of I.R.C. § 664(d). In Section 201(j)

(7)(A) it is provided that this amendment to I.R.C. § 2055(e) shall apply in the case of decedents dying after the date of enactment of H.R. 13270.

As a consequence, it would appear that the estates of many thousands of decedents dying after the enactment of H.R. 13270 (in its present form) would be irreparably damaged in a most inequitable manner. That is so because virtually all charitable remainder trusts now in existence are irrevocable and thus could not be amended to conform to the annuity trust or unitrust definition. This would mean that as estate tax would be due based upon the inclusion of assets within the taxable estate of the decedent even though the estate would not have such assets available to it for the payment of the tax.

Assume, for example, that an individual owning net assets valued at $2,000,000 established a charitable remainder trust in 1965 and, from time to time, since then, has transferred $1,000,000 to that trust. The trust provides for the payment of income to the grantor for his life, with the remainder going to a designated charitable beneficiary on his death. Under present law, upon the death of the described individual, the then value of the corpus to the charitable remainder trust would be included in his gross estate (under I.R.C. § 2036—transfers with retained life estate), but would be offset by an equivalent charitable deduction (under I.R.C. § 2055—transfers for public, charitable and religious uses). If, however, that individual were unfortunate enough to die after the enactment of the above discussed amendment to I.R.C. § 2055, his gross estate still would be approximately $2,000,000 (the $1,000,000 corpus to the charitable remainder trust and $1,000,000 of other assets) but, because of new I.R.C. § 2055(e), the estate would be entitled to no charitable contribution deduction and thus (disregarding other deductions and the $60,000 exemption) would be taxable on the full $2,000,000. Whereas a taxable estate of $1,000,000 is subject to a tax of $325,700, a $2,000,000 taxable estate would be subject to a tax of $753,200. Thus, such an estate, with only $1,000,000 of net assets, would be required to pay a confiscatory tax equal to more than 75% of the net assets of the estate because of what appears to be an omission in the drafting of the amendment.

The apparently unintended inequity above described could be corrected quite easily by expanding the effective date provision (Section 201(j)(7)(A), as follows:

"The amendments made by paragraph 3 (1) and (2) of Subsection (h) shall apply in the case of decedents dying after the date of enactment of this Act, *except as to the value of charitable remainder interests in irrevocable intervivos trusts entered into prior to the date of enactment of this Act.*"

This suggested revision would appear to create a "loophole" because it would permit additions to the corpus of such "old" trusts, which additions could be made after the enactment of H.R. 13270. However, this does not constitute an area of practical exposure since, under Section 201(i), I.R.C. §664 would define the new concepts of charitable remainder annuity trusts and unitrusts and no contribution made to a trust would be deductible for income tax purposes unless the recipient trust could meet the new definition. Thus, future transfers made to an old form of charitable remainder trust would not be deductible for income tax purposes. For that reason, either future transfers would not be made to such trusts or, if made, should properly give rise to an estate tax deduction because there would not have been an income tax deduction available in the year of the transfer.

Although the preceding discussion has been couched in terms of specific charitable remainder trusts, it must be recognized that the inequity under consideration would exist in the case of every present holder of a so-called "life income contract" of the type issued by close to 2,000 educational institutions and charitable organizations throughout the country. Therefore, it would seem imperative that the recommended change be made.

Section 201(f)

I.R.C. § 642(c), providing for the unlimited deduction of charitable contributions made by estates and trusts, would be amended so that the deduction (which now relates to amounts paid or permanently set aside for a charitable purpose) would be limited only to amounts paid for a charitable purpose.

The problem inherent in this provision is essentially similar (although not nearly so serious) as the above discussed problem of Section 201(h), since the apparent inequity is one which would fall upon presently existing irrevocable intervivos charitable remainder trusts. In general, such trusts provide for the payment of income to the grantor (and/or other designated individuals) for life or for a term of years, with the remainder going to charity. "Income" is defined

to exclude capital gains. Thus, when trust assets are sold at a gain (and the proceeds thereafter reinvested) the amount of that gain is not distributable to the then current income beneficiary but, instead, is retained as part of the corpus of the trust. As such, it constitutes gross income to the trust, which gross income is not taxable to the trust under present law only because of the operation of I.R.C. §642(c) (providing an unlimited deduction for amounts paid or *permanently set aside* for a charitable purpose.)

Under the proposed revision of I.R.C. § 642(c), the unlimited deduction rule hereafter would apply only to amounts *paid* for a charitable purpose, and Section 201(j)(6) makes this new rule applicable "... to amounts paid, permanently set aside, or to be used for a charitable purpose after the date of enactment of this Act."

In order to illustrate the unfortunate prospective consequences of this provision, assume the case of the charitable remainder trust described in the earlier portion of this letter (in connection with comments made on Section 201(h)). That trust was created in 1965 and has, over the years, received assets valued at approximately $1,000,000. Assume, further, that $200,000 of trust assets are in the form of I.B.M. stock, with a bax basis of $50,000. If, in 1970 (after the enactment of the provision in its present form), the trustee determines, as a matter of investment policy, that the I.B.M. stock should be sold and does, in fact, sell that stock for $200,000, the problem here being described would become a reality. Because charitable remainder trusts of the type presently in existence do not provide for the payment of any amount other than the remainder to charity, the $150,000 gain just described could not be offset by a charitable contribution deduction because I.R.C. § 642(c) then would apply only to amounts *paid* to charity and not to amounts *permanently set aside.*

Thus, unless this inequity now is corrected, irrevocable intervivos charitable remainder trusts presently in existence either must refrain from selling any of their appreciated holdings or must be prepared to absorb the impact of the tax attributable of any gains realized on such sales. Since the grantor of such a trust already would have benefited (in prior years) from the income tax deduction referable to his transfer of assets to the trust, the only loser will be the charitable remainderman, because the amount of tax paid by the trust merely will decrease the value of the corpus which eventually will pass to such charitable remainderman.

In order to correct the inequitable consequences above described it is respectfully suggested that H.R. 13270 be amended in a manner which will, in no way, alter the underlying intent of the proposed legislation above described. The suggested change could be accomplished as follows:

1. The present I.R.C. § 642(c) would be retained and redesignated as I.R.C. § 642(c)(1) and its introductory phrase (now reading "In the case of an estate or trust") would be expanded to read "*In the case of an estate of a decedent dying on or before 1969, or an irrevocable inter vivos trust created on or before 1969 ...*"

2. The material set forth in Section 201(f) as a newly amended I.R.C. § 642(c) would be redesignated as I.R.C. § 642(c)(2) and the introductory language thereof would be altered to read "*in the case of an estate or trust (other than an estate or trust governed by the provision of paragraph (1) of subsection (c) of this section, and a trust meeting the specifications of Subpart B) ...*"

Section 201(a)

Included in Section 201(a) is a provision which would create a new I.R.C. § 170(b)(8) entitled "Denial of Deduction In Case of Contribution of Partial Interest In Property." In all of the material which preceded the passage of H.R. 13270 by the House, including the hearings held by the House Ways and Means Committee, the "tentative decisions" announced by that Committee and the Report of that Committee on the Bill, it was indicated that the area with respect to which the legislators were concerned related to the charitable deduction for gifts of the use of property. Further, this area is referred to specifically in the language of the proposed legislation.

However, the area of concern develops from the use of certain broad language in the proposed statute, which would appear to allow for the inclusion of limitations substantially beyond those relating to the denial of a deduction for the contribution of the right to use property. The language which rises this concern appears at the beginning of the statutory paragraph and reads "In the case where a taxpayer makes a charitable contribution of less than his entire interest in property..."

Although there is no basis for this in any of the prior materials, including the Report of the House Ways and Means Committee, this broad language would appear to cover the deduction otherwise available for the contribution of an undivided fractional interest in property made to a charitable beneficiary. For example, if an individual who owns a parcel of commercial real property contributes an undivided half interest in such property to a charitable organization, it seems that I.R.C. § 170(b)(8) could be relied upon to disallow his right to deduct the value of that interest.

Thus, if, in fact, it was the intent of the House to make such a change in the present statute (although no prior reference was made or consideration given to this question) then it should be so indicated. If, on the other hand, it was not intended that this type of transfer (made to other than private foundations) be barred, then the statute should be amended so as to reflect the real intent, which would seem only to be to bar a deduction for the granting to a charity of the right to use property.

Very truly yours,

STANLEY S. WEITHORN.

PEPPERDINE COLLEGE,
Los Angeles, Calif., September 26, 1969.

The SENATE FINANCE COMMITTEE
Senate Finance Office Building,
Washington, D.C.

GENTLEMEN: Thank you for the opportunity to submit for your careful consideration a statement setting forth my views of the proposed legislation relating to tax reform, particularly insofar as such legislation would affect philanthropic support of higher education.

My position today is as it was last February when I testified before the House Ways and Means Committee. At that time I made it clear that I could not presume to speak for individual colleges other than Pepperdine. I said that we are not asking for handouts but for a greater opportunity to serve in a tax climate which will encourage concerned citizens to invest in a segment of higher education which they believe will produce rich dividends for themselves, for their children, and for their country.

Studies of our institution indicate that we have saved the taxpayer more than $30,000,000 in providing education for students who, otherwise, would be the responsibility of the State. At Pepperdine we receive approximately 5000 contributions per year from friends, corporations, and foundations. Only with this support are we able to operate a $6,000,000 annual budget. We have been able to grow—our current enrollment is at an all-time high of 2000—to increase faculty salaries and to improve in quality by virtue of the tax climate which stimulates investments in independent higher education. It is my judgment, as well as that of my advisors, that the proposed legislation, particularly the features which would tax the appreciation of donated securities, would bring about a drastic reduction in voluntary support. This would affect all privately supported colleges, some of which, I am told, find that as much as 70% of their total philanthropy is in the form of appreciated property.

President Nixon has called upon the Nation to become involved in the volunteer process. It seems to me that some of the provisions of the Tax Reform Bill, notably because they tend to diminish philanthropic giving, are incompatible with the President's views on voluntarism.

While I am not unmindful of the responsibility resting upon you gentlemen and your fellow legislators to assure adequate financing for our Federal Government, I trust that you will not find it necessary to adopt legislation which jeopardizes the quality—yes, even the survival—of America's independent institutions of higher education.

Cordially yours,

M. NORVEL YOUNG,
President.

STATEMENT OF DR. J. ROSCOE MILLER, CHANCELLOR AND PRESIDENT, NORTHWESTERN UNIVERSITY

My name is J. Roscoe Miller. I am Chancellor and President of Northwestern University, and have been President and Chief Executive Officer of the University since 1949.

I have prepared this statement because of my deep concern over certain provisions of H.R. 13270 as they bear upon the tax treatment of charitable contributions. I do not pretend to be a tax expert, but I do know the considerations that must, in common sense, govern the philanthropy of even the most generous donor and believe that I am in a position to tell the Committee of the seriously adverse impact particular features of the House Bill would have upon private educational institutions generally and Northwestern University in particular.

Northwestern University, founded in 1851, now has a total enrollment of 21,737, including students from all 50 states and 68 foreign countries. Our full-time undergraduate enrollment is 6,510, and the balance of the students are in our expanding graduate programs and in our Evening Division in Chicago. Northwestern has a faculty of 2,297, and spends $72 million a year in conduct of its educational and research programs.

Twenty years ago, when I became President of Northwestern our expenditures were about $16 million per year for all operating costs. That amount, which then seemed so large, is today scarcely sufficient to underwrite the annual operating costs of our College of Arts and Sciences alone. The primary factor in the five-fold budget increase has been the cost of improving the quality of our programs and of providing support services and facilities.

I think I need not justify the statement that America has a powerful national resource in a system of higher education that is made up of both public and private institutions. No one fails to recognize the importance to the country's strength and prestige of the great private colleges and universities—among which I of course place Northwestern. And nearly everyone knows that tuition and endowment income do not meet the cost of education. Private gifts are, therefore, essential to the survival of private schools. Indeed, substantially increased volume of private giving is needed if existing programs are to be continued, new programs designed to meet changing needs, and new facilities constructed to expand on or replace those that are inadequate.

It is because of the pressing need for encouraging more giving by individuals that I urge this Committee to review carefully and to reject those provisions of H.R. 13270 which would discourage the most important kinds of gifts to private universities—most particularly those provisions that operate, in a varley of ways, to eliminate the existing tax incentives for large gifts of appreciated property.

As a prelude to a discussion of the distressing features of H.R. 13270, it is important to convey an understanding of the realities of philanthropy. Each year the University seeks and receives support from many individuals, corporations, and foundations. These gifts come from thousands of donors and in the aggregate provide the essential difference between strength or mediocrity in our educational endeavor. It has been our experience that while many will participate, a relatively small number of donors will provide most of the money. At Northwestern one percent of the donors accounts for 60 percent of the gifts. Even more noteworthy, in the past fiscal year three individual donors accounted for over 12 percent of total gifts from individuals. This, I am certain, is a fact of philanthropy repeated in greater or lesser degree among all private colleges and universities. We need and must continue to seek gifts at all levels, but the major gifts from the few are crucial both for their substance and for their leadership example.

Another significant factor is the large proportion of gift income received in the form of property other than cash. Since 1960, more than 50 percent of total gift income from individuals has been in the form of property other than cash (largely in appreciated securities.) Substantially all of the major gifts are in the form of appreciated securities. This background of dependence upon large gifts of appreciated property from a relatively few major donors is not, I believe, at all unique to Northwestern.

1. REDUCTION OF THE INCENTIVE TO MAKE CHARITABLE GIFTS, PARTICULARLY OF APPRECIATED PROPERTY

We do not feel that the House in its proposals for tax reforms intended to discourage charitable gifts. Whatever the intention, however, the unfortunate reality is that H.R. 13270 would operate in such a way as seriously to discourage gifts, particularly appreciated property, to colleges and universities.

I have consulted with University tax counsel and conclude with them that H.R. 13270 contains three proposals which have a direct impact on individuals who provide a substantial portion of the financial support of private universities. First, under the LTP proposal, a donor may have to increase his gross income by a

portion of the appreciated value of property he contributes to charity. For example, if Donor A had $100,000 of taxable income and $100,000 of untaxed income (e.g., tax-exempt bond interest) and made no charitable contributions of appreciated property, the LTP proposal would not have adverse tax consequences. However, if Donor A were to give $30,000 worth of appreciated property to Northwestern, he would have to increase his gross income by as much as $15,000.

Second, under the allocation of deductions proposal, a donor must allocate his non-business deductions between taxable and untaxed income. For example, if Donor A were to make his contribution in the form of cash rather than appreciated securities, approximately one-half of his $30,000 contribution would be allocated to his untaxed income and therefore be rendered non-deductible. The net effect of this would be to almost double the cost to the donor of making his contribution.

Third, the formula used to compute the allocation of deductions not only includes appreciation in the value of property donated to charity, but is also applied to all non-business deductions, with the result that there is a double impact on many donors. For example, if Donor B had $100,000 of taxable income, $70,000 of interest on municipal bonds and $15,000 of non-business deductions other than charitable contributions, the allocation of deduction formula would permit him to deduct approximately 60 percent of his non-business expenses. Thus his taxable income, before personal exemptions, would be approximately $91,000. Now let us say that Donor B made a charitable gift of $30,000 of appreciated securities. The denominator of the allocation of deduction formula would be increased so that approximately one-half of all non-business deductions would be lost—including deductions which would have been allowable if the gift were not made. Donor B would thus lose an additional $1,500 of his non-charitable deduction and approximately $15,000 in deduction allowed for his charitable gift. Thus the $30,000 gift would produce a net deduction of only about $13,000. In other words, the combination of including appreciation in the value of property donated to charity in the formula used to compute the allocation of deductions plus the application of that formula to charitable gifts would almost triple the cost of making the gift.

Even more startling, if Donor A (with $100,000 of taxable income and $100,000 of untaxed income) made a charitable contribution of $30,000 of appreciated property, the $15,000 increase in his gross income under the LTP proposal coupled with the disallowance of almost one-half of the gift under the allocation of deductions proposal would eliminate virtually all of the deduction for the gift.

We feel it is indefensible for purposes of the LTP and the allocation of deduction formula to treat the appreciation in the value of property donated to a university as though it constitutes "untaxed income." A taxpayer who gives $100,000 in appreciated securities to a university does not have an additional $100,000 of economic income from those securities *out of which he can pay* for items that constitute non-business deductions. It is wrong in principle to regard a gift of stock as a realization of "untaxed income" in the same category as items which do in fact increase a taxpayer's net worth and his cash but which are excluded from taxable income, such as tax-exempt interest and capital gains.

As the examples given above illustrate, treatment of a gift of appreciated stock as a realization of "untaxed income" for the purpose of allocation of deductions would operate not only to reduce substantially the charitable deduction for the gift of appreciated assets, but would also reduce the taxpayer's other personal deductions (such as non-business interest, state taxes, medical expenses, theft losses and charitable gifts of cash). Such a proposal, if enacted, would operate as a very real deterrent to charitable giving.

Moreover, we believe that the policy underlying the granting of tax incentives to charitable giving requires the exclusion of charitable gifts from the allocation of deduction formula. Deductions for medical expenses, mortage interest, state taxes, etc. represent a Congressional decision that these items affect an individual's ability to pay tax and therefore should be taken into account in determining his tax liability. Accordingly, where an individual has untaxed income in the form of tax-exempt interest and realized long-term capital gains, it may be appropriate to take this other income into account in determining his tax liability.

The charitable contribution deduction, however, differs substantially from other types of deductions. It represents a Congressional policy to grant an incentive for donors to part with their assets without receiving any economic benefit in return. This incentive has proven to be necessary to stimulate gifts to charity. Since *donors are under no obligation to make any gift at all*, if the current tax

incentive is substantially curtailed by applying the allocation of deduction formula to charitable gifts, the spring of this critical source of financial support for private universities will soon run dry, forcing us to request financial assistance from the Congress if we are to continue the work we have been doing in educating the nation's youth.

In summary, we believe that in order to maintain the present level of charitable giving, it is essential that H.R. 13270 be amended to eliminate appreciation in value of property donated to charities from the list of "tax preference" items and the "allocation of deduction" formula, and to delete charitable gifts from the list of items which are to be allocated between taxable and non-taxed income.

2. REPEAL OF THE UNLIMITED CHARITABLE DEDUCTION AND THE TERMS OF SUCH REPEAL

Since 1954, the tax laws have provided that the usual 30% limit on deductions of charitable contributions shall not apply if in the tax year and eight out of ten prior years the annual charitable contribution plus tax exceeds 90% of taxable income.

The Treasury Staff, under the last administration, proposed that the unlimited charitable deduction be repealed. However, recognizing that persons qualified for the unlimited deduction had made nondeductible contributions in past years in reliance on this provision, this Treasury proposal provided a ten-year grace period to make contributions without limitation on deductions. This proposal also provided that the unlimited deduction would not be subject to allocation and that the appreciation element in such deduction would not be included in the proposed allocation of deductions.[1]

H.R. 13270 would repeal the unlimited charitable deduction effective with 1975 returns. The total "non-business" deductions (such as charitable contributions, state taxes, interest, etc.) of taxpayers who avail themselves of the unlimited deduction would be limited to 80% in 1970, 74% in 1971, and so on until 1975, when the generally applicable 50% ceiling on charitable gifts would apply. Further as discussed below, the effect of H.R. 13270 on the present unlimited deduction would be far more abrupt than this phase-out schedule would suggest. *This is particularly so for a qualified taxpayer who contributes appreciated securities.* This is of the greatest importance to Northwestern University since three donors who account for 12% of our total individual gifts are qualifed for the unlimited deduction *and donate appreciated securities.*

Unlike the initial Treasury proposal, H.R. 13270 would not exempt a taxpayer qualified for the unlimited deduction from the "allocation of deductions" provisions. For qualified taxpayers who contribute appreciated securities, the practical result would be to make the unlimited deduction immediately useless. This is inconsistent with the recognized need for at least a gradual phase-out of the unlimited deduction.

Also unlike the initial Treasury proposal, H.R. 13270 would further stultify the phase-out of the unlimited deduction by making immediately applicable a 30% limitation on contributions of appreciated property without any relief provision for taxpayers qualified for the unlimited deduction. The only explana- given for this provision was that "contributions of appreciated property would continue to be subject to the present 30% limitation."[2] Even accepting the idea that the present generally applicable 30% limit should be continued with respect to appreciated property despite the general provision increasing the limit to 50%, the application of this 30% limit to the taxpayers qualified for the unlimited deduction and making gifts in the form of appreciated property would immediately deprive the unlimited deduction of any practical significance. The application of the 30% limit to such taxpayers may well have been inadvertent in view of the stated purpose to "continue" the existing limits. But whether inadvertent or not, the application of the 30% limit to taxpayers qualified for the unlimited deduction will create an immediate deterrent to these important gifts.

These several features of H.R. 13270 directed at the unlimited charitable contribution deduction lose sight of the very significant difference between that deduction and other methods used by high-bracket taxpayers to reduce payments of federal taxes. Unlike capital gains, municipal bond interest and

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[1] Tax Reform Studies and Proposals, U.S. Treasury Department, Committee Print, February 5, 1969, part 2, p. 205.
[2] Staff Summary of H.R. 13270, August 18, 1969, p. 31.

other so-called "tax preference" items that increase net worth, an individual who gives an amount equaling substantially all of his income to charity reduces his net worth. Since charity and education benefit from such gifts in an amount substantially greater than the reduction in taxes paid, the Government also benefits. Such gifts reduce the amount Government might otherwise be obliged to furnish through scholarships and grants.

The large loss that the nation would incur as a result of decreased financial support to charity and education is an excessive price to pay for the small increase in tax revenues which would result from repeal of the unlimited deduction. This is especially true where, for the eight years in which a taxpayer is qualifying, charity and education benefit from gifts far in excess of the amounts a taxpayer-donor can deduct.

If Congress nevertheless decides to repeal the unlimited charitable deduction, a reasonable transition period is essential. In fairness to the qualified taxpayer who committed himself to long-range philanthropic programs extending over eight to ten years, an equal grace period is required (including exemption from the "allocation of deductions" provisions with respect to charitable contributions). The Treasury Department staff, under Professor Surrey, proposed such a 10-year grace period. Congress should not reduce the length or efficacy of such a grace period.

I make this plea not only in the interest of fairness to the qualified taxpayer but, more directly, because private universities simply cannot afford the immediate diminution of gifts that would result. Even after a 10-year grace period, I do not know how or where Northwestern would replace the important funds presently supplied by the few major donors now qualified for the unlimited deduction. But, at the very least, we desperately need such a transition period within which to search for substitute sources of funds as the alternative to a cut-back in educational programs.

8. RETAINED LIFE INCOME AND CHARITABLE REMAINDER GIFTS

Colleges and universities have benefited significantly through life income plans, under which the donor retains the income for life and the university receives the remainder. At Northwestern we have many examples of large outright gifts and bequests made by donors who originally became interested and committed to our university because of a life income program.

H.R. 13270 would, in effect, eliminate this program of giving by treating the gift of a future interest in appreciated property as a taxable transaction unless the deduction is limited to the donor's cost.

There is no sense in the distinction drawn by H.R. 13270 between outright gifts of appreciated securities (the appreciation generally is not included in gross income) and gifts of less than all of a donor's interest in the same securities (the appreciation is included in gross income unless the donor limited his deduction to his cost of the securities). Gifts of remainder interests do not constitute an abuse of the contribution deduction warranting the drastic action taken by the House of Representatives.

A prospective donor, having a choice between (1) retaining his appreciated property and the income therefrom without paying a tax on the appreciation and (2) retaining the income from the property and paying a tax on giving the remainder to charity will refrain from making the gift of the remainder interest. Thus, the revenue likely to be gained under the proposal under discussion is negligible. However, the effect on colleges and universities would be most harmful.

H.R. 13270 also proposes that if property comprising part of the corpus of an existing trust in which charity has a remainder interest is sold, a tax would be imposed on the realized gain. This proposal, in effect, would place an indirect tax on the charity, since the value of the remainder is reduced through the payment of the tax. We believe that this proposal would generate little additional revenue but would create difficult administrative problems. Perhaps more important, the fiduciaries of such trusts may decide not to make alterations in the trust portfolio, even though such alterations would, in the absence of tax considerations, protect the interests of all the beneficiaries.

For the reasons described above we urge that these changes in the treatment of retained life income and charitable remainder gifts be deleted.

4. CHARITABLE INCOME INTERESTS

H.R. 13270 would, in effect, remove the present income and estate tax deductions for income interests given to charity.

We believe that as long as income interests can be valued with reasonable accuracy, there is no logical reason for treating the gift of an income interest to charity differently from any other charitable gift.

If there are objectionable features to allowing income tax deductions for so-called "short term" charitable income trusts, the way to meet these objections is not in effect to deny the charitable deduction altogether for income interests, but to require a term of ten years or longer.

I have also been advised that there is a technical defect in H.R. 13270 that could have serious repercussions for charities. I refer to Section 201(b)(2) of H.R. 13270, which, in amending Section 2055(e)(2) of the Internal Revenue Code, disallows estate tax deductions for all gifts of income interests to charities. Since there is no income tax benefit where the gift is made in a decedent's will and since the valuation problem can be solved, there is no reason (and no reason was suggested by the House) for disallowing an estate tax deduction in this situation. This may be an omission in drafting the Bill. Whatever the source of this defect, it should be amended.

5. PHILANTHROPIC FOUNDATIONS

In situations where the privilege of foundation status has been used as a mask for self-dealing operations, controls to prevent such abuses are clearly desirable. My concern is that the transgressions of the few will jeopardize the proven philanthropic capacity of the many.

Our country has a great debt to the private foundations. In the area of medicine and public health, they have saved uncounted lives, prevented much suffering, and returned to productivity many who would otherwise be charges upon society. They have enriched our cultural life, adding to our prestige among the nations of the world. They have shared with government the support of education in the last twenty years when pressures of population and change have given schools a national and international significance.

In dollar value of grants, foundations continue to rank second among all sources supporting higher education. The 1967–68 Council for Financial Aid to Education survey of 861 colleges and universities reveals that grants of $311 million from foundations accounted for 24% of all gifts received by these institutions.

At a time when we are deeply concerned about the need to maintain and to increase the levels of support from all private sources, the great contributions of foundations should be remembered and no legislation should be enacted to limit their grant-making capacity. The controls which are needed to cure abuse by the few in the main be achieved by tighter legislation governing reporting and review. The proposed 7.5% tax on the net investment income of foundations would go beyond the intention to control abuse and would, if enacted, divert a significant level of grants from private education and other charities. The price of such a restriction on foundation would be greater in the long run than any tax revenues such a proposal would produce.

The foregoing deals with several features of H.R. 13270 which would have a retarding impact on Northwestern and other private colleges and universities. If this Bill is not amended, particularly in the areas discussed above, contributions will be adversely affected at a time when increased gifts are urgently needed.

I should also note that the Secretary and Assistant Secretary of the Treasury, in their appearance before this Committee on September 4, 1969, have proposed some modifications in H.R. 13270 affecting the treatment of charitable gifts. Recognition of the problems of the private universities and charities is gratifying, but I regret that the Treasury did not go far enough. Even as modified by the Treasury proposal, H.R. 13270 would seriously deter gifts, particularly by the relatively few large donors upon whom we depend for such a large portion of our needed gift income.

There are no assurances of perpetuity for private colleges and universities. Our programs and the planning for future service are undertaken with explicit expectancy of a continued and increased commitment of gift support from private sources.

While donors are primarily motivated in furthering the programs of the institutions they support, it is clear that curtailment of tax incentives would be detrimental to overall contributions. In the absence of such support, the Federal Government would itself have to fill this need as the alternative to the decline of these institutions. Considering the relatively small amount of tax revenues affected by these proposals and the very great loss to the nation if private colleges and universities were deprived of the funds necessary to their vitality, reduction in the tax incentives to private giving would constitute a most-sighted and unwise reversal of Congressional policy.

STATEMENT BY LANDRUM BOLLING, PRESIDENT, EARLHAM COLLEGE, RICHMOND, IND., SUBMITTED ON BEHALF OF:

The Associated Colleges of the Midwest

Beloit	Cornell	Macalester
Carleton	Grinnell	Monmouth
Coe	Knox	Ripon
Colorado	Lawrence	St. Olaf

and

The Great Lakes Colleges Association

Albion	Earlham	Oberlin
Antioch	Hope	Ohio Wesleyan
Denison	Kalamazoo	Wabash
DePauw	Kenyon	Wooster

As the president of one small, midwestern liberal arts college, I have been asked to speak formally for the member institutions of the Associated Colleges of the Midwest and the Great Lakes Colleges Association. These two groups are comprised of twenty-four institutions which have a collective undergraduate enrollment of almost 40,000 and a collective faculty of some 3,700.

We wish here to support the testimony given on September 18, 1969 by Dr. Logan Wilson, President of the American Council on Education and thus spokesman for all of our colleges and universities. Further, we have filed as written testimony to the Committee on Finance two earlier documents:

"Two Higher Education Associations Speak for Private Foundations," September 8, 1969.

"Statement on Tax Reform Act of 1969 to Committee on Finance of the United States Senate," September 16, 1969.

We conclude that our previous written testimony reflects the position of the academic community at large and will not repeat those arguments here. *There is however, an argument which appears only obliquely in testimony given to the Committee on Finance. It deserves special consideration and is the subject of this paper.* Briefly stated, it is that:

1. Testimony presented to date on HR 13270 clearly reflects higher education's conclusion that, as currently phrased, the Bill would significantly constrict fiscal support from private sources. Both sectors, public and private, agree to this.

2. Should such support become constricted, higher education would have to draw additional dollars from two chief sources: students and their parents, and tax-supported local, state, and federal agencies. There is, of course, no guarantee that these two sources could or would generate new revenues equal to the amount private philanthropy was reduced.

Suppose, however, these sources did generate new income. It would not be enough, for higher education needs *increasing* fiscal support. For us, to hold the line is to lose ground. Since it is clearly improbable that tuition revenues could dramatically increase, let us assume that new sources of tax dollars would not only be able to equal but significantly *exceed* the amount private philanthropy was reduced. We submit that this situation would weaken higher education even though the numbers of dollars we consider necessary were available.

3. The cutting edge of the argument is that the source as well as the amount of dollars is of keen importance to us—and to the country. Let me explain why:

(*a*) American higher education is characterized by diversity. Ours is a system of educational institutions which vary enormously in size, types of programs, admissions standards, graduation requirements, educational philosophies, rules and regulations, methods of control, methods of financing. Foreign educators and government officials, used to a unitary system of higher education regulated by a central ministry and almost totally dependent on tax funds, often consider our system confusing and impossible. But they are enormously envious of the way that our diverse, decentralized system serves American youth and our whole society. One of the chief reasons for our success is our educational diversity, and that diversity has been made possible by a diversity of financial support. We have not had to wait for a national ministry of education to draw up a nation-wide plan, for the Bureau of the Budget to give a green light after weighing all the other demands for tax funds, and for the Congress to pass enabling legislation and appropriate the money.

(*b*) American higher education is characterized by flexibility, and the opportunity allowed to each educational institution to develop new academic programs: to respond quickly to new technical, economic, and social needs; to try out new approaches to the improvement of teaching and learning. This flexibility has been and is a direct result of the availability of substantial private, voluntary contributions to higher education.

(*c*) American higher education is characterized by entrepreneurial creativity. This is a free enterprise nation. The entrepreneurial spirit is keenly exhibited in the vigorous, imaginative, and at all times highly competitive approaches we have taken to improve the quality and range of our educational programs, the breadth of our public services, and the quality and diversity of our facilities. *This entrepreneurial creativity is directly tied to the availability of voluntarily contributed funds and the tax incentives to encourage such giving.* This spirit of enterprise and the benefits derived from its exercise are to be found on the campuses of state colleges and universities as well as on the campuses of the independent colleges and universities.

To illustrate the meaning of private support to our institutions, we offer some examples drawn from recent years:

College A.—A graduate of the college and a member of the Board of Trustees is a physician. For many years, he served a certain family as their physician. Eventually, they told him that they wanted to express tangibly their deep appreciation over the years. He told them that he wanted no further rewards for himself but that he was most interested in the future development of College A. As a result, the family gave a donation to the college which permitted it to construct and equip a new biological sciences building.

College B.—Over the past two years a trustee of College B has given the college $250,000 to support the construction of an International Center on campus. He continues to be a generous donor. At a recent meeting of the Board of Trustees, he made the following statement: "My friends ask why I serve as trustee and contribute to this college. I am not a Methodist. I am not a graduate of a small college, I do not even live in this part of the State. By way of reply, I say that our country needs good private education and that good private education deserves fiscal support. There is no reason why individuals of one denomination should not give to institutions of another. There is no reason why one should not support institutions outside of his own area. The country and the world need educated young men and women. Private institutions do an especially fine educational job, and they deserve support."

College C.—Shortly after a new president arrived at the college in 1965, the student body presented him with a letter of request. The campus is small; approximately 2 square city blocks. Students spend 24 hours a day, seven days a week on or about the campus. Naturally, much of their time is spent outside the classroom, laboratory, and library. The students asked for a proper student center where their educational experiences outside of the traditional academic facilities could be enriched.

But the college was faced with difficult choices. It was aware that its community needed a student center. But it was also aware that it needed new classrooms, new laboratories, new equipment, additional faculty, etc. In assigning priorities, the college had to put the student center low.

The college is not wealthy. It has had to use every one of its dollars with extreme care to make sure that it was providing its students with the best education and facilities that it possibly could. The dollars went into faculty salaries and additions, laboratories, classrooms, and library additions.

The president, however, was able to bring the students' real needs to the attention of two young business men who live nearby the college. They made a gift of $600,000 to the college, an amount which enabled it to go over the top on its student center fund drive. The building is now under construction.

College D.—College D is located in a small town of 8,500. Recently, a local merchant gave the college a gift of $300,000 in appreciated securities. During the presentation ceremonies the merchant, whose business activities are limited to this small town, observed. "This is my finest hour." The gift paid for the entire library portion of the college's new science complex.

College E.—We cite six young men who graduated from this college during the past five years. Each came from extremely modest family circumstances, and each was supported wholly or in large part by scholarship funds from private sources. Here is what they are doing now:

1. Candidate for Pr. D in biology at Stanford University.
2. Candidate for Pr. D in classics at Princeton University.
3. Danforth scholar at Yale.
4. Completing Medical School at Yale.
5. Completing Law School at Harvard.
6. Completing graduate studies at Union Theological Seminary.

College F.—The college discussed a major gift with a prospective donor who cannot at this time make a large gift in either cash or appreciated securities However, he felt that by a deferred giving program he could set up a trust which would eventually bring the college a special fund as high as $750,000. When HR 13270 was passed by the House of Representatives, the donor's attorney advised his client that he could not afford to take the risks involved in making a deferred gift under the terms of the Bill. The college attorney reached the same conclusion.

These examples were drawn at random; we shall be pleased to document them upon request.

In conclusion, we call attention again to the importance of preserving the diversity, the flexibility, and the entrepreneurial creativity of our American system of higher education. These are the characteristics which give it energy and impact. They can be held if the Congress approves of a broad range of tax incentives for philanthropic giving. Specifically, existing incentives relating to deferred gifts and gifts of appreciated property should be retained—and without complicated and hampering amendments.

The problems of higher education are too severe and the importance of our colleges and universities to the whole society too great to place major financial handicaps upon them in this crucial period of our history.

KANSAS STATE UNIVERSITY,
Manhattan, Kans., September 25, 1969.

Hon. ROBERT DOLE,
U.S. Senator,
Senate Office Building,
Washington, D.C.

DEAR SENATOR DOLE: A few days ago Frank Mosier visited my office to relay your request that we prepare and send to you a statement regarding the proposed tax reform bill and how it might affect higher education or, more particularly, Kansas State University. May I first express our deep appreciation for your interest in the plight which could befall our institutions of higher education as a result of these proposals and your willingness to concern yourself with it.

I have delayed by several days writing the letter as requested because we wanted to make as detailed a study of such literature, written opinions, evaluations, etc., as are at our disposal concerning the proposed bill and its implications. I am forced to observe that this added study has made the letter much more difficult to write since it has only served to heighten our confusion. Since there seem to be so many contradictory opinions on many of these specific proposals, one becomes much less sure of what he knows. It cannot be disputed, however, that, regardless of what revisions or specific proposals might be made, the over-all principle of tampering with or denying the traditional policy of encouraging private support of education in this country could lead to disastrous results.

With the above statement I simply seek to explain why I have chosen to perhaps stay more with the broad implications rather than details of specific proposals which not even the experts seem to understand.

Generally speaking, it is my impression that House Bill 13270 is the result of a growing and commendable desire to correct tax abuses on the part of certain private foundations of a self-serving nature and that, under the present proposals, bona fide religious and educational institutions are innocent bystanders caught up in this knuckle rapping exercise.

Curtailing philanthropic tax deducton incentives as put forth in House Bill 13270 can have a twofold effect. First, it would unquestionably eliminate an appreciable amount of voluntary support from individuals, organizations, and foundations—support that has consistently been a major factor in the development of America's present system of higher education.

Secondly, such a curtailment would consequently burden an already heavily taxed nation of people with yet more taxes. Without the voluntary financial support educational institutions now receive (our relatively new program here at Kansas State produced over $1,000,000 last year), they will have to be supported through a tax program or disappear from the educational scene.

Frank mentioned your desire for suggestions of what might possibly be incorporated into an amendment to House Bill 13270. I wouldn't presume to claim either the information or the legislative skill to be specific on this, but I would like to say that, difficult as it might be, a highly desirable alternative would restrict the use of voluntary, philanthropic funds by the recipients. What I am trying to say is that the Bill seems to penalize the charitably inclined donor more than it seeks to define legitimate and constructive use of philanthropically generated income. Equally difficult, but surely possible, would be a differentiation between bona fide and nonbona fide institutions eligible to recive tax-deductible contributions.

We would hope a consideration could be given to those tax changes proposed in House Bill 13270 which would endanger private philanthropy to 501(c)(3) institutions, such as the KSU Endowment Association. Changes pertinent to contributions of appreciated property (Bill Section 201 (c) and (d), page 122) as outlined in the Bill would deprive donors of the *incentive* to continue giving property as a charitable contribution. Subsequent income derived from these gifts constitutes a major portion of financial aid to students and faculty. We would like to see this portion of the Bill deleted.

In recent years we have had increasing success in promoting private gifts to carry out worthwhile educational programs (scholarships, loans, fellowships, etc.) through the use of the Life Income Contract or Trust. Section 201(i), page 135, dealing with these charitable remainder (life income) trusts should also be isolated from the bill as it pertains to bona fide or accredited educational institutions seeking to develop funds which will enable our most talented young people to be trained for service to the state and nation.

Much is being made of the proposal to increase the present 30% deduction of adjusted gross income to 50% as a positive factor of the Bill. This may well be true, but I doubt seriously if it would affect the great majority of the nation's colleges and universities. Certainly few of our contributors make gifts in such large amounts that the privilege of deducting up to 50% of adjusted gross, rather than 30%, is of any significance. Of far greater concern to us is the proposal which violates a long standing principle of encouraging private donations by denying the tax advantages inherent in gifts of appreciated property. We have been able to use this in past years to generate many thousands of dollars in contributions for the benefit of Kansas State activities which would have had to otherwise be supported by public funds or be foregone entirely.

I think it is worth while to point out that it is *not* a Congressional oversight that a contribution of appreciated property presently entitles the donor to a deduction for the property's full present fair market value with no capital gains tax on the appreciation. In 1938 the House of Representatives passed a bill calling for the contribution deduction to be measured by the donor's cost—not the fair market value at the date of the gift. *However, the 1938 Tax Act as finally passed did not contain the House provision eliminating the added tax benefit on the donation of appreciated property to charity.*

The Senate Finance Committee rejected the House provision. In doing so it stated, "Representations are made to the Committee by officials of educational and charitable institutions that the effect of such a provision would be to discourage the making of charitable gifts of property. *The Committee believes that charitable gifts generally are to be encouraged and so has eliminated the provision of the House Bill.*"

Even so, this stand was simply a reiteration of a philosophy of much longer standing in this country that private support of education be encouraged by every possible means.

Respectfully yours,

KENNETH M. HEYWOOD,
Director, KSU Endowment and Development.

STATEMENT BY THE CHICAGO SOCIETY OF FUND RAISING EXECUTIVES, SUBMITTED BY SIDNEY SCHONBERGER, CHAIRMAN, COMMITTEE ON LEGISLATION

The Chicago Society of Fund Raising Executives is an organization of 150 men and women professionally engaged in raising funds for the Chicago Metropolitan Area's leading private health, welfare, educational and civic organizations and institutions.

As citizens, we favor a tax system based on ability to pay—a progressive rather than a regressive program. Tax reform to reduce the disproportionately high taxes required of low- and middle-income families is long overdue and should be enacted.

But the Tax Reform Bill of 1969, as passed by the House of Representatives and now pending before the U.S. Senate Committee on Finance, contains several provisions which will be seriously harmful to philanthropic giving while contributing little or nothing to progressive tax reform or to increased governmental revenue.

The Bill would impose taxes on appreciation in securities and property donated to charities if the securities or property had been held by the donor less than one year; and on property and securities held a year or longer if the tax-payer came within the "limitation on tax preferences" or "allocation of deductions" proposals. These gains are not taxed now when given to charities. They should not be taxed in the future.

The desirable purpose of the "limitation on tax preferences" can be achieved without including appreciated property donated to charity as a tax preference; similarly, the desirable purpose of "allocation of deductions" can be achieved without including charitable contributions among the allocable items. We are pleased to note that on these two points we are in agreement with amendments proposed by Secretary of the Treasury, David M. Kennedy, in testimony given last month before the Senate Finance Committee.

Gifts of appreciated property are vital to charities. For a number of the voluntary, charitable, educational and similar organizations, one-fourth to three-fourths of their income is in the form of gifts of appreciated securities and property. Any deterrent to such gifts can have most serious effects. The donors involved are among the largest contributors.

Charities have nothing in common with the list of "tax preferences" with which they have been lumped in the House bill—such as excess depreciation, hobby farm losses, tax free interest on municipal bonds, untaxed capital gains. Charitable gifts should therefore be deleted from that list. The other items can be dealt with on their own merits.

The beneficiaries of the gains in securities and property given as charitable donations, rather than the taxpayers, are the people who depend on these gifts. They are the aged and the sick, families in trouble or already broken, emotionally disturbed and retarded children, and others.

The Senate Finance Committee in the past has recognized the harm in the House proposals. In 1938 the Committee eliminated such tax proposals from a House bill because "the Committee believes charitable gifts are to be encouraged." That position is equally valid now.

Charities are not a "loophole"—they are a life-time to human needs. With one exception, exclusions and deductions of particular items from income affect only the personal economic welfare of the taxpayer and the receipts of the government. The exception is the tax deductible charitable contribution, which vitally affects the income of a third party—the charitable organization. Unlike other items, tax deductibility of a charitable gift provides an incentive to the taxpayer for making the expenditure (as intended by the law); were tax deductibility removed from *all* items currently covered (such as state and local taxes, interest, medical expenses, etc.) it is doubtful that the taxpayer would actually reduce his expenditures for these items, with the sole exception of his charitable contributions.

Throughout our history, it has been the policy of the government to encourage voluntary philanthropy to meet health and welfare needs. The charitable contributions deduction was first enacted in 1917, almost simultaneously with the imposition of the income tax. The incentives for charitable gifts have been consistently increased by the Congress in revising the tax laws. Now for the first time, that policy would be reversed by the House bill. The House action comes at the very time that the Administration is emphasizing a larger role for voluntary citizen responsibility in welfare and health services. The House bill undercuts that purpose. The human problems met by voluntary philanthropy will still have to be met—and a result of the House measure will be to press these problems upon the government to be financed with larger tax funds, and thereby would be self-defeating.

Tax equity can and should be achieved without harm to the charities.

The principal changes needed in H.R. 13270 to avoid adverse effects on charitable giving are:

1. Delete section 201(c) dealing with charitable contributions of appreciated property. This section sets forth the general principle that when an individual makes a charitable contribution in the form of property which has appreciated in value, the amount to be reported as a charitable contribution by the taxpayer shall be either (a) the fair market value of the property (in which case the taxpayer would pay the appropriate tax on the amount of the gain in value) or (b) the cost of the property to the taxpayer (in which case the capital gains tax would be avoided but the taxpayer, or course, would get credit for a smaller charitable contribution), whichever he chooses.

2. Delete section 201(d) pertaining to bargain sales to charitable organizations. This section provides that when a bargain sale is made to a charitable organization, the amount counted as a charitable contribution shall be (as at present) the difference between (a) the value received by the charity from the sale of the donated property and (b) the amount returned to the taxpayer in his bargain sale; but the taxpayer would no longer (as at present) be able to avoid the capital gains tax on that portion of the money he receives back which can be prorated as a gain. The taxable portion of the money returned to the taxpayer would bear the same ratio to the total amount returned as the gain in value of the property bears to the price at which the charity sells it.

3. Delete that portion of section 301(a) which includes a charitable contribution of appreciated property in the list of disallowed tax preferences, namely, the added section 84(c)(1)(A). This sets forth the principle that charitable contributions of appreciated property together with other tax preferences (like accelerated depreciation or interest on bonds) may not under any circumstances be greater than one-half of the total amount of income derived from all sources (those which are presently taxable and those which are presently exempt from taxation).

4. Delete that portion of section 302 pertaining to the allocation of deductions which includes charitable contributions together with other deductible items (like interest payments, State and local taxes, etc.) as an item which is to be apportioned between taxable income and presently nontaxable income. The amount of disallowed deductions would bear the same ratio to the total deductions subject to allocation as the amount involved in income from tax preferences bears to total income from all sources.

STATEMENT BY J. W. PENFOLD, CONSERVATION DIRECTOR, IZAAK WALTON LEAGUE OF AMERICA

Mr. Chairman, I am J. W. Penfold, Conservation Director of the Izaak Walton League of America. We appreciate the opportunity to comment on H.R. 13270, the Tax Reform Bill. We agree that tax reform is necessary and long overdue. Representing a voluntary citizens organization, we bring no special claims to the Committee. The 50,000 League members nationwide will share equally with all other citizens the results of your deliberations and action.

The League however, was organized nearly a half century ago with purposes and objectives which compel us to question certain provisions of H.R. 13270 relating to tax deductible organizations, foundations and contributions. It seems clear that the tax bill as now written and approved by the House will frustrate the conservation effort and wipe out the progress made in alerting the public to the deterioration of the national environment. The foundation and the private

donor have been a crucial part of this effort and deserve commendation and the support of the American public for turning idle wealth into socially productive use.

As with dozens of our colleague groups, the Izaak Walton League is tax-exempt under Section 501(c)(3) of the Code. Organized into National, state division and local units, our membership is open to all who want to do something constructive about our deteriorating environment. The League is not-for-profit and we neither contribute to or endorse candidates for public offices. We do, however, sponsor workshops on natural resource issues, provide speakers for public engagements, promote conservation education in the schools and in our communities, serve on committees of all kinds at every level of government, and on occasion take part in non-partisan legislative affairs, clean water bond referendums for instance, public hearings, protests and court proceedings . . . in short, action and the espousal of environmental causes as befits free and concerned citizens and the organizations they establish to bring before the public and the policy-maker alike environmental problems and alternatives to activities and projects destructive of natural resources and environmental quality.

The bulk of our operating funds comes from nominal membership dues. We do receive from time to time grants, bequests and contributions though we rely less on such donations than most of our colleague citizen organizations. Nonetheless, such funds are vitally important and often make the difference between staying out of the red and actually accomplishing something.

They are not easily obtained now and we believe that unless there are fundamental changes in the tax bill, funds for conservation causes from foundations and private donors will dry up altogether.

Even under present limitations of the Code, it is difficult to determine what activities are permitted (and to what degree) without violating the "substantiality" test of Section 501(c)(3). IRS has not seen fit to define "substantial." There is a fine line between education and propaganda, between the communication of ideas and the endorsement of proposals, and between editorializing and the espousal of a cause. It is no easy line to walk now. Under the new law it will be impossible. The foundation manager would be required not only to make precise judgments on the intent and good will of groups approaching the foundation for funds but also supervise minutely the expenditure of every penny of each grant made. The 100% tax liability and 50% penalties prohibits him from making such judgments without subjecting his foundation to inordinate risks. We believe it would be tragic that such punitive measures be applied to bona fide public service foundation. It would be manifestly unfair and discriminatory to do so, while at the same time permitting *for-profit* interests, many of which are responsible for environmental degradations, such as water and air pollution, to take business deductions and make "good will" contributions under Section 160 of the Code for lobbying and propagandizing.

Just prior to the recent debate in Congress over the Timber Supply Act, for instance (an eye ball to eye ball confrontation between conservationists and the timber industry) full page newspaper ads appeared in the Wall Street Journal and allegedly some 11,000 publications, extolling the "necessity" of increasing the timber harvest on public lands. Placed by the forest industries because it was to their economic interest at that moment, the ad stated that the "Solution (to the timber shortage) lies in the hands of the federal government" and that timber representatives were meeting with the Congress about it. No doubt, the cost of these activities will be reported as business expense, and deducted, yet what other purpose could there have been but to condition the public to accept legislation conservationist believed to be against the long-range public interest.

The practice is common. For example, some public utilities issue streams of publicity on how harmless "thermal pollution" is or how necessary it is to run power lines through some of the most scenic spots on earth. The public picks up the "tab" for this education, of course. But what would be the IRS response, particularly under the proposed bill, if a citizen organization issued a release or placed an ad just prior to the debate on the Public Works bill pointing out to the public that "There is a Backlog of 4600 Unfunded and Needed Sewage Treatment Plants in the Nation. . . . The Answer Now Lies with Congress." The IRS response was made clear in the Sierra Club case. They would be set upon. It is ironic that the public, the Izaak Walton League for example, should be flatly denied the opportunity to publicly support and urge support of appropriations to implement the Clean Water Restoration Act of 1966 in which Congress itself set a national policy and goal and which is now the law of the land. While on the

other hand an industry for whatever reason could oppose those appropriations through every means at hand and write off the cost as a business expense. Ridiculous as it sounds, this is the unfairness which exists now and would be worsened by the proposed bill. And yet, what have we to gain in personal profit or to protect except the health and safety and wholesomeness of the world we all live in.

It would be presumptuous for us to comment on the values that conservationists, organized or not, tax-exempt or not, bring to Society. Walter Lippmann once wrote that the public "does not rouse itself normally at the existence of evil. It is aroused at evil made manifest by the interruption of a habitual process of life." People become accustomed to evil as they become accustomed to crowding, pollution and all forms of environmental deterioration. Whether it is valuable for the Nation to have concerned, active and aggressive citizens on the scene to remind us that we are becoming "accustomed" and that rivers like the Potomac do not have to be foul sewers nor the air unfit to breathe, is a question which Congress will decide. We believe that the issue with respect to the tax deductible section of the Reform Bill is just that plain!

Americans expect and deserve meaningful tax reform, and prohibitions against self-dealing transactions, the hiding of capital gains and similar abuses of the law's intent. But we cannot help but feel that many public service, non-profit, organizations and foundations must share our apprehensions at being the "babes" likely to be thrown out with the bath water, while well-financed and protected special interests can continue to blight the environment in the name of progress.

The League believes that the section on tax-deductible organizations and the foundations that support them should be far different, *literally* "reformed." Nonpartisan legislative activity and public education (propagandizing if you will) are vital to the workings of our democratic system. Legislation has become the corner stone of our democratic system. Legislation has become the corner stone of our complex social, economic and political society. It is impossible to do anything without influencing legislation. Even complete apathy and inaction influences legislation. If citizens band together to tax their financial resources and energies in an attempt to be heard, to have their viewpoints considered, our tax laws should encourage it. We do not believe this has been thoroughly explored, let alone faced.

Again, the issue is not the protecting of the League's tax-exempt status since we believe we now operate well within the limitations imposed by Section 501 (c)(3). We will continue to do so or voluntarily give up our tax status. Rather the issue is whether we as a Nation will encourage special treatment for the despoiler and the polluter while imposing additional sanctions on those who seek to turn idle wealth toward the betterment and restoration of the environment.

Mr. Chairman, we respectfully recommend that those sections in the Tax Reform bill relating to tax deductible organizations, foundations and contributions be stricken from the bill and referred for separate hearings with full opportunity for all concerned to be heard.

Thank you.

STATEMENT BY ELDRIDGE R. PLOWDEN, ED. D. ON BEHALF OF CHAPMAN COLLEGE, ORANGE, CALIF.

Mr. Chairman and Members of the Committee, my name is Eldridge R. Plowden. I am the Provost and Washington Representative of Chapman College, Orange, California. Thank you for permitting me to call your attention briefly to a matter of vital concern to this relatively small, but we believe, representative, private, independent, liberal arts institution, which is typical of the great majority of our American colleges.

While I am authorized to speak for only the one college - Chapman, we believe it can be regarded as a microcosm of higher education in America--excluding, of course, the one hundred or so large universities which serve the nation with such great distinction.

The small colleges, supported by church organizations and public spirited individual donors have, for well over a century borne the heaviest burden of higher education in this country, and deserve the gratitude of the nation for the large and singular contribution to the national development and well-being.

Chapman College is and will continue to be dependent on the volutary gifts of its friends and patrons if it is to continue effective service to the youths its

program attracts—unless government assumes the costs now borne by free-will contributions. Chapman does not oppose the concept of federal aid to education at any level, but it does wish to continue to be a free, independent, self-financing institution insofar as possible.

We fully sympathize with the effort of the Congress to restructure the tax system to eliminate the inequities and inconsistencies in the law. But we feel strongly that the legislation presently being considered, in the form passed by the House of Representatives, unless modified in some respects by the Senate, will greatly reduce these essential voluntary contributions on which our college depends for its operation, progress, development and growth.

Chapman College feels that several provisions of the proposed legislation may well influence adversely the will of prospective donors to contribute to our college. We are especially concerned with three aspects which we believe will be most injurious to our fund raising program.

1. ALLOCATION OF APPROPRIATION TO TAX PREFERENCE INCOME WILL HURT GIVING. (SEC. 302 AND 301)

The section which treats the appreciation in the value of property donated to charity as an item subject to the provisions dealing with Tax Preference Income we hope will be deleted. This provision constitutes an indirect method of taxing the appreciation on gift property and will undoubtedly tend to keep such gifts from being made.

Also, a donor would have no way of knowing the actual effect of his gift on his tax position until the end of the tax year. He would tend to delay making such a charitable gift. It is well known that a postponed gift is often a lost gift.

We respectfully request therefore that the Committee reconsider this provision and not make charitable gifts subject to the tax preference income allocation rule.

2. COLLEGE GIFT INCENTIVE SHOULD BE RETAINED. (SEC. 302)

We also feel that the section which includes all charitable contributions within the allocation of deductions will have a decidedly inhibiting effect on prospective donors. The requirement would reduce greatly the present fully justified incentive to make such charitable contributions. For more than a half century the Congress has periodically liberalized the tax incentive to charitable giving. This provision reverses that trend.

We do not understand how the full deduction of charitable contributions can be regarded as a loophole. The motive is not profit, but, in the case of college giving, has to be a sincere and honest desire to enhance the national welfare. We greatly hope that the Committee will see fit to delete this section.

3. CHARITABLE REMAINDER TRUSTS SHOULD BE RETAINED. (SEC. 201 (E), (H), AND (I))

Chapman College feels that the proposal to substitute the highly complicated charity remainder trust and the charitable unitrust for the simple charitable remainder trust now widely used and understood in the processes of making gifts to colleges is uncalled for and unwise. The Internal Revenue Service has adequate means at its command to curb any abuses in connection with remainder trusts. We feel that the greater flexibility of such residual trust funds provide desirable latitude in the management of college resources.

Chapman College has just completed the construction and equipping of a two million dollar science complex, made possible by deferred gifts from individuals who sometime ago set aside certain parcels of real property as a charitable gift to the college to be available on the termination of the estate. The considerable increment in value, since being permanently set aside for a charitable gift, did not increase the estate tax, but the college gained greatly thereby.

We had expected to begin the construction of a Fine Arts Building, also to be partly funded from deferred gifts of appreciated property. This project will have to be held in abeyance, pending the outcome of the legislation under consideration and the determination of its effect on such deferred gifts from estates.

Chapman College does not believe that the Congress intends, through this proposed revision of the tax law, to make the task of securing adequate gift funds for its operation, improvement and growth inordinately more difficult. We are completely in sympathy with the desire of the Congress to eliminate the abuses that such charitable gifts are subject to at times.

However, we do feel that incentives for making bona fide charitable gifts to colleges should not be abandoned in the effort to "plug the loopholes" that are at times used for tax evasion.

Such instances as do occur, usually constitute fraud, with which the Internal Revenue Service is now adequately equipped to cope. We believe the Committee in its wisdom can find means to deal with problem cases without hurting the colleges.

Thank you.

JULIETTE M. ATHERTON TRUST,
Honolulu, Hawaii, September 4, 1969.

Hon. RUSSELL B. LONG,
Chairman, Senate Finance Committee,
Washington, D.C.

DEAR SENATOR LONG: We are deeply concerned about the possibility that Congress will enact legislation to tax the investment income of charitable trusts and foundations. The effect of such a tax would be to reduce the amount of income available for grants to many worthy charitable, educational and religious organizations in Hawaii, as well as throughout the Nation and the World. We sincerely ask that you carefully study such legislation before supporting any measure to tax charitable trusts and foundations.

Enclosed you will find a copy of our annual report for 1968 which includes a list of the grants authorized by this Trust last year.[1] We will be pleased to furnish any further information you may desire concerning the Atherton Trust.

Yours very truly,

DONALD C. MAIR,
For the Trustees.

CONSOLIDATED TESTIMONY OF THE ORGANIZATIONS AND INSTITUTIONS OF THE SEVENTH-DAY ADVENTIST CHURCH, SUBCOMMITTED BY HOWARD R. WEEKS, PH. D., VICE PRESIDENT FOR PUBLIC RELATIONS AND DEVELOPMENT, LOMA LINDA UNIVERSITY

The purpose of this statement is to register support for certain proposals contained in H.R. 13270, the Tax Reform Act of 1969; to register opposition to other proposals and to acquaint the Congress with their adverse effects on specific programs of urgent social importance conducted by the Seventh-day Adventist church and its medical and educational institutions.

The church believes that the Congress should forthrightly adopt tax rules that prevent individuals from exploiting to their personal advantage the long established tax incentives to philanthropic support. However, it believes just as firmly that some of the rules proposed to accomplish this in H.R. 13270 would grievously injure the philanthropic causes themselves—greatly out of proportion to the tax revenues they might preserve for the federal government.

The result would be incompatible with the historic principles of the Congress and of the pluralistic society it represents—that is, an unacceptable weakening of our free institutions, among which are those participating in this statement.

THE ADVENTIST CHURCH AND ITS PUBLIC SERVICE PROGRAMS

The Seventh-day Adventist church is a religious denomination whose 400,000 members in the United States support medical, educational, and social welfare programs in this country and throughout the world. Their well-known hospitals serve both national and overseas personnel in many lands. Their programs of both general and medical education, particularly since the turn of the century, are a well established national resource.

The Seventh-day Adventist educational and medical system in the United States includes two universities, eight colleges, seventy-nine secondary schools, 895 elementary schools, twelve schools of nursing, and thirty-one hospitals. The schools annually enroll 89,200 students; the hospitals annually treat 659,000 patients.

One small measure of the social usefulness of these institutions is the fact that among the ten undergraduate colleges in the United States with the highest proportion of male graduates later earning M.D. degrees, during the past decade

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[1] The annual report was made a part of the official files of the committee.

(1950–1959), four were Seventh-day Adventist colleges. (Public Health Monograph No. 66—U.S. Department of Health, Education and Welfare, p. 18.)

LOMA LINDA UNIVERSITY—A MAJOR ILLUSTRATION

The principal center of Adventist medical education and the institution illustrating most clearly the adverse social effects of some sections of H.R. 13270, is Loma Linda University, with campuses at Loma Linda and Riverside, California, about sixty miles east of Los Angeles. This institution, in terms of its assets of $65,000,000, ranks fourth among the independent universities of California. Its annual budget is approximately $35,000,000.

Programs of Medical Education and Research.—In addition to graduate and undergraduate programs in the arts and sciences and education, Loma Linda University offers professional programs in medicine, dentistry, nursing and other health related professions, and public health (incidentally the only privately supported school of public health west of the Mississippi).

Among the 13,000 graduates of Loma Linda University are 4,035 physicians, making this university first among all those in the State of California, public or private, in terms of graduates who are medical doctors.

Significant medical and public health research is conducted and the School of Medicine serves as the focal point of Regional Medical Program, Area VI, encompassing Riverside, San Bernardino, Mono, and Inyo Counties.

The only university medical center in inland Southern California, Loma Linda serves also as a patient referral and diagnostic center for an even wider area, extending into portions of Nevada and Arizona. Because of the assurance of medical school cooperation, a proposal to locate a new veterans hospital at Loma Linda is presently receiving serious consideration by the Congress and the Veterans Administration.

Graduates Serve Nationwide.—Of even greater importance nationally is the fact that because of the university's national constituency and support, Loma Linda students come from throughout the United States as well as many foreign countries. Consequently, medical, dental, and public health graduates of Loma Linda return to serve in virtually all states, and to staff many of the overseas hospitals operated by the church. Approximately 50 percent of Loma Linda's medical school graduates serve outside California, compared with approximately 15 percent of those who graduate from the University of California.

Gifts of Future Interest Makes Medical Center Possible.—This comprehensive university medical center has been concentrated in inland Southern California for only four years. Previously, its clinical programs were conducted in Los Angeles. Its service to this more needy area has been made possible by the erection of a new medical center at a cost of some $24,000,000.

It is safe to say that this complex as it now exists with all its values to society would almost certainly never have been built without the backing of assets contributed irrevocably to the university in various charitable trusts, life income agreements, and annuities by alumni and other persons interested in medical education. These deferred gifts provided the security necessary for the long-term financing required for construction of the medical center.

Similar gifts are essential for the future development of the university that will enable many more young people even than at present to prepare for professional service to the nation.

Loss of Tax Incentives Will Imperil Private Support.—The large gifts necessary in major enterprises of this kind frequently if not usually consist of properties substantially appreciated over the donor's cost. The fact that under long established rules such gifts may be made on a deferred basis at their fair market value without tax burdens imposed on the appreciated portion is a crucial factor in the decision to give.

Donors to Loma Linda University, for the most part, could not possibly afford to make these major gifts under the rule changes now proposed. The practical effect of these rule changes, therefore, will inevitably be a drastic curtailment of the private support of this institution and its programs of medical education, as well as the programs of similar charitable organizations.

A study published last year (Fall, 1968, pp. 35–45) in *College and University Journal* well documents this warning. If the capital gains tax had been imposed on the appreciated values included in major gifts analyzed in this study, donors would have reduced the amount of those gifts by 34 percent—even if the full fair market value had been deductible. Had deductibility been limited to the cost basis, donors would have reduced the amount of their gifts by 46 percent.

Proposed Rules Penalize Once-in-Lifetime Donor.—Loma Linda's experience fully supports this study with respect to the deferred gift of a future interest in appreciated properties. In fact, this university would in all probability suffer an even more drastic reduction in giving than the study indicates because its gifts of this kind often represent all or a major portion of the donor's estate.

Such gifts are not the gifts of "operators" more interested in personal gain than in philanthropy. They are once-in-a-lifetime gifts in which a husband and wife, providing only for their retirement years, commit substantially all they have to the education of youth.

Obviously these persons could not afford such acts of philanthropy were they to be penalized by the proposed tax rule changes. The losers would be young people deprived of the opportunity for professional education or receiving less quality in education than they might otherwise have.

When it is realized that during the past seven years, 1962–68, irrevocable gifts in trust constituted 47 percent of the private support of Loma Linda University, it is clear that any substantial reduction because of the proposed rule changes would be a serious blow to this educational program.

Proposed Changes Presently Damaging.—In fact, this committee will wish to know that certain of the proposed changes are *already presently* seriously diminishing the support of Loma Linda University because of their retroactive character. In process and ready for signature at the time this legislation was introduced were major deferred gift agreements that would have brought approximately $9,500,000 to the university. The possibility that the proposed taxes may be imposed retroactively has made it impossible to complete these agreements. One can only imagine the present effect on the support programs of much larger institutions of higher learning.

The only hope of realizing these gifts is for the adverse tax proposals to be eliminated so that the long established rules with their incentives for the support of education, medicine, and other socially valuable programs may continue to function.

Moreover, Loma Linda's corps of highly trained field representatives, like that of other units of the church, has been marking time during this period of uncertainty, unable to advise or assist prospective donors concerning the future tax consequences of a gift in trust made now. The time and expense of these men is a loss to the university, in addition to the deferred gifts they normally would receive.

These are *present* losses, merely under the shadow of the proposed changes. Extend this indefinitely into the future if the proposed changes are actually made, and the long-term damage is evident.

Proposed Changes Would Inhibit Future Growth.—Loma Linda University is now initiating a new ten-year development plan in which it is hoped that, in keeping with the national need and interest, enrollment in the medical curriculums can be significantly increased. In medicine, for example, the university hopes to increase enrollment by as much as 45 percent.

The proposed tax changes, however, with their radically reduced incentives to giving, cast substantial doubt on our ability to accomplish this. The same damaging effect will be felt in other university, college, and hospital programs of the church if tax rule changes that curtail deferred giving are adopted.

PRIMARY AREAS OF CONCERN

The Seventh-day Adventist church, with its organizations and institutions has special concern for those sections of the proposed legislation dealing with charitable remainder trusts, like income contracts, and the allocations of deductions, as well as the retroactive character of some of the suggested changes.

Charitable Remainder Trusts.—In charitable remainder trusts [Bill Section 201 (c)(d)(1)] there should be no capital gains tax upon transfer of appreciated property to a trust or upon any subsequent sale, because such gains are permanently set aside for charity, not for the donor.

The current fair market value should be recognized as the basis for computing the charitable remainder according to existing tables.

If abuses in investment policies exist which result in the wasting of trust corpus to produce unusually high current income, such abuses should be curbed by means other than those proposed in the bill, section 201(e).

Life Income Contracts.—In life income contracts, the same tax incentives which we believe should be maintained for charitable remainder trusts should also be

maintained for life income agreements. That is, the charitable contribution deduction should be based on the fair market value at inception, without capital gains tax; and no capital gains tax should be imposed on any future gain realized by the life income fund, as these gains are irrevocably set aside for charity.

Allocation of Deductions.—The proposed allocation of deductions between taxable and non-taxable income introduces burdensome complications in computation and results in penalties imposed on charitable contributions, both deferred and present.

Charitable contributions should not be included with the deductions to be allocated between taxable and non-taxable income, thereby reducing the charitable deduction.

Appreciation on assets contributed to charity should not be included in non-taxable income because this reduces not only the charitable deduction but also all other deductions which are subject to allocation.

The extremely complex nature of the allocation formula itself will tend to discourage charitable gifts.

Retroactive Provisions.—The retroactive character of some of the proposed changes (variously April 22, 1969, May 26, 1969, and December 31, 1969) is detrimental to present support programs and unfair to donors now making substantial gifts. Any changes should be effective only as of December 31, 1969.

SECONDARY AREAS OF CONCERN

Secondary areas of concern relate to rule changes that will detract from private support, but which are not quite so damaging as those discussed above. These include:

The proposed elimination of the two year charitable short term trust which provides income to the charity without tax to the donors;

Disallowance of use of property as a charitable deduction;

Change of rules regarding bargain sales, taxing a portion of the appreciation.

AREAS OF CONCURRENCE

The Seventh-day Adventist church as a whole concurs in other provisions of the Bill, notably those that will enhance the support of private education:

Increase of the ceiling on charitable deductions from 30 percent to 50 percent;

Stimulation of increased disbursement of foundation assets for their intended purposes.

However, the church also supports the principle of taxation on income generated by debt-financed investments (Clay Brown legislation); and the extension of tax to unrelated business activities conducted by charitable organizations.

In addition, it would fully support legislation aimed at correcting any situation in which a donor has more after-tax income because he makes a gift than he would have without the gift; provided, of course, that such legislation is carefully drafted so as to cure only the abuse and not discourage or penalize legitimate charitable gifts. The major objection to some of the proposed changes is that the attack on the problem of abuse is so broad that it would gravely injure the charitable beneficiaries out of all proportion to the abuses that would be corrected.

The church would also support any legislation aimed at the elimination of charitable deductions where the chances are remote that the charity will ever benefit from a deferred gift (i.e.: contingent remainder gifts, deferred gifts of art objects, etc.) with the proviso once again, that the legislation is not so broadly drafted as to discourage legitimate deferred giving.

If, as the report of the Committee on Ways and Means of the House indicates, there are instances where safety of trust principal is disregarded in order to maximize current income for the lifetime beneficiary, thus eliminating or substantially reducing the charitable remainder, the church would support legislation designed to cure this evil on an individual basis, but not by a blanket denial of the present tax advantages of the charitable remainder trust which is conservatively administered in harmony with well established trust laws and procedures.

Actually, it is more likely that the charitable remainder will be increased under prudent administration in times of economic expansion such as this nation has experienced in recent years, than that the trust estate will be dissipated by endeavors to secure an unreasonably high return for the donor.

SUMMARY

Tax rule changes proposed in H.R. 13270 with respect to charitable contributions and especially to deferred gifts of future interest would *seriously curtail private support* of the medical, educational, and social welfare programs of the Seventh-day Adventist Church.

Most critically injured would be the Adventist medical training program at *Loma Linda University* in southern California.

With more physician graduates than any other university in California, Loma Linda receives *47 percent of its private support* in gifts of future interest in irrevocable trust, usually consisting of appreciated assets.

Attributable to this source of support is the *existence of its new University Medical Center*, an important regional and national asset, with a large proportion of its medical graduates serving throughout the nation.

Plans for an increase in medical enrollment would be *jeopardized* by any diminishing of private support.

Donors of large amounts in trust with Loma Linda are *not* the stereotyped *"loophole" seekers.* They represent a *wide range of people*, and more often than not are likely to be a husband and wife conveying all or most of their entire estate in a *once-in-a-lifetime gift* to a socially useful cause in which they believe. Tax penalties on appreciated values contributed would make it impossible for them to make these sacrificial gifts so vital to the institution.

The *retroactivity* of some of the proposed rule changes has already caused the probable loss of approximately $9,500,000 to the University. *Any* changes made should be effectively only as of December 31, 1969, to avoid great unfairness to persons who have made gifts during this calendar year.

Placing a *justifiable reliance* in the *historic Congressional position* in support of charitable institutions through tax incentives, most Seventh-day Adventist organizations and institutions have developed a *staff* of field representatives and office specialists to encourage and process deferred gifts. This costly apparatus is now largely *unproductive* as the result of the tax changes proposed.

The primary concern is that appreciated properties given in a *charitable remainder trust* should incur *no capital gains tax* on transfer or on subsequent sale—these gains are for the benefit of charity, not the donor. The *fair market value* should be the basis for computing the charitable remainder.

The same provisions should apply to *life income contracts.*

The *allocation of deductions* concept is so *burdensome* as to discourage even present giving. Charitable contributions, benefiting a charity, are not like accelerated depreciation, etc., whose primary benefit is to the individual. Charitable contributions should not be included with other allocable deductions, nor should appreciation of assets contributed be included in non-taxable income.

The Seventh-day Adventist church, with all its organizations and institutions, wishes to continue and enlarge its services to the nation in medical education and social welfare. It appeals to the Congress to preserve the long-established tax incentives to charitable giving that make such services possible. It will support measures to prevent individual exploitation of such incentives where measures avoid substantial damage to charitable causes themselves.

THE AMERICAN PUBLIC HEALTH ASSOCIATION, INC.,
New York, N.Y., September 10, 1969.

Senator RUSSELL LONG,
Senate Office Building,
Washington, D.C.

DEAR SENATOR LONG: I am writing to call your attention to the adverse impact which H.R. 13270 (The Tax Reform Act of 1969) may have on the private schools of medicine and public health in the United States, and to urge you, while making needed tax reforms, to avoid enacting measures which will also seriously reduce bona fide financial support of private medical and public health education.

As President of the American Public Health Association, Chairman of the Department of Preventive Medicine and Public Health at UCLA, and former Director of the California State Department of Public Health, I am familiar with the problems of training health care professionals, especially the sky-rocketing costs of buildings, equipment and instruction.

Private schools of medicine and public health must rely primarily upon donations for their financing. Loma Linda University is one example with which I am familiar, but there are other examples just as needful throughout the nation.

Loma Linda University has just established (in 1967), in addition to its Medical School, a School of Public Health approved by the American Public Health Agencies. It is the only private institution west of the Mississippi operating such a school, one of but three schools of public health in California. The Medical School at Loma Linda has been turning out substantial numbers of excellently educated physicians who practice all over the United States.

Although not a Seventh Day Adventist, I understand that the genesis of Loma Linda University and the motivation for its support is essentially missionary in character, in the best sense of that term. It is designed to spread principles of good health as a part of the Seventh Day Adventist religion. This characteristic does not detract from its contribution to the training of physicians and other health service professionals. If anything, it reduces Loma Linda's costs in comparison with other institutions and it stimulates alumnae and members of the Church to be generous in financial support.

As evidence of the fact just stated, I am informed that over 45 per cent of the private support of Loma Linda comes from gifts in trusts of a type that would be adversely affected by the legislation you are considering.

I hope you will measure with care the probable impact of H.R. 13270 on support of private medical institutions such as Loma Linda University and find some way to eliminate that impact. Such schools supply a large percentage of the physicians and other health professionals throughout our country today. Any diminution in their production of trained personnel would be detrimental to health programs already adopted by the Congress, such as Medicare. It would be a substantial obstacle to maintaining health in our nation which now requires many more physicians than we now have.

I urge your staff to gather all available facts on the medical personnel needs of our country, for example from the Department of Health, Education, and Welfare. These facts will indicate to you the demands that our country is making upon the private medical and public health institutions, and the financial needs of those trainee institutions to meet our country's needs.

Thank you for your attention.

Sincerely yours,

LESTER BRESLOW, M.D.,
President, APHA.

STATEMENT OF THE COMMITTEE OF FRIENDS OF THE MUSEUM OF MODERN ART, SUBMITTED BY MONROE WHEELER, VICE CHAIRMAN

STATEMENT ON THE PROPOSED TAX TREATMENT OF CHARITABLE CONTRIBUTIONS BY ARTISTS OF THEIR OWN WORKS

The Committee on Finance of the U.S. Senate currently is considering two proposals to alter the tax treatment accorded the donor who makes gifts of works of art to museums. The first of these is contained in the Tax Reform Bill of 1969 (H.R. 13270) recently passed by the House of Representatives. The second was submitted to the Committee by the Treasury on September 4, 1969.

The House bill would alter drastically the tax treatment of any donor who makes a gift of a work of art to a museum. In our judgment it would greatly hamper the further growth and development of museums in the United States and thereby would damage greatly the quality of cultural life available to Americans generally.

The Treasury proposal would have a more limited effect. It would recognize the great dependence of American museums on contributions by collectors and, in the case of such gifts, would continue the practice of allowing the donor an income tax deduction equal to the fair market value of the item given even if that value exceeded his original cost.

However, both the House bill and the Treasury proposal would change the long-standing rules concerning contributions by artists (and by others who would have ordinary income if the work were sold). Since 1917 artists have been subject to the same rule of deductibility as have been collectors—that is, they have been entitled to income tax deductions equal to the fair market value of their works contributed to museums.[1] Under the House bill and the Treasury proposal an

[1] See Law Opinion 1118, II-2 Cumulative Bulletin 148 (1923).

artist making such a contribution in the future would be required either to include the appreciation in value in income, as ordinary income, or to claim a deduction only in the amount of his out-of-pocket cost of the item given. Effectively, he would be deprived of any meaningful deduction on a contribution of one of his own works to a museum.

Our Committee supports the Treasury proposal concerning the tax treatment to be afforded contributions by collectors. We think that the Treasury officials stated extremely well the case for continuing a rule of full deductibility for such contributions and we do not propose to restate that case here. However, in the case of contributions by artists we think that both the Treasury proposal and the House bill propose rules that are too drastic. Many museums—such as the Museum of Modern Art in New York and a number of regional museums and university museums—depend heavily on such contributions.

We suggest that a middle ground exists—a tax rule that would encourage a continued flow of contributions by artists to public museums but would recognize the fact that the appreciation in value of self-created works arises from the donor's own efforts and would not accord a greater after-tax increment to an artist contributing a work than to an artist selling a work. In part II of this memorandum we suggest a specific change to the House bill that we think would accomplish these objectives.

I. DEPENDENCE OF MUSEUMS ON DONATIONS IN KIND

Most American museums do not have significant endowed purchase funds for works of art. Unlike their European counterparts, they do not receive government subsidies for their acquisition programs. While the lack of funds for acquisitions is a general problem among museums, the problem is most acute among smaller and newer museums and among museums that wish to acquire contemporary works of art.

In these circumstances both the establishment of new museums and the growth of the collections of existing museums are dependent principally on private philanthropy in the form of donation of works of art by individuals. In effect the rules permitting charitable deductions to such individuals equal to the fair market value of the donated art objects have comprised the sole significant governmental support for the establishment and growth of museum collections during the last fifty years. That the growth of these collections during this period has been spectacular must be attributed largely to this subsidy. Should it now be removed without provision being made for a substitute source of acquisition funds—such as the direct governmental subsidies enjoyed by European museums—the effect must be to reverse the trend to the detriment of the American public.

During the calendar years 1966-1968, almost 65% of the dollar value of the works of art acquired by the Museum of Modern Art was received as gifts. While the dependence of the Modern Museum on such gifts is very great, it screens carefully works offered before accepting them as donations. The Modern refuses more gifts than it accepts, its primary purpose being to maintain standards of quality consistent with its duty to the public. For the Modern, as for most museums, collectors are the most important source of donations: However, as one of the museums exhibiting important works of contemporary American culture, the Modern also is greatly dependent upon donations by artists. Since its founding, it has consistently encouraged artists to donate selected works to its collection of twentieth-century art.

Today's museum is not merely a storehouse for the treasures of the past. It has become a vital force in the development and dissemination of the flourishing arts of our time, providing the public, scholars and artists with the opportunity to see, enjoy and study current work and work of the recent past. To such a museum it is essential that living artists be encouraged to contribute works of their own creation.

II. LEGISLATIVE PROPOSAL

(A) General statement

As has been shown in part I of this memorandum, the rules proposed by the House of Representatives restricting charitable contribution deductions for all contributions of paintings or other tangible personal property will in effect deprive public museums of the only meaningful governmental support generally available for their acquisition programs. The rules proposed by the Treasury

would have a more limited effect, but still would be damaging to museums exhibiting works of contemporary culture.

Our Committee would propose a new approach to the problem of contributions by artists (or by others who would be taxed at ordinary income rates upon a sale of the work). We recognize the anomaly—stressed by both the Ways and Means Committee and the Treasury—of the present rules under which an artist may enjoy a greater after-tax increment by contributing a work he has created than by selling it. However, we do not think that the extreme approach of H.R. 13270 and the Treasury proposal—which would deny virtually any deduction to an artist making a contribution of one of his works—represents the optimum solution to the problem.

We recommend the application of the tax-neutrality approach, stressed by the House, to contributions by artists. Specifically, contributions by artists to *public* museums would be deductible—without recognition of income—but only as to a percentage of the value of the work contributed, that percentage to be fixed so that a top-bracket artist may achieve approximately the same after-tax return by contributing his work or by selling it. We think that such an approach will encourage artists to make decisions as to whether a work should be sold or donated to a museum on the basis of non-tax considerations. On the other hand, we regard the provisions of the House bill and the Treasury proposals as affirmatively discouraging contributions by artists and, thereby, as violating the concept of tax neutrality.

As an example of our proposal, if the top tax bracket applicable to income from a sale of a work of art by its creator were 65% (as is proposed by H.R. 13270 for 1972 and thereafter), the percentage of value deductible when an artist contributed his work to a public museum would be approximately 55%, since the value of the resulting deduction to the top-bracket artists then should approximately equal the after-tax residue had he sold the work. Similarly, if such top-bracket were 50% (as would be the case if the earned income rates of H.R. 13270 were made applicable to the income from such sales), the entire value would be deductible since with a 50% top rate and a 100% deduction, an artist could expect to retain about one-half the value of his work whether he sold it or donated it to a public museum.[3]

We think that by limiting our proposal to institutions that genuinely qualify as "public" in that they are open to the public on a substantially full-time basis—whether or not operated by a governmental unit—we would effectively prevent abuses. Truly public institutions can be relied upon not to sacrifice the public interest to the tax advantage of particular individuals.

(B) Proposed amendment

Specifically, our Committee proposes that H.R. 13270 be amended in the following respects:

(a) Section 201(c) of the bill would be amended by including in proposed Section 170(e) of the Code a new definition of a "public institution"—an institution:

(i) whose facilities are open to the public on substantially a full-time basis *and*

(ii) that exhibits items of the type donated or makes such items available for use or study by the public.

(b) Proposed section 170(e) and proposed Section 83 would be amended to provide that donations of tangible personal property that would produce ordinary income on sale (other than letters or memoranda prepared for the taxpayer and described in Section 513(a) of the bill) made to institutions qualifying as "public institutions" under the foregoing two tests would not be subject to the rule of income recognition and would be subject to the rule of reduction of the contribution, but only to the extent necessary approximately to equalize the tax effects to a top-bracket donor of a gift of the work and a sale of the work.

Our proposals are designated to benefit the huge segment of the public that does not have access to important works of art except through public museums. While we have not had adequate time to compile statistics it appears that the revenue loss should be very small. The Report of the House Committee on Ways and Means (Part 1 and page 62) estimates the revenue increases from *all* charitable

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[3] Our committee understands that an extension of the 50% earned income rate to artists will be proposed to the Senate Finance Committee. We would strongly favor adoption of such a proposal.

contributions portions of H.R. 13270 to be $5 million in 1970 and $20 million in 1974. By way of contrast, *The New York Times* of July 19, 1969 reported that the City of West Berlin spends $25 million per year on subsidizing the arts.

THE UNIVERSITY OF SANTA CLARA, CALIFORNIA,
September 12, 1969.

HON. RUSSELL B. LONG,
Chairman, Senate Committee on Finance,
Washington, D.C.

DEAR SENATOR LONG: I had asked and hoped to appear to testify in person but I fully understand why the list of witnesses had to be pared to a reasonable number. I shall be brief in what I have to say about HR 13270.

We fully understand the need for substantial tax reform—the need for a better measure of equity in assessment of taxes by the Federal Government. Now, however, not only the University of Santa Clara but also all of higher education and, indeed all of philanthropy, are faced with a hastily passed Bill, the provisions of which, in my opinion, do violence to the philosophical principles that have guided and guarded our traditional American principles of self help and self reliance in solving our own problems.

Since its founding in 1851, 17,500 men and women have obtained their academic or professional education and training in 23 fields of study at the University of Santa Clara. No tax dollars had any part in enabling them to do so. Most of the cost was borne in the traditional American way of self help—tuition, payments by students, contributions of teaching by the religious who served practically without compensation, and finally, and most important, by the gifts of unselfish individuals who wished to serve the cause of higher education and, in so doing, are not unmindful that Congress has always by its declarations and its enactments affirmatively provided an incentive for philanthropic giving to the end that privately supported higher education might flourish in this country.

We applaud warmly some of the Bill's provisions that seek to abolish abuses and eliminate inequities, even though some of them would result in some diminution of gift support. Any provision of the law or supporting regulations which are susceptible of abuse should, of course, be eliminated.

Unfortunately, this too hastily passed piece of legislation includes strictures that would inhibit the incentives for philanthropic contributions which until now the Congress has always affirmatively encouraged.

Our principal objections relate to the suggested treatment of gifts of property, specifically, in our opinion, the inclusion of philanthropic gifts in the other items categorized in the provisions for Limited Tax Preferences and subsequently in the Allocation of Deductions. The deductibility of charitable gifts which benefit society as a whole is not of the same nature and it not to be compared with the other items in the LTP category, which are solely a benefit-detriment by-play between the tax payer and the Treasury. True, the philanthropic donor does derive some tax benefit from his gift and the Treasury suffers some loss of revenue because of it, but the giver's net worth is lessened and society's welfare heightened.

The provisions relating to the charitable remainder trust which eliminate the advantages of the normally heretofore approved deduction for the gift and the charitable remainder will cause incalculabe damage to higher educatiton. The fact is that many, if not most, who are philanthropically inclined will refrain from making such contributions. The result will be that appreciated property will be retained and there will neither be a benefit to the Treasury by way of capital gains tax, nor will the college be able to inaugurate programs knowing full well that they can be some day financed by the dollars they have in hand.

A final objection relates to the retroactivity promulgated when it was announced in August that April 22 was the effective date for charitable remainder trusts, life income contracts, gift annuities, short term trusts and bargain sales. Neither the University nor the donor, both of whom acted in good faith in entering into some of these transactions, knew until early August that the tax result of the gift might some day, if the Bill were to be passed in its present form, be altered.

Taken as a whole, the net effect of the Bill is to stop the flow of major philanthropic giving, and if some of the restrictive provisions I have referred to are enacted into law it will only mean that privately supported institutions like the

University of Santa Clara will shrink in their scope and quality, and that higher education will then need more tax dollars to serve the nation as it must.

I appreciate the opportunity to present these views to you in writing because I am convinced that this law as it now stands is the greatest legislative threat which has ever faced private higher education in the United States.

Sincerely yours,

THOMAS D. TERRY, S.J., *President.*

BOARD OF NATIONAL MISSIONS,
OF THE UNITED PRESBYTERIAN CHURCH
IN THE UNITED STATES OF AMERICA,
New York, N.Y., September 24, 1969.

Hon. RUSSELL B. LONG,
Chairman, Senate Committee on Finance,
Senate Office Building,
Washington, D.C.

MY DEAR SENATOR LONG: The Senate Finance Committee is presently holding hearings on the Tax Reform Act of 1969, Bill H.R. 13270. Certain features of this act, as it was passed by the House of Representatives, are beneficial to philanthropic organizations such as the one I represent, the Board of National Missions of the United Presbyterian Church in the United States of America.

On the positive side is the intention to lift the limit of contribution deductions from 30% to 50% of a person's income for one year. Also the continuation of the five-year carry-over plan is helpful.

There are, however, certain features of the bill which will discourage potential donors from contributing toward the support of charity.

1. One of the strongest deterrents is the provision of section 201(1), page 135, line 3 which repeals the unlimited charitable deduction for appreciated gifts.

2. Another ill-advised feature is that the bill, as it now is written, will not allow charitable deduction on capital gains for life income contracts. Thus the donor will be held responsible for capital gains tax on a life income gift even after that gift is in the hands of and under the control of the recipient of his charity.

3. Third feature of the law with which we are in disagreement is Section 302, page 178, line 4 in which charitable and other deductions are reduced by allocation of deductions between taxable and non-taxable incomes. Therefore, because of his generosity, a donor must reduce not only his charitable deductions, but also his deductions for taxes, interest, medical expenses, et cetera.

The Federal Government has, over the years, continually liberalized the tax benefits for those who voluntarily contribute to our nation's philanthropies, each time stating that the liberalization was designed to further aid charities to meet rising costs and the increased needs of society. At this time when the Federal Government finds it necessary to curtail many of the programs which are designed to augment the work of charitable organizations, it is important that tax incentives be increased rather than decreased for those who generously contribute to causes that materially benefit mankind.

Anything you can do to assist in this matter will be greatly appreciated by us.

Very truly yours,

OSBORNE K. TAYLOR,
Vice Chairman, Development Committee.

STANFORD UNIVERSITY,
Office of the Chancellor,
Stanford, Calif., September 12, 1969.

Hon. RUSSELL B. LONG,
Chairman, Committee on Finance,
Washington, D.C.

DEAR SENATOR LONG: I am sorry that my request to testify in person was denied, but I understand why the number of witnesses has to be limited.

The need for tax reform has long been apparent; it has been the subject of much discussion. It is regrettable, therefore, that H.R. 13270 seems to have been passed with undue haste. Despite its several commendable provisions, it delivers a seriously damaging blow to the historic tradition of philanthropy and therefore jeopardizes the financial health of great institutions without providing even approximately commensurate revenue benefits.

In my judgment, the suggested treatment of gifts of property, specifically the inclusion of philanthropic gifts with the other items set forth in the provisions for Limited Tax Preferences and subsequently in the Allocation of Deductions, is wrong—fatefully wrong. The deductibility of charitable gifts which benefit society as a whole is not the same as the other items in the LTP category. The philanthropic donor does indeed derive some tax benefit from his gift, and the Treasury suffers some loss of revenue because of it—but the giver's net worth is reduced and society's welfare enhanced.

The provisions relating to the charitable remainder trust, which eliminate the advantages of the normally heretofore approved deduction for the gift and the charitable remainder, will cause incalculable damage to higher education. Many persons, if not most, who are philanthropically inclined, will refrain from making such contributions. They will retain appreciated property and, in consequence, there will be no benefit to the Treasury through capital gains tax, nor will the institution be able to inaugurate programs in the assurance that it can finance those programs with the dollars it has in hand in the expectation of later gifts.

Finally, the announcement in August that April 22 was the effective date for charitable remainder trusts, life income contracts, gift annuities, short term trusts and bargain sales introduced a retroactive provision which adversely affects both institution and donor, each of whom acted in good faith in entering into these transactions, only to discover that the tax result of the gift would, if the Bill were to be passed in its present form, be altered.

The net effect of the Bill will be to stop the flow of major philanthropic giving. If some of the restrictive provisions to which I have referred are enacted into law, privately supported institutions will diminish in quality and strength; higher education will become dependent on more tax dollars; and the healthy mix of private and public support which has provided the distinction and broad base of our nation's higher education will be lost. Such loss is not in the best interest of this nation.

I take the liberty of enclosing a statement I made to Secretary Douglas Dillon on 29 November 1961, when I served as spokesman for a number of colleges and universities. I still believe strongly in that statement.

Sincerely yours,

J. E. WALLACE STERLING.

MR. SECRETARY: We appreciate greatly your courtesy and interest in receiving us this afternoon.

Educators at every level, including those in higher education, speak today of "the crisis" in education. And well they might, because there is one. But informed people are aware of this fact, and we have not come here to belabor it.

Nor have we come to plead that all educational institutions are altogether virtuous or are the sole custodians of virtue. We deplore lack of virtue among ourselves when it is manifest, and are eager and willing to exercise self-discipline to correct errancy and abuse. In the field of taxation, we seek the opportunity to cooperate with your office to identify and eliminate such abuses as may exist.

We *have* come, however, to plead with all the earnestness at our command the high value to all of United States Higher Education, both public and private, of a tax structure which is congenial and conducive to generous gift support of higher education. If a given institution has erred, or should err, in a way which is abusive to its privileged tax status, we would urge on you the wisdom and propriety of not penalizing the many for the fault of the one or the few. We are confident that ways can be found of disposing of the bathwater while preserving the baby in good health.

We cannot over-emphasize the value of gift support to higher education: It is literally vital to the private sector; it is essential reinforcement to the public sector.

We would plead also that unresolved tax issues affecting the flow of such gift support be resolved with all reasonable speed. Until there is such resolution and clarification, the flow of gifts will be retarded by a prospective donor's understandable uncertainty and concern as to the tax consequences of his gift. We make this plea with genuine appreciation of the magnitude and complexities of the responsibilities of your office.

Finally, we would urgently request that your office discuss with representatives of higher education such tax changes or clarifications affecting gifts to education as your office may have under consideration, before official conclusions are drawn

and decisions made. And we respectfully suggest that the discussion we request be arranged with and through the American Council on Education.

Let me express again our gratitude for the opportunity you have accorded us of making this representation to you.

J. E. WALLACE STERLING.

NOVEMBER 29, 1961.

STATEMENT OF THE AMERICAN COUNCIL OF VOLUNTARY AGENCIES FOR FOREIGN SERVICE, INC., SUBMITTED BY EUGENE SHENEFIELD, EXECUTIVE DIRECTOR

In view of the brief time available for oral presentation the following statement is presented for Committee consideration. This statement is made in behalf of the forty American voluntary agencies (list appended) with overseas programs, representing major American voluntary sectarian, non-sectarian and nationality overseas social and welfare agencies, the combined constituencies of which include tens of millions of U.S. citizens who through these agencies express their concern for fellow-beings in need abroad. Over 5 billion dollars has been contributed since 1939 by Americans through their voluntary agencies for a wide variety of assistance and services to meet a multitude of needs. This voluntary, tangible expression of concern reflects the spirit of voluntaryism which is traditional to the American people, and an integral part of American life and our democratic heritage.

The forty listed voluntary agencies wholeheartedly support tax reform in principle as being wise and good for our country and therefore good for the organizations who so often work in partnership with our national government through the Departments of Treasury, Agriculture, Labor, Justice, Health, Education and Welfare, and the State Department, particularly in foreign aid, in promoting the welfare and development of needy people overseas. However, we are concerned that preoccupied as we are with tax reform we do not make the mistake of confusing tax deductions for charity as evasion of taxes. Charity in the American tradition is not a loophole.

Reversal of the long history of the concept of government recognition of charitable organizations through tax exemption would appear to place the government in contradiction to its repeated expressions of particular interest and confidence in the value of voluntary agency programs as implicit in other laws having to do with foreign aid in which specific reference to American voluntary foreign service organizations is made. On the basis of these laws and with the warm understanding and cooperation of Congress and the Committees a partnership between government and voluntary agencies has grown up that enhances the image of America in the minds of the tens of millions of people aided overseas, with resultant benefits to the people and government of the United States. It would be unfortunate indeed if this image were to be in any way blurred because of proposals now under consideration. In relation to the bill under consideration we feel that:

1. The minimum tax provision should be exclusive of contributions to voluntary charitable agencies.
2. Contributors of appreciated gifts of securities and real estate should be permitted full deduction of the value of the gift without tax on the appreciated value.
3. Bargain sale contributions to voluntary charitable agencies should be deductible at market price.
4. Contributors of gifts in kind, which are used by the voluntary charitable agencies in their programs, should be permitted deduction on the basis of fair market value.
5. We heartily concur in efforts to provide tax relief to the wage-earner and lower income brackets. Greater tax equity could possibly be achieved by changing the rates that apply to those income levels, or by increasing personal exemptions.

We are concerned with the effect of this bill on living trusts, life annuities or other similar sources of income to voluntary charitable agencies.

Custom, state constitutional provisions, charter provisions, decisions of the Supreme Court, statutes, all have supported assistance to charitable agencies in various ways including exemption from taxation. In the past charitable giving has been consistently encouraged by the Congress. Now for the first time that policy would be reversed by this bill at the very moment that the Administration

is emphasizing a larger role for voluntary citizen responsibility in welfare and health services.

The forty listed American voluntary agencies, working overseas in people-to-people programs in over 100 countries building bridges to peace and better understanding, are completely dependent upon the generosity of the American people. If tax legislation is going to discourage or down-grade the importance of voluntary contributions then who is going to pick up the slack?

We believe tax equity can be achieved without injury to the voluntary charitable agencies.

AGENCY LIST

AMDOC, Inc.
American Council for Judaism Philanthropic Fund, Inc.
American Council for Nationalities Service
American Friends Service Committee, Inc.
American Fund for Czechoslovak Refugees, Inc.
American Jewish Joint Distribution Committee, Inc.
American Middle East Rehabilitation, Inc.
American National Committee to Aid Homeless Armenians
American ORT Federation, Inc.
American Relief for Poland, Inc.
Assemblies of God, Foreign Service Committee General Council of the
Baptist World Alliance
CARE, Inc.
Catholic Releief Services
Church of the Brethren World Ministries Commission
Community Development Foundation, Inc.
Co-ordinated Hungarian Relief, Inc.
Hadassah
Heifer Project
International Rescue Committee, Inc.
Iran Foundation, Inc.
Mennonite Central Committee, Inc.
Migration and Refugee Services U.S. Catholic Conference
Mizrachi Women's Organization of America, Inc.
Near East Foundation
Polish American Immigration & Relief Committee, Inc.
Salvation Army
Save the Children Federation, Inc.
Seventh Day-Adventist Welfare Service, Inc.
Tolstoy Foundation, Inc.
Unitarian Universalist Service Committee, Inc.
United Friends of Needy & Displaced People of Yugoslavia, Inc.
United Hias Service, Inc.
United Israel Appeal, Inc.
United Lithuanian Relief Fund of America, Inc.
United Seamen's Service, Inc.
United Ukrainian American Relief Committee, Inc.
World Relief Commission, Inc.
World University Service
Young Women's Christian Association of the U.S.A.

STATEMENT BY PRESIDENT SIDNEY A. RAND, LUTHERAN EDUCATIONAL CONFERENCE OF NORTH AMERICA

SUMMARY

1. Congress should continue to encourage private philanthropy.
   (a) LTP and ADR discourages giving, especially appreciated property.
   (b) Charitable remainder annuity trusts and unitrusts should not be substituted.
   (c) Transfer of appreciated property for charitable gift annuity should not be considered a "bargain sale".
2. New paragraph (8) under Section 201(a)(3) may be ambiguous and deny charitable deductions for life income agreements and should be deleted.
3. 7½% tax on foundations is excessive.

STATEMENT

The Lutheran Educational Conference of North America represents sixty-two institutions of higher education in the United States and Canada having affiliation with Lutheran churches. In the United States, member institutions located in twenty-two states include fifteen two-year colleges and thirty-one four-year colleges and universities. Several of the member institutions offer graduate and professional work in addition to the undergraduate program.

During the 1968–69 school year, these colleges and universities enrolled 55,360 full-time students and another 26,300 students in part-time graduate and undergraduate programs.

Graduates of these institutions enter such varied career fields as teaching, medicine, nursing, law, engineering, the ministry, social work, foreign service, and business. Some of them send an average of one-third of their graduates into professional and graduate schools. One of the institutions has a school of law and a school of engineering. All of them are dedicated to the serving of our society by providing students with the opportunity for an education which broadens the vision, deepens the understanding, and nurtures the spirit of man.

These institutions share with all private education a common characteristic—they depend for support on private philanthropy. The Congress has long encouraged this support as beneficial to the common good. The Senate Finance Committee of the 75th Congress, third session, in referring to a provision included in the House bill that would have placed a capital gains tax on the appreciation of equities and real property given to an exempt organization, said:

"Representations were made to the Committee by officials of educational and charitable institutions that the effect of such a provision would be to discourage the making of charitable gifts in property. The Committee believes that charitable gifts generally are to be encouraged and so has eliminated the provision of the House Bill."

Today the private support of higher education is even more critical than it was in 1938. Private colleges and universities are facing a severe financial crisis. Their continued existence as private institutions is dependent on not only maintaining but also increasing gift income. During the latest fiscal year, the institutions in this conference received over $40,000,000 in gift income. Of this amount, about 10% has come in the form of appreciated property, a growing source of gifts in the last three or four years. Some of these institutions receive annually as high as 33% of gift income in the form of appreciated property, amounting in one instance to more than $2,000,000.

A change such as that advocated in H.R. 13270 would materially affect the flow of such gifts and could well cripple the programs of these colleges. While it is true that the House bill retains the present provision in regard to the treatment of gifts of appreciated property, it effectively negates this retention by categorizing such appreciation as one of the "tax preference" items. In addition, making the charitable deduction subject to the allocation of deduction rule certainly discourages rather than encourages private philanthropy.

We are also deeply concerned with the provisions having to do with the tax treatment of deferred gifts. This method of philanthropy is of increasing importance.

One of the important reasons this type of philanthropy should be encouraged is that it enables people of more moderate wealth to make substantial gifts to educational and charitable institutions in which they have a profound interest. It is our opinion that the very complicated provision for charitable remainder annuity trusts and charitable remainder unitrusts should not be substituted for the widely used and understood charitable remainder trust.

A widely used gift method involving deferred gifts, often of modest amounts of $1,000 or less, namely the Life Income Agreement, may be endangered by an ambiguous section of the House bill, Section 201(a)(3) adding a new paragraph (8) to I.R.C. Sec. 170(b). Although not entirely clear, this section could be interpreted to deny any charitable deduction for life income agreement gifts. Because of this possibility, the proposed pargaraph (B) should be deleted.

If the source of support is to continue, it is essential that capital gains incurred by a trust or life income pooled fund and permanently set aside for charity should not be taxed. If the provisions presently in H.R. 13270 regarding "bargain sales" are adopted, we would hope that the law would specifically state that the transfer of appreciated property for a charitable gift annuity is not a bargain sale.

These institutions received $1,465,000 from private foundations last year. These grants have strengthened these colleges and universities and have made possible

programs which could not otherwise be financed. These programs have in turn benefited not only the institution that was the beneficiary of the grant but also many other colleges, public and private alike.

For this reason we feel that the 7½% tax on foundation income is excessive and will penalize not the foundations but rather education, both in its teaching and research aspects.

Many provisions of the proposed legislation appear to be equitable and should be enacted into law. However, all provisions which embody change should in fairness be prospective from the date of enactment.

Dr. Solomon Fabricost, professor of economics at New York University and a former director of research, the National Bureau of Economic Research, stated in a recent article entitled "Philanthropy in the American Economy": "Our society has developed a variety of means to cope with the needs of its less fortunate members and to enhance the well-being of all . . . Indeed it is not going too far afield to recall that the moral justification of our type of economic system is its great effectiveness in harnessing self interest for the benefit of the entire community." The tax laws in respect to the items we have mentioned have to date done exactly this. The changes which are contained in the House bill threaten to destroy the foundations on which our pluralistic system of higher education is built. We respectfully request the Senate Finance Committee to proceed with great care in considering these changes lest irreparable harm be done to the private colleges and universities, to all people who benefit from the work of these institutions, and to the American society itself.

THE EQUITABLE LIFE ASSURANCE SOCIETY OF THE UNITED STATES,
New York, N.Y., September 25, 1969.

Hon. RUSSELL B. LONG,
U.S. Senate,
Washington, D.C.

MY DEAR SENATOR LONG: I write to urge you to oppose a provision in the Tax Reform Bill (HR 13270) which will disastrously discourage private charitable giving if left unchanged.

The provision to which I refer changes the method of taxing charitable contributions of appreciated securities and other property. Under present law, appreciated securities are deductable to the full extent of their market value at the time of the gif and are the means by which most large gifts are made to educational institutions, churches, hospitals, and other welfare services.

I am sure you are aware that at no time in recent history have the financial needs of education, both private and public, been greater. At no time in recent history have the demands on educational institutions been greater to expand their enrollments, provide greater financial aid, accept broader academic responsibilities (such as participation in the solution of urban problems), and a host of other worthy objectives. Under these conditions, it seems almost ironical that serious consideration should be given to legislation which can only have the effect of drastically curtailing the incentives of donors of both large and medium sized contributions.

I know from personal experience in helping to raise funds for Princeton University that the large donor is important, not only for the dollars represented by the gift, but also for the stimulation these large gifts provide for many moderate and smaller contributions. A most effective and common practice is for a donor to pledge a large gift to be matched by a combination of many smaller gifts. Indeed, the House of Representatives has recognized this practice in the provision of HR 11400 of $300 million to match private gifts to the National Foundation on the Arts and Humanities. It seems to me that this most recent act of the House merely extends a long legislative history of the Congress, which has recognized and encouraged the unique practice, so extensively developed in this country, of private as well as public support of educational institutions at all levels, while also encouraging philanthropic support of many organizations of a social or cultural nature.

We need the initiative and diversity in our social organizations which comes from multiple sources of support. I would urge your Committee to evaluate most carefully any tax changes which would reduce financial support from individuals to a broad range of educational, social, or cultural institutions.

Faithfully yours,

JAMES F. OATES, Jr.

STATEMENT OF STANLEY MARSHALL, PRESIDENT, FLORIDA STATE UNIVERSITY

Along with many other Americans, I recognize the need for extensive revision of our tax structure and heartily endorse the goal of achieving greater utilization of our national resources and greater equality in the method of taxation.

I watched with interest as the House Ways and Means Committee began its deliberations, but my interest became concern and then alarm with the announcements of tentative decisions regarding philanthropic gifts to charitable and educational institutions. On July 23, I conveyed that alarm to your committee as well as to the House committee. On July 29, I discussed my concern in a meeting with the Florida Congressional Delegation. The subsequent passage of HR 13270 intensified my concern, and, as President of the Florida State University and as one who has spent all of his adult life in public education, I feel impelled to address these brief comments to this distinguished committee.

"The crisis in American higher education" is a familiar story, a major portion of which is economic in nature. The problems at the Florida State University which are no doubt typical of public institutions around the nation emerge in the form of mushrooming enrollment, diminishing space allocations and a desperate need for new and improved programs and facilities. Our expected fall enrollment of 17,000 is projected at 28,000 by 1975. We have an acute shortage of classrooms, laboratories and other academic space, and we have abandoned attempting to provide housing for all our students.

As a state-assisted university, we look to the Florida Legislature for our primary funding. However, in fiscal 1968, state appropriations accounted for less than 53 per cent of our total operating budget. There was no appropriation for capital outlay. For the same period, student fees accounted for approximately 14 per cent of our total operating budget. That left approximately one-third of our total budget to be funded from all other sources including federal agency grants and gifts from private corporations, foundations and individuals. The total of all these funds scarcely met our minimum requirements and fell far short of what would have been required for a program of genuine excellence.

The financial outlook for the immediate future is bleak. The state budget has been strained almost to the breaking point. Federal budget tightening and proposed cutbacks in spending suggest little additional help can be expected from that source. To materially increase student fees in a public institution would be totally contrary to our basic philosophy of public education. Resident tuition in Florida has been increased 20 per cent this fall, but the increase in student fees can hardly be considered a major source of additional funding.

All that remains is the private sector of our economy. House Bill 13270 threatens to destroy the major portion of that source by removing much of the tax incentive accruing from gifts of appreciated property. The vast majority of major philanthropic contributions are in some form of appreciated properties. The Florida State University recently received an inter vivos gift amounting to approximately one million dollars. Not one cent was in cash. The donor, now deceased, named Florida State in his will for a substantial amount which we are told will also be largely, if not entirely, in stocks and properties.

Although HR 13270 does not place a direct capital gain tax on gifts of appreciated property to qualified institutions, I am advised that the provision for allocation of tax preferences would have a serious restricting effect on potential gifts of this type. I am advised also that the capital gains provision regarding life income contracts and charitable remainder trusts would almost totally remove these methods of deferred giving from our programs.

Although state appropriations will continue to be the predominant factor in our budget at Florida State, there can be no denying that private gifts are desperately needed if we are to provide the youth of our state and nation with the quality education they deserve. I respectfully urge the removal from HR 13270 of any provision which would inhibit or discourage private support of our educational institutions.

STATEMENT SUBMITTED BY THOMAS A. MELFE AND WILLIAM D. DOINO, VICE PRESIDENTS, ON BEHALF OF UNITED STATES TRUST COMPANY OF NEW YORK

SUMMARY

I. *Charitable income trusts with noncharitable remainder*

Sec. 201 (a) and (h) of the bill.

The United States Trust Company of New York proposes that the present value of a charitable income trust continue, as under present law, to be permitted as an income tax deduction to the donor taxpayer.

If it is deemed absolutely necessary to amend the law to avoid a "double tax benefit" as stated in the Committee Report, the present rules should be modified only to the extent necessary to accomplish that purpose. A suggested formula is included in this statement.

If it is deemed appropriate to amend the income tax rules because of a "double tax benefit" we urge that the present estate and gift tax deduction be preserved since there is no "double tax benefit" on the estate and gift tax side.

II. *Charitable remainder trusts*

Sec. 201 (e), (h) and (i) of the bill.

The United States Trust Company of New York proposes that the income, gift and estate tax charitable remainder deduction provisions under present law are sound, are not the subject of abuses as alleged by the Committee Report, and ought to be preserved. Adequate controls exist outside the tax laws to avoid abuses.

The proposed annuity trust and unitrust requirements of H.R. 13270 are unnecessary to achieve the Committee's objectives. Incorporating them into the tax law complicates it further without serving any useful purposes.

The bill's provisions which would disallow an income tax deduction for a charitable remainder contribution should not be made applicable to the estate and gift tax deduction rules affecting such transfers.

The effective date provisions of the bill will cause undue hardship and should be changed to curtail its retroactive application and to afford a reasonable period of grace with respect to its prospective application.

Also, we note that the Administration has proposed that the effective date apply only to persons dying after December 31, 1970. We think this is only a partial solution and urge that a presumption be incorporated in the law which would automatically provide that in any charitable remainder trust which does not specifically provide for an annuity trust or unitrust it shall be deemed to be a unitrust as defined under the bill. This will protect the charitable deduction where a person cannot change his will because of incompetency or other reasons beyond his control.

III. *Charitable contributions by estates and trusts*

Sec. 201 (f) of the bill.

The United States Trust Company of New York proposes that the "set aside" deduction doctrine under present law applying to estates and trusts be retained.

Funds permanently set aside for charity should not be subjected to tax. Donors should not be restricted to a choice of only two trust forms (annuity trust or unitrust) in order to keep a charitable beneficiary's interest tax exempt.

If the "set aside" doctrine is eliminated, the change should be made applicable only to trusts created, and estates of persons dying, *after* the date of enactment of the new bill.

IV. *Repeal of alternative capital gains tax for individuals*

Sec. 511 (a), (b) and (c) of the bill.

The United States Trust Company of New York proposes that the provision of the bill increasing the rate of tax on long term capital gains be deleted.

If such provision of the bill is enacted, it is proposed that it's application be made effective to long term capital gains sustained in taxable years beginning after December 31, 1969.

V. *Charitable income trusts with noncharitable remainder*

A. *Double income tax benefit.*—Sec. 201 (a) and (h) of the bill; secs. 170(b) and 2522(c) of the code.

It is proposed to deny a taxpayer a charitable contribution deduction for the present value of an income interest in trust given to charity unless the trust income is taxable to the grantor.

It is argued, that a "taxpayer receives a double tax benefit where he is allowed a charitable contribution deduction for the present value of an income interest in trust given to a charity and also is not taxed on the income earned by the trust. *In fact, this double benefit allows a taxpayer to increase his after tax cash position by postponing a planned noncharitable gift.*"[1]

The Committee report adduces the example of a taxpayer in the 70% bracket who transfers property worth $100,000. currently earning interest at the rate of

[1] House Report on H.R. 13270 (p. 61); italics supplied.

5% to a trust of 2 years specifying that $5000. be paid to charity each year, remainder to A. And, the example seems to demonstrate that the taxpayer's after-tax cash position is improved by $6,648.95, in that his taxes on other income are reduced by that amount, i.e. by 70% of $9,498.50—the latter being the present, value of a 2 year $5,000, annuity.

The figure of $6,648.95 needs further analysis in that it can be variously interpreted. Let this be done at the hand of three successive tax years: (1) donation made December 31, 1969; and (2) the two succeeding years (1970 and 1971) of payment to the charity. Let it further be assumed that the taxpayer has pre-donation income of $20,000 in the 70% tax-bracket.

	1969	1970	1971
1. If no donation is made:			
Income	20,000.00	20,000	20,000
Deductions	0	0	0
Taxable	20,000.00	20,000	20,000
Taxes (at 70 percent)	14,000.00	14,000	14,000
Net spendable income—			
1969	6,000.00	6,000	6,000
1970	6,000.00		
1971	6,000.00		
3-year net	18,000.00		
2. If a donation is made with "benefits" available under present law:			
Income	20,000.00	15,000	15,000
Deduction	9,498.50	0	0
Taxable	10,501.50	15,000	15,000
Taxes (at 70 percent)	7,351.05	10,500	10,500
Net	3,150.45	4,500	4,500
Add back	9,498.50		
Net spendable income—			
1969	12,648.95		
1970	4,500.00		
1971	4,500.00		
3-year net	21,648.95		
3. If a donation is made, with lump-sum deduction taken under proposed law:			
Income	20,000.00	20,000	20,000
Deduction	9,498.50	0	0
Taxable	10,501.50	20,000	20,000
Taxes (at 70 percent)	7,351.05	14,000	14,000
Net	3,150.45	6,000	6,000
Add back	9,498.50		
Deduct: paid to charity		5,000	5,000
Net spendable income—			
1969	12,648.95	1,000	1,000
1970	1,000.00		
1971	1,000.00		
3-year net	14,648.95		
If a donation is made, no lump-sum deduction taken (2):			
Income	20,000.00	20,000	20,000
Deduction (paid to charity)	0	5,000	5,000
Taxable	20,000.00	15,000	15,000
Taxes (at 70 percent)	14,000.00	10,500	10,500
Net spendable income—			
1969	6,000.00	4,500	4,500
1970	4,500.00		
1971	4,500.00		
3-year net	15,000.00		

The figure of $6,648.95 is clearly the difference between $21,648.95 (Example 2) and $15,000. (Example 4). On the other hand, it may perhaps be reasonably maintained that the true measure of the taxpayer's "advantage" in this case is the difference between $21,648.95 (Example 2) and $18,000 (Example 1), or *$3,648.95* (rather than $6,648.95).

So viewed, it is not difficult to establish a limit on the amount of the income tax deduction which can be taken in the year of donation: the purpose of the limit being that the taxpayer will be no better off than if he had not granted Charity the income interest for a term of years.

If

N=the number years of Charity's term,
A=the amount annually paid to Charity,
R=the taxpayer's top rate of taxation,
L=the maximum amount which can be taken as a deduction in the year of donation;

then

$$L=\frac{N\times A(1-R)}{R};$$

not to exceed, however, the present value of annuity.

Taking the above example, the limit would be established at:

Application of limit	1969	1970	1971
Income	$20,000.00	$15,000	$15,000
Deduction	4,285.71	0	0
Taxable	15,714.29	15,000	15,000
Taxes (at 70 percent)	11,000.00	10,500	10,500
Net	4,714.29	4,500	4,500
Add back: Deduction	4,285.71		
Net spendable income (1969)	9,000.00		
Net spendable income (1970)	4,500.00		
Net spendable income (1971)	4,500.00		
3-year net	[1] 18,000.00		

[1] See example 1 above.

It is clear that the expression

$$\frac{N x A \ (1-R)}{R}$$

will have a value greater than NxA when rate of taxation (R) is less than 50%. At 48%, for example, $\frac{1-R}{R}$ would be $\frac{.52}{.48}$, a factor greater than 1. For that reason the limit on the deductible amount would be the present value of the annuity whenever *that* value is less than $\frac{N x A(1-R)}{R}$.

Further, to introduce an element of additional realism into the computation of the deduction limit, it might be provided that, if $\frac{N x A \ (1-R)}{R}$ is applicable, then N, and, if the tabulated present value is applicable, then the number of years to be considered, is to be limited to the number of years of the donor's life expectancy; the excess years being considered as testamentary in nature.

Also, the example of the 2-Year Annuity, which leaves a taxpayer in the 70% tax bracket better off, gives the impression that this is always the case. This is decidedly not so.

For example, in a 40% "composite" top bracket this is the picture:

Approach "B"	1969	1970	1971
Income	$20,000.00	$15,000	$15,000
Deduct	9,498.50	0	0
Taxable	10,501.50	15,000	15,000
Taxes (at 40 percent)	4,200.60	6,000	6,000
Net	6,300.90	9,000	9,000
Add back	9,498.50		
Net spendable income	15,799.40		
Do	9,000.00		
Do	9,000.00		
3-year net	33,799.40		

$$L = \frac{2 \times \$5000.\ (1-.70)}{.70}$$

$$= \frac{\$10,000. \times .30}{.70}$$

$$= \$10,000. \times .428571 = \underline{\underline{\$4,285.71}}$$

Had the taxpayer not made the gift, then he would have kept $12,000. out of each of the 3 years' top income of $20,000.—for a total of *$36,000.*, a fact which involves no "betterment" but rather a "sacrifice" of $2,200.60. The phenomenon complained of is, therefore, directly related to the magnitude of the tax rates rather than to the principle of deductions *per se*. The point of "equilibrium" is reached, in the case of a 2-Year Annuity, when a taxpayer is in the 51.285996% "composite" top bracket.

The point of "equilibrium"—no advantage or disadvantage to the taxpayer—is a function of the number of years income (N) and the present value (P) of the annuity for N years:

$$\frac{N}{N+P.}$$

For a ten-year annuity that would be

$$\frac{10}{10+8.3166} = \frac{10}{18.3166} = 54.595285\%$$

In other words, a taxpayer in a 54.595285% "composite" top bracket who grants a 10-Year income interest to charity will gain no advantage (or disadvantage) from using a lump sum deduction in the year of donation and excluding the income paid to charity from his returned income in the years of payment. If he is in a lower bracket, he is worse off; if he is in a higher bracket, then he would be better off: except that on applying the limitation principal contained in

$$\frac{N \times A \times (1-R)}{R}$$

he would be brought back to the point of equilibrium.

It is submitted that the proposal that the grant of an income interest to charity be denied the status of a deduction be reviewed in the light of these comments. A mathematical accident traceable directly to the rates of taxation should not be used as a basis for building into our tax laws a thesis repugnant to all concepts of property ownership and enjoyment—that donating the income from property for a term of years is less of a sacrifice that donating the fee.

It is herewith proposed, then, that the present value of a charitable term (granted inter vivos) continue to be permitted as an income tax deduction to the donor subject, however, to the limitation that the taxpayer gain no advantage

therefrom; that range to be determined in each case on the basis of the formulae and other tests submitted above.

B. *The gift tax deduction of the present value of the charitable term*

Sec. 201(h)(3) of the bill.

Sec. 2522(c) of the code.

It is proposed to amend Sec. 2522(c) of the code to limit the amount of the gift tax deduction for an income interest to charity to that of the income tax deduction (without regard to the "ceiling" limitation applicable in the case of the income tax).

We submit that this interrelationship between income and gift taxes is completely unwarranted. The income is based on what a taxpayer receives whereas the gift tax is based on what he transfers to other

When a person irrevocably transfers property to a charity, retaining no interest in it to himself, it follows that he should be allowed a gift tax deduction for the full value of the interest passing to charity. Limiting the gift tax deduction, in these cases, to the value of the allowed income tax deduction forces a taxpayer to *pay a gift tax on a transfer of property to an exempt organization.* We submit that the gift tax code provisions with respect to charitable transfers should remain intact and should not be "amended".

C. *The estate tax deduction of the present value of the charitable term*

Sec. 201(h)(1) of the bill.

Sec. 2055(e) of the code.

It is proposed to amend Sec. 2055(e) of the code to allow an estate tax deduction only for a *remainder* interest and then only if the trust is either an annuity trust or a unitrust.

If not specifically, then certainly by implication, this change would disallow an estate tax deduction for a bequest of an income interest to chartiy where the remainder goes to natural persons.

Under present law, an estate tax deduction is allowed whether charity's interest is an *income* interest or one in *remainder.*

We see no reason for the indicated change. An income interest to charity for years certain is as valuable an interest in property as is a deferred interest in fee. This is particularly so since the interest by its very nature, is a present one.

We therefore urge that the estate tax treatment now given under the code to an income interest to charity be retained. The double benefit of an income tax deduction as well as an estate deduction has never been present in a testamentary transfer.

Accordingly, Sec. 201(h) of the proposed bill should be amended to expressly permit an estate tax deduction for a charitable income interest in a trust, and to do so at its full actuarial value.

II. *Charitable remainder trusts*

Sec. 2016 (h)(1) of the bill

Sec. 170 (h); 644; 2055 (e); 2106 (a); 2522 (c); of the code

A. *The Bills' Provisions.*—Under present law an individual may make an indirect charitable contribution by transferring property in trust with income being paid to private persons for a period of years or life, and the remainder passing to a charity. A charitable deduction is allowed based upon the present value of the remainder interest determined upon certain prescribed actuarial and interest tables.

HR 13270 proposes to disallow an *income, gift or estate tax deduction* for a charitable gift of a remainder interest in trust unless the trust is either a "charitable remainder annuity trust" or a "charitable remainder unitrust" as defined in the bill.

The Committee Report cites, as reasons for the bill's provisions, that a charitable contribution deduction for a remainder gift does not necessarily have any relation to what the charity actually receives because the trust assets may be invested in such a manner so as to enhance the income beneficiary's interest to the detriment of the charity's remainder interest. It states further that the bill's requirements will remove the present incentive to favor the income beneficiary over the remainder beneficiary by means of manipulating the trust's investments (Pages 58 and 59, Committee Rport).

B. *Reasons for opposition to the bill's provisions which affect charitable remainder deductions.*—We believe the Committee's stated purposes for changing the present law on charitable remainder deductions are unfounded. Adequate

controls exist outside the tax laws to prevent the undesirable results cited by the Committee, i.e., favoring the income beneficiary to the detriment of the charitable beneficiary by trustee manipulation. Examples of these controls are:

Court supervision of trusts

Elementary fiduciary principles of impartiality as between income and principal beneficiaries of a trust

State attorney general or similar regulatory agencies supervising trusts in which charities have an interest (e.g., New York Estates, Powers and Trusts Laws, Sec. 8-1.4)

In addition, our experience as a major corporate fiduciary and trustee of several hundred charitable remainder trusts would, contrary to the alleged abuses stated in the Committee Report, indicate that both income and principal beneficiaries share equitably in the productivity of such trusts. We have no reason to believe that our experience is any different from that of other corporate fiduciaries.

The Committee Report (page 58) specifically charges that "the trust corpus can be invested in high-income, high risk assets. This enhances the value of the income interest but decreases the value of the charity's remainder interest". The aforementioned court and regulatory controls make this possibility quite improbable. Furthermore, a review of our records for charitable remainder trusts reveals, contrary to the Committee's allegations, that the average income yield is comparable to that received by beneficiaries of non-charitable remainder trusts. Again, we believe our experience would be representative of other corporate fiduciaries.

For these reasons, we do not believe any change in existing law on charitable remainder deductions is necessary or desirable.

C. *Annuity trust and unitrust provisions of the bill.*—Secs. 201 (a), (e), (h) and (i) of the bill.

The bill would disallow a charitable deduction unless the charitable interest is a remainder interest in a "charitable remainder annuity trust" or a "charitable remainder unitrust".

This requirement for an annuity trust or unitrust (presumably designed to protect a charity's remainder interest), as opposed to the usual trust form or arrangement, is arbitrary and unsound. It unduly restricts the taxpayer who wishes to pass on a future interest in property to charity. If he fails to use one of the two prescribed trusts, he foregoes a contribution deduction to which he is in fact entitled because part of his property will ultimately pass to an exempt organization.

The traditional form of trust, with its flexible investment features and resulting advantages to both income and remainder beneficiaries, ought to be preserved. As stated above, the charitable remainder interests is adequately protected outside our tax laws. Accordingly, the present contribution deduction rules should be retained.

The annuity and unitrust requirements are also included in the bill's provisions relating to contribution deductions for charitable income trusts (see discussion under paragraph I of this statement). The Committee's purpose is to insure that the amount received by the charity corresponds to the contribution deduction allowed the donor. Again, protection afforded by basic trust principles of impartiality, together with court and regulatory agency supervision, makes this requirement of the bill unnecessary.

D. *Estate and gift tax provisions of the bill relating to charitable remainders.*—The bill proposes to disallow a charitable contribution deduction for estate and gift tax purposes unless the trust is either an annuity trust or unitrust.

We fail to see why the restrictive requirements of an annuity or unitrust for income tax purposes should automatically be applied to the estate and gift tax laws. The latter are transfer taxes and are not related to the income tax. Present estate and gift tax deduction rules and regulations, developed over a period of years, are sufficient to achieve the purposes of the Committee.

We see no useful purpose in changing present estate and gift tax charitable contribution deduction rules and therefore recommend that they be perserved.

E. *Effective dates of the bill concerning charitable remainders.*—The provisions of the bill with respect to charitable remainders will apply as follows:

Income tax—transfers in trust after April 22, 1969.

Gift tax—gifts made after April 22, 1969.

Estate tax—decedents dying after date of enactment of the bill.

These effective date provisions will cause undue hardship to taxpayers and should be changed. Irrevocable transfers, made in good faith under present law,

cannot be changed. Anyone who has included a traditional charitable remainder trust under his will must rewrite it or suffer the loss of an estate tax deduction. This is time consuming and costly. Some persons may not be able to change their wills.

We recommend that existing irrevocable charitable remainder trusts be exempted from the provisions of the bill, and with respect to other transfers, inter-vivos or testamentary, less stringent effective date provisions be used.

Alternatively, we recommend that the bill incorporate a presumption provision which would apply to charitable remainder trusts which are not in the form of an annuity trust or unitrust. The presumption would state that in such cases it will be presumed that a unitrust was intended by the transferor and the provisions of the bill applied accordingly.

III. *Charitable Contributions by Estates and Trusts*

Sec. 201(f) of the bill.

The bill would eliminate the so-called "set aside" deduction presently allowed estates and trusts for amounts permanently set aside for charity, unless a charitable remainder annuity trust or a charitable remainder unitrust is used.

Consistent with our belief that an annuity or unitrust should not be required to entitle a taxpayer to a charitable remainder contribution deduction (for the reasons stated under II C. above) we do not believe either trust technique should be required for a charitable deduction to be allowed *trusts and estates* for amounts set aside for charity.

If the "set aside" doctrine under present law is eliminated, it is especially important to make any such change applicable *only* to trusts created, and estates of persons dying after, the date of the enactment of the change. To do otherwise would be eminently unfair to those previously existing trusts and estates to which property was transferred in contemplation that the entire principal fund and its appreciation would enure to the benefit of the charitable remainder beneficiary.

IV. *Repeal of alternative capital gains tax for individuals*

Sec. 511 (a), (b) and (c) of the bill

A. *Current law and bill's provision.*—Under current law, the tax applicable to long term capital gains for individuals is 25%, plus the temporary surcharge. The underlying reasoning for the preferred tax rate on this type of income is to provide sufficient motivation for long term investment commitments. Under the provision contained in the House bill, the effective rate of tax on long term capital gains would be 35% before application of the temporary surcharge. If the tax rates, as proposed in the bill, are enacted, the effective tax rate on long term capital gains will be 32.5%. The effective date as proposed in the bill for application of the new rate is July 25, 1969. Accordingly, for sales and dispositions made after that date during the balance of 1969 and thereafter the new rates will be applicable.

B. *Points of opposition.*—With respect to the House proposal outlined above, we agree with the Nixon Administration conclusion that the increase of the effective rate of tax imposed on capital gains in all instances places too heavy a burden on the incentives for capital investment.

If, however, the proposal is enacted, we strongly urge the effective date be changed from July 25, 1969 to taxable years commencing after December 31, 1969. It is our experience that the majority of taxpayers affected by this proposal are on a calendar year basis. Accordingly, in our view, the increase in tax on the sale of capital assets, in many cases substantial capital assets accumulated for lengthy period of time, represents such an extreme change in the law that the majority of taxpayers should have ample opportunity to review its impact before making investment and business decisions. The effective date as proposed will cause undue hardship to taxpayers engaged in lengthy negotiations for the sale of large blocks of stock commenced in the beginning of the year and based on a stable rate of tax applicable to the gain sustained on the sale. Specifically, this could unfairly upset such negotiations and unduly interfere with business decisions. The identical hardships would be applicable to stockholders involved in a corporate liquidation in which payment is received after the effective date. It also should be noted that the proposed effective date is casting a great degree of uncertainty into current capital transactions as there is no degree of certitude that it will be enacted.

In the interests of orderly tax reform, we submit the effective date interferes with effective record keeping and makes compliance difficult. Specifically, it does

not provide sufficient time for system changes required to adjust record keeping procedures. This is particularly important in an era in which both taxpayers as well as the Internal Revenue Service is heavily dependent on computer equipment for processing of returns which require substantive programming changes to accommodate changes in the law. The problem will be severely aggravated by the fact that the enactment of a final bill will most probably be near the end of the year.

CLARK UNIVERSITY,
Worcester, Mass., September 5, 1969.

STATEMENT OF DR. FREDERICK H. JACKSON, PRESIDENT, CLARK UNIVERSITY, WORCESTER, MASS.

As a private higher educational institution, Clark University must depend on substantial philanthropic support of it is to continue to offer high quality educational programs for both undergraduate and graduate students. Some of the proposals included in H.R. 13270 would substantially decrease Clark University's financial support from the private sector. I refer specifically to the proposals regarding 1) Gifts of Appreciated Property, 2) Allocation of Deductions and 3) Life Income (Deferred) Gifts.

GIFTS OF APPRECIATED PROPERTY

During the fiscal year July 1, 1968 through June 30, 1969, Clark University received from individual donors directly, and through their personal foundations, gifts of approximately $1,200,000 of which we estimate at least $540,000 or 45% were gifts of appreciated securities (including some cases in which the securities were given to a private foundation and the foundation made the gift to Clark). We believe that the long standing provision which allows a deduction for the fair market value with no capital gains tax on the appreciation should be retained. If it is not, philanthropic support for Clark University from private donors will be substantially reduced, perhaps by as much as 50%. In addition, appreciation in the value of property donated to charity should not be considered a tax preference which, under the Allocation of Deductions provision, would reduce a donor's itemized deductions for interest, taxes, medical expenses, charitable contributions, etc. Enactment of this provision would indirectly tax appreciation on property gifts and would certainly inhibit financial support from the private sector.

ALLOCATION OF DEDUCTIONS

The charitable deduction should not be subject to the allocation rule and thus should not be reduced because a donor has capital gain income, tax exempt income and so forth. This provision would inhibit support from the private sector in that it not only reduces the charitable deduction but also it would make it more difficult for an individual to anticipate the amount he could afford to contribute The charitable deduction is different from other deductions and the so-called tax preferences because the donor gives up his money and property to help worthy causes and better our Nation.

LIFE INCOME (DEFERRED) GIFTS

In the 6 years since Clark University began to encourage gifts through charitable remainder trusts, life income contracts, and charitable gift annuities, we have received contributions of more than $917,000 in these forms. Few, if any, of these gifts would have been made without the incentives offered under these plans. Furthermore, these plans offer many individuals the opportunity to make a more substantial gift than they would otherwise find possible.

Charitable remainder trusts.—The rules should be retained which provide that there is no capital gain on the transfer of appreciated property to fund a charitable remainder trust and that there is no capital gain if the property transferred is later sold by the trust and the gain permanently set aside for the charity. Abuses in investment policies of these trusts are rare and means are now available to—and used by—the Internal Revenue Service to curb any abuses which exist. The very complicated provisions for charitable remainder annuity trusts and the charitable remainder unitrust should not be substituted for the widely used and understood charitable remainder trust. Should Congress decide to abolish existing charitable remainder trusts and substitute the annuity trusts and the unitrusts,

the law should *not* be retroactive to April 22, 1969, but should be effective with the passage of the Tax Reform Act. Whether a new trust form is enacted or the present type of trust is retained, provisions should not be included which will make it unreasonably difficult to use. Accordingly, 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 and capital gains incurred by the trust and permanently set aside for charity should not be taxed.

Life income contracts.—The present law should be retained which provides that there is no capital gain on the transfer of appreciated property nor a capital gain when property transferred is later sold by the life income pooled fund. Also, as in the case of the charitable remainder trust, the deduction should be based upon the full fair market value without imposition of a capital gains tax, and capital gains incurred by the life income pooled fund and permanently set aside for charity should not be taxed.

Charitable gift annuities.—The present tax treatment when appreciated property is contributed for the annuity should be retained. If the provision in H.R. 13270 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.

We at Clark University certainly support you in your efforts to improve the equity and effectiveness of the Internal Revenue Code. We believe that it is appropriate and desirable to make many of the changes proposed in H.R. 13270 such as extending the unrelated business tax to cover all organizations now exempt and taxing organizations on income received from debt-financed investments. We also favor increasing the ceiling on deductibility to 50 percent. However, with the problems facing our Nation, now is the time to increase not decrease tax incentives for those who generously contribute to our educational institutions and other charities. The points made in this statement relating to three areas of the tax reform bill would have a disastrous effect on philanthropic support for colleges and universities and would substantially offset the positive effects of this bill.

Statement Prepared by Rodney L. Houts, Representing Washington Friends of Higher Education

(An organization representing the presidents and boards of trustees of all but one of the independent accredited colleges of the state of Washington)

Higher Education in the State of Washington

The Washington Friends of Higher Education represent all but one of the independent accredited colleges in the state of Washington. This organization has been authorized to speak for the colleges by the presidents and trustees of nine institutions of higher learning. These are, as follows: Gonzaga University, Pacific Lutheran University, Fort Wright College of the Holy Names, St. Martin's College, Seattle Pacific College, Seattle University, University of Puget Sound, Walla Walla College, and Whitworth College. The average age of these institutions is more than 88 years. They present more than 64,000 living graduates—and presently have enrolled approximately 19,000 students. The annual operating budgets of these institutions exceeds $38 million annually.

During their last fiscal year, these institutions received in gifts more than $7.5 million, of which more than $3 million was in the form of appreciated property. During the last five years, these schools have received more than $44 million in gifts, of which some $17 million dollars was in the form of appreciated property.

These institutions have received in the form of trusts, annuities, and other types of deferred, irrevocable gifts in excess of $10 million in the last five years. Nearly $7.5 million of these gifts came in the form of appreciated property. In addition, these institutions are now holding deferred gifts subject to life estate, some form $14 million worth of expectancies.

It is evident from the foregoing figures that gifts—both outright and deferred, and particularly those that come in the form of appreciated property—are absolutely essential to the continuation and the growth of the private sector of higher education in the state of Washington. A sector which incidentally provides a substantial number of the graduates placed into the working economy of the state annually. We therefore urge your careful attention to our testimony which has a direct bearing on our ability to help ourselves.

PARTNERS IN A CAUSE

We, the Washington Friends of Higher Education, believe that our institutions are playing a vital role in preparing young men and women for the leadership of the nation. Our graduates are found in many walks of life—in business, the professions, politics, education, and in social service. We feel, therefore, that we are partners with the Government and Governmental leaders in a cause which is directed toward the highest national good.

For this reason we want it clearly understood that we are in favor of tax reform, that we are in sympathy with Congressional leaders who are seeking equitable and just tax legislation. We would be the first to encourage Congress to eliminate those places in our tax law where individuals are able to use the law for their own selfish means in a way not intended by Congress. We therefore support the underlying principles which created House Bill 13270—and much of what is contained in that Bill.

We are, however, desperately concerned about a few items in House Bill 13270 which would seriously affect our ability to encourage increased support of our institutions. We are totally dependent upon such gifts. Some of the things contained in this Bill would have a devastating effect on those gifts.

HOUSE OF REPRESENTATIVES BILL 13270

The items contained in House Bill 13270 which gravely concern the colleges and universities of the state of Washington are as follows:

1. The Inclusion of Gifts of Appreciation of Property in the Limit on Tax Preferences and the Allocation of Deductions

We are pleased that the House Bill retains the present law that a deduction is allowed for the full present fair-market value of a gift and that there is no direct capital gain on the appreciation. However, if a gift of appreciated property is included in the limit on tax preferences and the allocation of deductions, the appreciation will be indirectly or partially taxed because the appreciation on the charitable gift reduces the donor's itemized deductions under the allocation of deductions provision, and may be taxed under the limit on tax preference provision. We are pleased that the Nixon administration has recommended that this provision in H.R. 13270 be changed; and we urge you to accept that recommendation. Under the House provision for the allocation of deductions, the donor who contributes the appreciation on property would have to reduce not only his charitable deductions but also his other deductions for taxes, interest, medical expenses, etc. This is an indirect way of taxing the appreciation and would discourage gifts of appreciated property which are so vital to our institutions. By including the appreciation on property contributed to a charity in the limit on tax preferences, large individual gifts of appreciated property would be discouraged. These large individual gifts are also very much needed and have long been encouraged by Congress.

2. Charitable Remainder (Life Income) Trusts [Bill Section 201(4), p. 135, line 3]

Present law providing for the charitable deduction allowed for the type of charitable remainder currently used should be retained. Present law provides that there is no capital gain on the transfer of appreciated property to fund a charitable remainder or life income trust, nor is there a capital gain 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 a chairtable remainder annuity trust and a charitable remainder unitrust should not be substituted for the now widely used and understood chairtable remainder trust. These latter trust agreements are too complicated to be understood by donors and would greatly hinder our ability to raise these types of funds. These types of gifts are becoming an increasing part of our gift income. Abuses of the investment policies or other handling of these trusts are very rare, and the Internal Revnue Service has ample means available to curb any abuses which might exist. We urge you not to destroy this important part of our gift income.

However, should Congress decide to abolish the existing charitable remainder trust and substitute the annuity trust and unitrust, the laws governing the present remainder trust should not be retroactive to April 22, as provided by House Bill 13270. This is totally unfair to our donors who have established such trusts since April 22, unaware that such a law would be passed—and

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without prior warning. Such irrevocable gifts are presently in effect in our institutions.

In addition, whether the present remainder trust remains in effect, or whether the new unitrust or annuity trust is established, the charitable deduction for gifts of appreciated property should be based on the fair market value of the trust at the time of is creation. The donor should not be required to base his deduction upon his cost basis or pay a capital gain if he elects to compute his deduction based on the fair market value.

Furthermore, capital gains incurred by the trust—and permanently set aside for the chairty—should not be taxed. We do not believe that a donor should be taxed on money which he can never, and will never, receive since it is laid aside for the permanent use of charity.

Finally, the House bill allows no estate tax charitable deduction for a charitable remainder trust unless it is a unitrust or annuity trust. It is our understanding that this law would apply to charitable remainder trusts created before the bill's enactment. Therefore, one of our donors who may have created such an irrevocable trust many years ago, but who dies after the bill's enactment, would lose his estate tax charitable deduction unless that charitable remainder trust were a unitrust or an annuity trust. This provision in the House bill is unusually harsh and unfair. We can only assume that it must be an oversight. This retroactive change would require that substantial estate taxes would have to be paid. which would come usually not out of the trust's principal but from other assets of the estate thereby reducing or in some cases even eliminating bequests to the donor's wife, children, and other family members. We urge you not to apply an estate tax to the trust principal of a charitable remainder trust. However, if such a provision is to be passed, it should not apply to charitable remainder trusts and life income contracts made prior to the passage of the bill.

3. Life Income Contracts

We urge that present law governing life income contracts be retained. Presently there is no capital gain on the transfers of appreciated property for a life income contract, nor is there capital gain when the property transferred is later sold by the life income pooled fund. As is the case with the charitable remainder trust, we believe that the deduction should be based on the full fair-market value without capital gains tax—and that no further capital gains tax should be incurred by the life income pooled fund, which is permanently set aside for charity.

However, if this important form of gift income should be denied us, such laws should not be retroactive to April 22, 1969, as provided by HR 13270. There was no indication by either the House Ways and Means Committee or the Nixon administration that a retroactive date would be in effect for these contracts. This is, therefore, especially unfair to donors who have provided for these kinds of contracts after that date.

4. Charitable Gift Annuities

The provisions concerning bargain sales, provided for in House Bill 13270 and enacted, should specifically state that the transfer of appreciated property for a charitable gift annuity is not a bargain sale. Under the present House bill, the transfer of appreciated property for a gift annuity could be construed as a bargain sale, the donor receiving an annuity rather than cash from the charitable institution. This long established form of giving should not be abolished. Most of our colleges hold a substantial amount of funds subject to gift annuity agreements. We believe that the failure to except gift annuities from the provision governing bargain sales must have been an oversight by the House Ways and Means Committee. We urge you to provide for that oversight.

5. Abolishing of the Income Tax Charitable Deduction for Gifts of Partial Interest in Property [Section 201(a)(3), p. 121, line 8]

We assume that this portion of the House Bill is intended to deny a charitable deduction to a donor for the fair rental value of property which the donor allows a charity to use rent free. However, the language of this section of the bill has us concerned, inasmuch as it could be interpreted to abolish a deduction for gifts of undivided interest in real property as well as for gifts of remainder interest in real property. If the Senate wishes to deny a deduction for the use of property, we would urge you to rewrite the House provision so that it does not include gifts of real property subject to life estates and gifts of undivided interest in real property.

IN SUPPORT OF H.R. 13270

We support and commend Congress for many of the provisions in House Bill 13270. Some of these also affect charitable giving. Three items in particular come to our attention:

1. We support you in eliminating Clay Brown transactions. We believe organizations should be taxed on income received from debt-financed investments.
2. We believe that organizations now exempt from tax should be taxed on unrelated business income.
3. We applaud Congress on its attempt to encourage charitable giving, to organizations serving the national good, by increasing the ceiling on gift deductions to 50 percent.

CONCLUSION

The colleges and universities of the state of Washington are dependent upon gifts for their support and continued growth. A substantial portion of these gifts come in the form of appreciated property. An increasing amount comes in the form of deferred giving programs, which include charitable remainder trusts, life income contracts, and gift annuities. If the House Bill is passed, these gifts to our institutions will be greatly reduced. At a time when Congress is seeking ways to assist higher education in meeting heavy financial needs, it is inconceivable to us that tax law should be passed which would make it impossible for us to help ourselves. Now is the time to increase tax incentives, not decrease them. Congress has continually, over a long period of time, liberalized tax law to encourage gifts to our institutions. And each time Congress has indicated that any tax revenues lost were more than made up for by the good which these charities provided in the national interest. We urge you not to reverse that magnificent record.

The Independent Colleges of Washington are making a substantial contribution in preparing leadership for our nation. Were they to cease to exist, the burden of educating these young people would have to be carried by our state institutions, at the cost of an enormously increased tax burden for our citizenry.

A charitable deduction should not be thought of in the same terms as are other deductions. The philanthropically-minded person does not give up his money and property for personal gain, but rather to help our institutions to provide for others—and for the good of the nation. Although he is not motivated solely by tax advantages, these tax advantages do assist by making it easy to give and by allowing him to give larger amounts than might otherwise be possible.

Provisions in the House Bill which have to do with charitable giving, both directly and indirectly, are extremely complicated. Our institutions have succeeded in increasing their gift support by making it easy for the donor to give. The very complex nature of the House Bill will tend to discourage our donors from giving.

Again, we wish to support Congress in its desire to reform tax law. We urge you, however, to protect those long established tax incentives which have enabled America's charities, colleges, and universities to show compassion and concern, to educate, to teach and build—and indeed to share with you, and with all America, the task of building a better and a greater America.

STATEMENT SUBMITTED BY T. WILLARD HUNTER, EXECUTIVE VICE PRESIDENT, INDEPENDENT COLLEGES OF SOUTHERN CALIFORNIA

The following resolution has been adopted by the ICSC Board of Directors, a group of business leaders and college presidents joined together to strengthen this independent sector of higher education: (ICSC is an association of 14 independent colleges, educating 20,000 students, which make their case unitedly to industry.)

Twelve years ago, in 1957, President Eisenhower's Commission on Education Beyond the High School, included this significant recommendation in its export to the nation:

> "That the Federal revenue laws be revised in ways which will even more strongly encourage large contributions from more individuals to private and public non-profit higher educational institutions."

In the 56 years since the first Federal income tax was enacted, the Congress has an almost unbroken record of liberalizing the tax laws to encourage philan-

thropy. If this policy is now to be reversed, it should be so labeled and not backed into under the guise of "tax reform."

The Congress is to be congratulated on its skilled determination to effect true tax reform. We certainly want to ensure that all people pay their fair share of taxes. But we also do not want to make paying taxes, an involuntary act, more important than making contributions, a voluntary act. Indeed, contributions might well be termed a "voluntary tax," by which a taxpayer undertakes to discharge his obligations to the public by non-government means. We need also to face squarely whether we wish to shift more completely the burden of all health, education, and welfare from the private to the public sector.

Philanthropy is not a "loophole." Deductions for philanthropy are an encouragement to voluntary responsibility, not a device for avoiding responsibility.

Too much stress is being laid on how people reduce their taxes by making gifts. We need more emphasis on the good accomplished through voluntary philanthropy, at a lower cost to government, and with resulting enrichment of pluralism. Since the Government is calling for more initiative by the private sector in taking responsibility for identifying and solving public problems, it is particularly important that legislation not be enacted which would severely limit the private sector's *capacity* to take such responsibility.

The following recommendations are respectfully submitted:

1. Contributions of appreciated property should be removed from the Limited Tax Preference group and from the Allocation of Deductions process. Such contributions should be deductible at fair market value with no capital gains tax on the appreciation.
2. In case of charitable remainder trusts and life income contracts, where appreciated property is contributed, the deduction should be based on the fair market value and no capital gains tax levied, and any capital gains enjoyed by the trust or the life income pooled fund and permanently set aside for the exempt organization should not be taxed.
3. In case of charitable gift annuities, where appreciated property is contributed for the annuity, present tax treatment should be retained.
4. While the general fundations themselves are in a better position to discuss most of the sections of the House Bill that will help or hinder them in the performance of their services in the public interest, we wish to oppose the levying of a 7.5% tax on their investment income, especially on the foundations through which corporations make their contributions to independent colleges. We oppose this for two reasons: (a) it will divert many millions away from the colleges; and (b) it is a dangerous precedent which later might mean the imposition of an income tax on other types of exempt organizations such as colleges.
5. We favor the House Bill's proposal which would end the so-called Clay-Brown practice of debt-financed purchases of businesses by exempt organizations.
6. We favor also the Bill's move to tax the income of unrelated businesses owned and operated by exempt organizations.
7. We favor also increasing the limit on deductibility from 30 percent to 50 percent of an individual's income.
8. We believe that donors of tangible personal property, such as art objects, rare manuscripts, and the like, should be allowed a deduction of the fair market value. We understand a special commission for determining proper values in such cases is working well with the Internal Revenue Service.
9. We ask that "private foundations" be so defined as to exclude the state associations of colleges organized to secure financial support from corporations.

Adopted, Los Angeles, September 10, 1969.

Harold M. Hecht, ICSC Chairman of the Board, and Chairman, J. W. Robinson Co.; M. Norvel Young, ICSC President, and President, Pepperdine College; Victor C. Andrews, Partner, Andrews Brothers Co. of California; Ralph Carson, Chairman, Carson/Roberts/Inc.; J. S. Fluor, Honorary Chairman, Fluor Corp.; George R. Hearst, Jr., Publisher, Herald-Examiner; Robert T. Howard, General Manager, KNBC; Roy G. Johnston, First Vice Chairman, Brandow & Johnston Associates; Arthur D. MacDonald, President, Coca-Cola Bottling Co. of Los Angeles; A. C. Pelletier, Honorary Chairman, Purex Corp.; Thomas P. Pike, Vice Chairman, Fluor Corp.; Forrest N. Shumway, President, The Signal Co.; William French Smith, Partner, Gibson, Dunn & Crutcher; John Stauffer, Director Emeritus, Stauffer Chemical Co.; George H. Armacost, President, University of Redlands; John W. Atherton, President,

Pitzer College; Louis T. Benezet, President, Claremont Graduate School; John L. Davis, President, Chapman College; Mark H. Curtis, President, Scripps College; Richard C. Gilman, President, Occidental College; Sister Helen Kelley, President, Immaculate Heart College; Father Donald P. Merrifield, S. J., President, Loyola University of Los Angeles; Sister Cecilia Louise Moore, President, Mount St. Mary's College; Howard R. Neville, President, Claremont Men's College; Leland B. Newcomer, President, La Verne College; Paul S. Smith, Chancellor, Whittier College; John W. Snyder, President, Westmont College.

IOSC MEMBER COLLEGES

Chapman College
Claremont Graduate School
Claremont Men's College
Immaculate Heart College
La Verne College
Loyola University of Los Angeles
Mount St. Mary's College
Occidental College
Pepperdine College
Pitzer College
Scripps College
University of Redlands
Westmont College
Whittier College

EAGLEBROOK SCHOOL,
Deerfield, Mass., August 29, 1969.

Hon. RUSSELL B. LONG,
Chairman, Committe on Finance,
U.S. Senate,
Washington, D.C.

DEAR MR. LONG: Because Eaglebrook is an independent school largely supported by private contributions, I am extremely concerned about some aspects of the tax reforms presently being considered by the Congressional Committees involved.

There is no question in my mind that some reforms are deperately needed. However, measures that might reduce the incentives to support philanthropic and educational institutions do not fit my definition of "reforms." I refer specifically to the legislation that would place limitations on deductions for gifts of appreciated property.

I know that as an independent school we are not alone in relying heavily upon this specific source of income. During the past fiscal year we have received approximately $82,500 from donations of appreciated stocks. Even when this amount was added to our other sources of income we still experienced a deficit. Any measurable reduction of the $82,500 figure could have been termed disastrous.

In addition, we have just embarked upon a major and urgently needed capital improvement program, the cost of which will be several million dollars over the next few years. Traditionally, support for such programs has come largely in the form of appreciated property. At the present date we have pledges in the amount of $210,000 that we know will be coming to us in this form.

On a national scale our figures are infinitesimal. It seems to me that passage of any such limitations is likely to open a Pandora's Box of financial woes for most of the nation's private schools, museums, hospitals, orchestras, etc. Certainly many of these may be forced to close their doors—or alternatively—draw upon the public sector for financial support. It does not appear to me to be in the national interest for Congress to take such a risk.

I fervently hope that alternative programs will be carefully considered that might affect the necessary reforms without endangering the status of this vitally needed source of support.

Sincerely,

O. STUART CHASE, *Headmaster.*

STATEMENT SUBMITTED BY ARLAND F. CHRIST-JANER, PRESIDENT, BOSTON UNIVERSITY, AND PRESIDENT, ASSOCIATION OF INDEPENDENT COLLEGES AND UNIVERSITIES IN MASSACHUSETTS*

Mr. Chairman and Members of the Committee, All colleges and universities, public as well as private, face critical financial problems as they attempt to maintain and develop sound educational programs for an increasing number of students. At no time in the history of this country have educational institutions needed so much private support to meet their challenges.

The Congress of the United States, recognizing the will and the wish of the people to participate, independently of the government, in the development of educational and philanthropic institutions, established income tax laws which provided incentives for voluntary support of such organizations.

Realizing that our existing tax system requires reform in terms of fairness and equality, we are deeply concerned that some of the remedial proposals will seriously curtail our ability to meet the growing demands for expanded and improved facilities and programs.

The passage of H.R. 13270, understandably introduced in part to curb the highly-publicized though rare tax abuses of certain individuals and foundations, threatens the very principle of private philanthropy. Congressman James B. Utt (Republican-California), a member of the Ways and Means Committee and of the Joint Committee on Internal Revenue Taxation, takes note, in this statement on the bill, of the imagination and creativity of private philanthropy to meet the heavy financial responsibilities of private educational institutions, and warns that withdrawal of such support would place a heavy burden on the Federal government.

Passage of the proposed tax reform legislation would result in serious loss of income to educational institutions, thereby effecting a reduction of services which they render and a substantial weakening of their financial stability. State-supported as well as private colleges and universities would be affected, for all higher education institutions receive voluntary support from alumni and friends.

A review of the services offered by the independent colleges and universities of Massachusetts and some of their financial problems reveals some pertinent factors.

. . . During the 1967–68 academic year, 66% or 166,741 of the 252,638 students enrolled in the Commonwealth were in private institutions.

. . . 75% of the Bachelor's degrees, 85% of the Master's and first professional degrees, and 95 of the Doctoral degrees were granted by independent colleges and universities.

. . . Approximately 57 institutions of higher learning in Metropolitan Boston serve an estimated 141,000 students; of these, 48 are privately supported, enrolling 124,000 or 88% of the total.

Of more specific interest, these 48 private institutions faced estimated operating deficits of nearly $7 million for 1967–68, and conservative projections point do not include expansion of physical facilities which, by tradition, have been to deficits of $10 million annually before 1976. These are *operating* deficits and financed largely by gifts of alumni, friends, industry, and foundations.

If the independent colleges and universities of Massachusetts are to continue their important role in our system of higher education, their financial viability must be enhanced, and new avenues of financial support must be developed. Legislation which would curtail gift support would be catastrophic, and would increase the financial burdens of the people of the Commonwealth. For if the Massachusetts residents currently enrolled in our independent institutions were to transfer to publicly-controlled institutions, it would add over $100 million annually to the current tax burden for *operating* expenses only.

We are deeply concerned with any decisions affecting gifts of appreciated securites, life income gifts, and with the provisions regarding allocation of deductions. A recent study of 28 of the member institutions of the Association of Independent Colleges and Universities in Massachusetts revealed that during a single fiscal year, an average of 56% of gifts from individuals were in the form of securities and properties. If the present provisions for tax reform are approved, this support will be curtained drastically.

We believe that Congress can review and enact meaningful tax reform legislation that is compatible with traditional and historic policy that has nurtured the growth of free and independent institutions in our country.

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* Names of 52 member colleges and universities attached to this statement.

On behalf of all of the independent colleges and universities in Massachusetts, I ask that the new tax law reaffirm and extend the long-established and essential tax incentives to charitable giving which will support the American philosophy of private philanthropy in support of educational institutions.

52 MEMBER INSTITUTIONS OF THE ASSOCIATION OF INDEPENDENT COLLEGES AND UNIVERSITIES IN MASSACHUSETTS

American International College, Springfield
Amherst College, Amherst
Anna Marie College for Women, Paxton
Assumption College, Worcester
Atlantic Union College, South Lancaster
Babson College, Wellesley
Bay Path Junior College, Longmeadow
Bentley College of Accounting and Finance, Waltham
Boston College, Chestnut Hill
Boston University, Boston
Bradford Junior College, Bradford
Brandeis University, Waltham
Cardinal Cushing College, Brookline
Clark University, Worcester
College of our Lady of the Elms, Chicopee
College of the Holy Cross, Worcester
Dean Junior College, Franklin
Eastern Nazarene College, Quincy
Emerson College, Boston
Emmanuel College, Boston
Endicott Junior College, Beverly
Garland Junior College, Boston
Gordon College, Wenham
Harvard University, Cambridge
Hebrew Teachers College, Brookline
Lasell Junior College, Auburndale
Leicester Junior College, Leicester
Lesley College, Cambridge
Massachusetts Institute of Technology, Cambridge
Merrimack College, North Andover
Mount Holyoke College, South Hadley
New England Conversatory of Music, Boston
Newton College of the Sacred Heart, Newton
Nichols College of Business Administration, Dudley
Northeastern University, Boston
Pine Manor Junior College, Chestnut Hill
Radcliffe College, Cambridge
Regis College, Weston
Simmons College, Boston
Smith College, Northampton
Springfield College, Springfield
Stonehill College, North Easton
Suffolk University, Boston
Tufts University, Medford
Wellesley College, Wellesley
Wentworth Institute, Boston
Western New England College, Springfield.
Wheaton College, Norton
Wheelock College, Boston
Williams College, Williamstown
Worcester Junior College, Worcester
Worcester Polytechnic Institute, Worcester

WASHINGTON, D.C., *October 14, 1969.*

Hon. RUSSELL B. LONG,
Chairman, Senate Finance Committee,
New Senate Office Building,
Washington, D.C.

DEAR MR. CHAIRMAN: We respectfully request that this statement be included in your committee's official hearing record on H.R. 13270, the Tax Reform Act of 1969. It is filed on behalf of United Student Aid Funds, Inc., 845 Third Avenue, New York, N.Y. USA Funds is concerned that the ambiguity of portions of proposed section 4945 of the Act might impair its ability to perform its charitable functions with maximum effectiveness.

United Student Aid Funds is a national, nonprofit, tax-exempt corporation which was established in 1960 to guarantee bank loans to deserving college students who could not otherwise obtain the necessary marginal funds for their education. USA Funds does not make loans; its function is to guarantee the loans made by private commercial lending institutions.

To assure banks that any loans not repaid by students will be made good by USA Funds, USA Funds maintains a reserve fund. The income this fund produces helps pay the administrative costs of the program. Any surplus income would be added to the fund, this increasing USA Funds, capacity to guarantee additional loans. For every dollar in the reserve fund, USA funds is able to guarantee at least ten dollars in loans.

Money for the reserve fund comes from contributions by many donors, including educational institutions, businesses, philanthropic charitable foundations, etc. In many instances, reserves are earmarked to serve a specified group of

students, for example, College A might deposit $10,000 to serve as the basis for guaranteeing $100,000 of loans to students at College A. Corporation B might make a similar deposit to provide the basis for educational loans to Corporation B's employees or their children. Philanthropist C might do the same, so that loans can be guaranteed for children in a geographic area of special concern to Philanthropist C. Private foundation D might make a contribution to guarantee loans to students who intend to pursue a specified profession, or people who live in a defined geographic area. But regardless of source, it is the continuing flow of contributions to the reserve fund maintained by USA Funds that has enabled it to expand its loan guaranty activities and thus enable an ever-expanding number of students to gain the advantages of a college education.

USA Funds fears that these special deposits, and thus the volume of loan guarantees, could be severely curtailed if the language of section 4945 of the Tax Reform Act of 1969 is not clarified. We do not believe this language was designed to discourage or prevent such contributions—but lack of clarity could effectively have that result.

Section 4945 creates a class of "taxable expenditures" by private foundations, the penalty for which is a tax levied on the foundation equal to 100% of the amount of the expenditure, and a tax on the foundation manager equal to 50% of the amount of the expenditure. Section 4945(b)(3) defines a taxable expenditure as "a grant to an individual for travel, study, or similar purposes" unless the requirements of section 4945(e) are met.

Section 4945(e) has the effect of excluding from the definition of taxable expenditures individual grants awarded on an "objective and non-discriminatory basis" if they are made pursuant to a procedure approved by the Secretary of the Treasury or his delegate. Thus, USA Funds and potential contributors thereto are confronted with a set of problems. Is USA Funds by guaranteeing loans thereby making a "grant" and thus a "taxable expenditure"? Are loan guarantees made, for example, to the children of Company B's employees considered "non-discriminatory"?

Again, USA Funds does not believe it is in the business of awarding grants of scholarships, and that proposed section 4945 does not apply to its activities—and we have been assured by officials in the Treasury Department that this is the case. But the mere existence of ambiguity when viewed in the light of the penalties makes it quite probable that foundations and their managers will be inhibited in making any contributions that might fall into the arena of "taxable expenditures" and for each dollar a foundation fails to contribute, ten dollars in loans to needy students are lost. One solution to this problem would be the inclusion of language in the Tax Reform Act and your Report expressly excluding the guarantee of stdent loans from the definition of "taxable expenditures" under section 4945.

Education of our young people is among our highest national priorities. It was solely with this in mind that United Student Aid Funds, Inc. was organized. In the ten short years of its existence, it has guaranteed more than $250,000,000 in loans and thus assisted in the education of more than 310,000 deserving students. We hope earnestly that your Committee will take the steps needed, so that this legislation pending before your Committee will not impair USA Funds' ability to continue its service to America's reserving young people.

Sincerely,

HAMEL, MORGAN, PARK & SAUNDERS,
By E. A. McCABE.

HONIGMAN MILLER SCHWARTZ & COHN,
Detroit, Mich., September 18, 1969.

Re H.R. 13270, tax reform bill of 1969

FINANCE COMMITTEE OF THE SENATE,
Senate Office Building,
Washington, D.C.

GENTLEMEN: In the period since H.R. 13270, the Tax Reform Bill of 1969, was passed by the House of Representatives, I have been giving increasing time to a review of its provisions, particularly insofar as they relate to charitable institutions and charitable contributions. I have been concerned with the provisions because a substantial portion of my practice deals with federal income tax matters and because it has increasingly seemed to me that the effects of many of the provisions are more far-reaching and more inequitable than first appears.

PROVISIONS CONCERNING CHARITIES

My concern deepened when I applied the provisions to a specific problem with which I have been faced in my practice. This problem arises in the case of a husband and wife the bulk of whose estates consists of real estate which has been held by them as tenants by the entireties for approximately 40 years. They desire to retain the use of the property during their joint lives and for the life of the survivor but to presently commit the property to charitable purposes upon the death of the survivor.

Because of the nature of tenancy by the entireties for local law purposes and because of its treatment for gift and estate tax purposes under the law as now in force and because of the fact that, as is normal in such cases, all of the consideration for the property was furnished by the husband, the only method of accomplishing their purpose is one which is effectively barred by the House Bill. It seems to me that this result follows, not by design, but because in drafting the House Bill insufficient attention was given to the overall estate and gift tax impact of the provisions dealing with estate and gift tax deductions for charitable remainder interests. While I am, of course, familiar with the problems which this provision was intended to meet, I am convinced that these problems can be solved by a combination of legislative and administrative action which will not be so disruptive of long established estate and gift tax patterns.

I have accordingly prepared a memorandum which discusses in greater detail the above problem and certain other problems raised by H.R. 13270. A copy of that memorandum is enclosed. In general, the conclusion which I have reached is that although many of the abuses sought to be restrained by the House Bill are real abuses, the remedies proposed are, in general, not advisable because of their wider social consequences, because of the inequities which many will create as between taxpayers similarly situated and because of the overwhelming complexity of the proposed statutory changes.

OTHER PROVISIONS

I have also given considerable attention to the other provisions of H.R. 13270. Generally, I believe that it is fair to conclude that many of the provisions are so complex that it is difficult to determine the real contribution that they will make to tax equity in the long run. Initially, the problems involved in the preparation and audit of returns of taxpayers will make it even more difficult than it is now to intelligently plan business transactions. One of the major criticisms of the Internal Revenue Code in its present form is that tax consequences of a business transaction may vary tremendously depending on factors which have no real business or economic significance. It is clear that this criticism will be even more valid if the provisions of the House Bill are adopted.

DEFERRED COMPENSATION

The provisions of H.R. 13270 dealing with the general problems of deferred compensation are intended to correct some of the unfairness of present law. What the House Bill does not recognize is that this unfairness results from the fact that it is a basic principle of our present income tax law that not all income is to be taxed at the same rate. Certain forms of deferred compensation, for example, are now and would remain subject to favorable tax treatment. The history of the law in this area has been that the types of deferred compensation eligible for this special treatment have alternatively been widened and narrowed with exception being heaped upon exception. No meaningful reform in this area is possible unless and until the entire question of special effective rates for different types of income is reviewed. As long as any type of income is to be specially treated, the creation of new categories, new rules and new exceptions can only compound the basic inequity of the law. Thus, under the income tax law as it would stand upon the adoption of the House Bill, employees of large publicly held corporations would be more favorably treated than employees of closely held corporations; who would be more favorably treated than teachers and other employees of exempt organizations; who would be more favorably treated than all individuals who are employed by Subchapter S corporations, by partnerships or by sole proprietorships.

While the House Bill does eliminate special benefits that were in the past available to employees of publicly held corporations through use of so-called "restricted property," the Bill creates, in the pension and profit sharing area, a

new discrimination between owner-employees of corporations which for other reasons elect to be taxed normally and owner-employees of corporations which for other reasons elect to be taxed under Subchapter S of the Code.

INSTALLMENT SALES

In its provisions dealing with installment sales and the election to be taxed under the installment method, the House Bill, intending to meet one problem arising from the use of convertible debentures in the acquisition of closely held businesses by publicly owned corporations, creates a whole area of new problems in its attempt to limit the use of the installment method in other types of transactions. It limits use of the installment method to situations in which payments are spread more or less evenly over the life of the installment contract. The House Bill will prevent many transactions in which payments are not made in this way for reasons having nothing whatsoever to do with taxes. For example, it is now possible for a real estate developer to buy land but to defer payment until a lengthy course of improvement is completed. This would be impossible under H.R. 13270 because the seller will be unable to defer his tax until he actually receives the cash purchase price. This will have the result of foreclosing from real estate development those who do not have access to other forms of credit usable for the purchase of land. Large developers will be able to make earlier payment because of their ability to secure bank or other commercial financing for land purchases. It should be noted that the original purpose of reform in this area was to prevent the use of the installment sale provisions in the process of concentration of economic power by merger and acquisition. In the example given, the effect of the reform provision will be to concentrate activity in one very significant area of the economy—in large land operators.

LIMIT ON TAX PREFERENCES

The provisions of the House Bill dealing with so-called limit on tax preference will, if adopted, have the dubious distinction of being probably the most complicated provisions of the Code. It is already clear that in many respects this provision will not accomplish its purpose but will simply direct the kind of activity to which it relates into other forms.

GENERAL CONSIDERATIONS

I believe that tax practitioners will generally agree that tax equity cannot possibly be increased unless the tax law is simplified. Inequity is both a cause and an effect of complexity. I also believe that it is only a half truth to state that there is a risk that our income tax system cannot survive unless it is made more equitable. As great a threat to our system is its complexity. So-called reform which increases the complexity of the law and which relies upon new categories of income, new definitions, new exceptions and new exclusions is not reform at all and can only lead to greater unfairness and greater distortion of normal business activity for tax purposes. For these reasons it is my belief that those desiring reform of the tax law cannot accept the nation that such reform is possible by anything like the House Bill. Reform depends upon issues much more basic than those considered by the House. Although I am convinced that many of the areas with which the House was concerned are areas in which real abuses take place and in which the application of the tax law is not sound, either from the point of view of economic or social policy. I am also convinced that on balance our tax law will be worse if the House Bill is passed than if it is not. Nor do I believe that it is possible to make technical corrections to the provisions of the House Bill which would change this result. The proper way in which tax reform should be accomplished is exemplified by the work that has been done in the area of the estate and gift tax laws. While I disagree with some of the conclusions of the American Law Institute study and recommendations in this area, the reforms which it recommends are based on a clear understanding of the social goals of these taxes. The result is a thorough-going revision of the law which provides a consistent, relatively simple statutory scheme. This could not have been accomplished by piece-meal revision but was possible only because the entire body of law dealing with these taxes was considered as a whole. A similar process is required for meaningful and useful revision of the income tax law.

Certain provisions of the House Bill are not intended as structural changes in the law. Examples are the provisions dealing with percentage depletion, foreign tax credit, bank bad debt reserves, farm and hobby losses, capital gain tax

rates and holding periods, increase in optional standard deduction, and other tax rate adjustments. These proposals take the present pattern of the income tax law as given. I believe that many have merit, and do not intend that the comments in this letter apply to them.

Tax practitioners have a responsibility to assist in the improvement of the body of the tax law, without regard to the special interests of their clients. I hope that this letter will serve as a partial discharge of that responsibility.

Very truly yours,

MILES JAFFE.

MEMORANDUM

EFFECTS ON PRIVATE CHARITABLE ACTIVITIES OF THE TAX REFORM BILL OF 1969, H.R. 13270

H.R. 13270 contains provisions which would drastically revise the income, gift and estate tax consequences of private charitable contributions. These changes will not only have substantial tax effects on donors but will, without doubt, significantly affect the manner and extent to which private charitable activities are conducted. Thus, some types of charitable activity will be substantially restricted in the future while others will be significantly less affected. Furthermore, the proposed changes in the tax law will have significant effects in other areas in which public policy ought to be concerned. This memorandum is intended to explore some of these problems raised by H.R. 13270.

The comments and criticisms of the provisions of H.R. 13270 that follow are based upon certain general criteria for judging the tax system as a whole as well as specific provisions within it. It is desired that certain of these general criteria be made explicit at the outset:

1. The tax system ought not to be used as a device for subsidizing any particular form of business activity. Such subsidies are by their nature indirect and are therefore not likely to be fully considered as such by the political process. Furthermore, no tax system which attempts to subsidize can be equitable.

2. At the very least, the tax system ought to be equitable; that is, persons in substantially similar economic circumstances should be similarly taxed.

3 One consequence of the application of the two foregoing criteria would be the simplification of the tax system, a major policy goal in itself. Most of the complicated provisions of the income, gift and estate taxes exist in areas in which the tax law is being used to subsidize certain forms of economic activity or in which discrimination as between taxpayers similarly situated from an economic point of view, is deliberately intended.

4. Application of the three foregoing criteria would necessarily mean that any nominal rate structure would approximate the actual tax rate structure.

The present tax law is notable for its non-conformity to all of these criteria.

While attempts to achieve the goals implicit in the foregoing criteria are laudable, it must be recognized that the present departures from them have resulted in the development of expectations among taxpayers which are clearly justifiable under the law as it has existed for many years. Furthermore, many social institutions operating in areas far removed from the tax law have developed because of the provisions of the present tax law. Piece-meal changes in the tax law in general intended to promote a sound tax system may therefore have the effect of discriminating between persons who can and who cannot change their business and personal affairs as the tax law changes, and may have substantial side effects in other areas affected with public interest. Improvement in the tax law should minimize inequities and unfairness resulting from the changes and should be devised and implemented to reduce undesirable social repercussion.

One general comment concerning the effect of H.R. 13270 on charitable institutions and charitable contributions should also be made at the outset. tI is doubtless true that a serious policy question exists as to whether activities now conducted by private charities should be taken over by government. Many of these activities are socially essential. It can only be bad policy to discourage these activities on the part of private charities before arranging for their continuance by government. Two examples will suffice.

The importance of the existence of private colleges and universities cannot be doubted. If private support for these institutions is to be discouraged, some arrangement or substitute support by government must be made in a way which will permit them to continue to function free from the influences of the political process. While H.R. 13270 will tend to discourage private support of such col-

leges and universities, no government financing alternative is in sight. If it is specifically desired to subject private colleges and universities to the political process by making them dependent upon government for financial support, that policy should be debated and decided explicitly by the political process and not hidden in the technical provisions of nominal tax reform.

Organizations that would be denominated private foundations under H.R. 13270 have demonstrated the ability to respond quickly and flexibly to natural and social emergencies and disasters. Whatever else may be said of the activities of publicly supported charities and of government, it is certainly clear that neither is generally capable of the prompt and flexible response that has been exhibited by the best private foundations. This consideration may not outweigh the desire to place these activities under government control. At the very least, however, this issue is another which should be debated in the political process specifically and not buried in legislation nominally concerned with and debated in terms of tax reform. If such explicit debate leads to the conclusion that this advantage of private foundations is outweighed by tax considerations, then certainly some alternative means of providing the flexible kind of response needed in a rapidly changing society should be provided contemporaneously with the elimination or restriction of the private foundation.

These general considerations lead to a discussion of certain specific provisions of H.R. 13270.

Sections 201(c) and 301(a) of H.R. 13270 impose substantial limits upon the incentives to contribute appreciated property to charity. In cases in which the appreciation is not directly taxed to the donor, it is treated as "tax preference income." The appreciation itself is taxed to the donor on all gifts of other than capital assets and on gifts of capital assets to private foundations. It is clear that a substantial portion of the support of both public and private charities has come from gifts of appreciated property, under the present provisions of the tax law which leave entirely untaxed the unrealized appreciation. These proposed changes in the law will tend to reduce this type of support, particularly in view of the fact that in many cases contributions could not or would not be made at all except in the form of appreciated property. No substitute for this type of support to public charities, including schools, universities and hosiptals, is in sight.

One major use of the present provisions of the tax law dealing with gifts of appreciated property to charities has been the transfer of control of closely held businesses to private foundations. In many cases this transfer of control has been tax-motivated in the sense that the transfer of the business to the charity either makes possible the realization of funds needed to pay, for example, estate taxes, or reduces the burden of those taxes. While the general criteria for a sound tax system proposed in this memorandum indicate the desirability of treating persons whose wealth is in the form of publicly held securities no differently from those whose wealth is in the form of closely held businesses, it must be recognized that the effect of these provisions will be to make it more likely that closely held businesses will be sold to large publicly held businesses in order to make alternative provisions for taxes.

The treatment of any untaxed appreciation in property donated to charity (i.e., to publicly supported charities) as tax preference income raises a serious policy question. Donors making such gifts do not normally retain control of the property. One may question whether in any meaningful sense they have realized the appreciation from the property. Under present law unrealized appreciation escapes income tax if the owner of the property dies before disposing of it. Nor is unrealized appreciation taxed at the time of an inter-vivos gift to a private person, even if control is retained. It is questionable whether the person who, instead of holding the property, gives it to charity ought to be subject to a tax which his less generous counterpart will escape. It would be ironic if a man who gives appreciated property to charity during life realized more income than the man who gives appreciated property to his children during life. It would appear wise to treat the general problem of unrealized appreciation in a unified manner so as to avoid this type of discrimination.

Section 101(a) of H.R. 13270 imposes a 7½% tax on investment income of charitable institutions. The bulk of this tax will be borne by the beneficiaries of charitable activities. This tax gives every appearance of being nothing but a device to discourage private charity without providing realistic alternative sources for the benefits private charity makes available.

Section 101(a) of H.R. 13270 imposes a substantial penalty tax on the termination of the tax exempt status of private foundations. At the discretion of the Treasury these penalties can be abated if as part of the termination of exempt status, all of the assets of the foundation are distributed to charity. There would appear to be no reason why such abatement should not be automatic unless the provision is an invitation to the Treasury to impose restrictions on the principle of abatement in these circumstances.

Section 101(b) of H.R. 13270 imposes a substantial tax on the ordinary income of private foundations not distributed currently for charitable purposes. Such undistributed income is defined to include a reasonable rate of return on all investment property whether it produces that return or not. The provision gives no relief in cases in which non-income producing property is donated to the foundation and the foundation's trustees, for good business reasons, hold the property for a time in order to realize what they consider to be its full fair market value. For example, if a private foundation receives a gift of non-dividend paying, listed securities today, the trustees might well decide that the market is depressed and that it would be desirable to hold the securities until the stock can be sold at a better price; or, a parcel of vacant land might be donated at a time at which money market conditions make realization of its intrinsic value impossible.

The law should permit trustees to hold such assets for a reasonable period of time without running the risk of incurring this penalty tax. The existence of the tax will further make it almost impossible for the trustees to properly exercise their fiduciary responsibility. If the property is sold at less than its intrinsic value because of an artificially depressed market, the trustees may be subject to surcharge. On the other hand, if the property is not sold promptly and the penalty tax is imposed, the trustees may also be subject to surcharge. While it is, without doubt, desirable to require private foundations to make distributions out of income reasonably currently, they should have a reasonable time to dispose of undesirable assets.

The same section of H.R. 13270 imposes a penalty tax on investments of private foundations which jeopardize its exempt activities. The statute provides no standards defining such unsafe investments. Further, the section would appear to apply to a case in which a foundation received a gift of highly speculative property and held it only for a period reasonably necessary to effect its orderly disposition. This provision of the House Bill, together with the provision imposing the penalty tax on undistributed income, will, as indicated herein, in many cases penalize responsible conduct on the part of private foundations. Both problems could easily be solved by covering specifically the problem of orderly disposition of non-income producing or speculative assets received by gift or becoming improper investments for the foundation through no fault of its trustees. A reasonable period of time for disposition of such property ought to be granted.

Section 201(e) of H.R. 13270 prohibits an income tax charitable deduction for remainder interests in trusts unless the preceding income interest provides for either the payment of a fixed amount of money per year to the income beneficiary or provides for the payment of a fixed percentage of the value of the corpus per year to the income beneficiaries. Section 201(h) eliminates the estate and gift tax charitable deductions for charitable remainder interests unless the life income interest meets the same standards. It is unlikely that the disallowance of the income tax deduction in these circumstances will have any really significant effect. However, the amendment of the estate and gift tax law does appear to be ill-advised at this time. An example of the perhaps unintended effects of this provision, developed from a real situation, indicates the kind of problem created. A husband and wife long ago acquired, with funds furnished entirely by the husband, as tenants by the entireties a substantial tract of real estate on which they have made their residence. They have provided for their children from other assets during their lives and desire to pass all of their property to charity on the death of the survivor of them. In addition to the real estate, each owns securities. However, the total value of the securities is less than the value of the real estate. Because the husband furnished all of the consideration for the purchase of the real estate, its entire value will be includible in his gross estate, notwithstanding that without the consent of the wife her interest in the property cannot be eliminated.

Under present law, without terminating the tenancy by the entireties and incurring a substantial gift tax, there is only one way that the property can be given to charity after the death of both without the imposition of a substantial

tax. The husband and wife have effectively agreed that unless both of them consent during their joint lives, on the death of the survivor the property is to pass to charity. Under the estate tax law as it now stands, the entire value of the real estate will be included in the husband's gross estate but he will receive a deduction for the value of the charitable remainder. Thus, estate tax will be imposed only on the value of the wife's life estate. Under the House Bill the entire value of the real estate will be included in the husband's taxable estate since the wife's life interest is not such as will qualify the remainder for the charitable deduction. Because the land is not income producing, there is no way to meet the requirements of the House Bill. Furthermore, no part of the value of the property will qualify for the marital deduction since the wife's interest is limited to a life estate. This result follows even though it would be impossible for the husband to make a present outright gift to the charity without the wife's consent.

This harsh provision is intended to eliminate valuation problems that arise when a remainder interest in a trust is given to a charity. Under present Treasury Department practice these remainder interests are valued on the basis of a discount table which uses an assumed rate of interest of only 3½%. Clearly such a low rate of interest is unwarranted. There would appear to be no reason why even without legislation the Treasury Department could not require the use of a discount table based on a more realistic rate of interest. Certainly, Congress could (and should) give the Treasury Department any specific authority it feels it may need to accomplish such a result. Another valuation problem arises because the courts have held that in some circumstances even if the life income beneficiary may receive emergency distributions of corpus, the value of the charitable remainder may escape significant reduction if it is unlikely that the power to invade corpus will be exercised. Specific legislation could also close this loophole. However, in the example given above, there is no possibility of invasion of corpus.

The American Law Institute proposal for the reform of the estate and gift taxes would free from such taxes transfers between spouses but would tax all transfers from one generation to the next. It should be noted that if this proposal were adopted, no tax on the real estate would be imposed on the death of the husband or on the death of the wife in the above example even if no commitment to the charity were made until the death of the survivor.

Piece-meal amendment of the estate and gift tax law of the type proposed in the House Bill is bound to create serious inequities and raise substantial technical problems. The example given deals with property held by the entireties, but other problems will doubtless arise in other situations in which gift and estate tax burdens do not coincide with ownership for local law purposes. The estate and gift tax law should be separately considered by the Congress, and until that consideration, the amendment proposed by the House Bill should be eliminated.

In the example given above, assuming the use of a discount table based on a reasonable rate of interest, no valuation problem exists. There would appear to be no other reason to make impossible the tax-free transfer of this particular property to charity after the death of the husband and wife who live on it. Even if there were a reason for imposing a tax, that reason should be considered in conjunction with a thorough-going reform of the estate and gift tax law, for, as indicated in this particular case, the extreme reform of freeing from tax all inter-spousal transfers and taxing all inter-generation transfers would permit a tax-free accomplishment of this charitable purpose, would eliminate the valuation problem, and would accomplish much more significant (and fairer) reform of these transfer taxes. In general, provisions which affect the manner in which property is held and the manner in which it is transferred without consideration by gift or on death, for gift and estate tax purposes, should not be adopted without careful consideration of the entire body of estate and gift tax law.

The types of income interest permitted to precede the charitable remainder under the House Bill are not the types which, absent any tax consideration, would be generally used in estate planning. Without regard to tax considerations, a fixed dollar income for the life beneficiary, given the fact of inflation, simply does not give sufficient protection to the income beneficiary. Similarly, however willing the taxing authorities may be to undertake periodic evaluations of the corpus of a trust, no fiduciary will welcome that responsibility where the amount to be paid annually to the income beneficiary would be so directly affected. The present money market illustrates another problem; If a trust providing for payment to the life beneficiary of a fixed percentage of the value of corpus today held debt securities, the amount of distributable income would have dropped,

because of the rise in interest rates, even though actual income remained unchanged and living costs continued to rise. Furthermore, in many cases opportunities for tax avoidance by over-valuation of corpus would be more difficult to eliminate than those afforded by the Treasury policy and court decisions referred to above. Whatever else the gift and estate tax laws are intended to accomplish they should make it possible, for example, for a husband to make adequate provision for the support of his wife after his death as well as for any other dependents who for any reason may be incapable of supporting themselves. A provision which discourages people from doing so in a reasonable manner, without consideration for tax effects, and which discourages the use of charitable remainders after that duty is discharged will simply have the effect of reducing charitable contributions. If the property is to be taxed anyway, it might just as well be given to private individuals rather than to charity. The tax revenues will be the same in either case but the policy of the estate tax law, namely the reduction of the amount of wealth passing from one generation to another, will be frustrated.

Section 201 (f) of H.R. 13270 changes present law under which trusts and estates are entitled to unlimited charitable deductions for amounts paid, credited or irrevocably set aside for charitable purposes. The House Bill limits the deduction to amounts actually paid. This provision contains a real inequity and what may be an unintended trap. The provision of the House Bill discussed immediately above eliminates the income, gift and estate tax deduction for charitable remainder interests unless the preceding income interest provides for payment of a fixed sum of money per year or a fixed percentage of the value of the corpus per year. Suppose the existence of a trust which provides for the payment of a fixed sum of money per year to a life beneficiary with remainder to charity. The corpus of the trust is composed of property having a low basis for tax purposes in relation to its fair market value. Sound investment policy dictates the sale of the property and it is accordingly sold. Under present law no part of the gain would be subject to tax and under the terms of the trust the amount distributable to the income beneficiary would not be affected. Under the House Bill, however, unless the entire gain were distributed to the charity, the trust would be required to pay a capital gain tax. That capital gain tax might be sufficiently large in relation to the total value of the corpus as to make it impossible to realize the guaranteed annual amount distributable to the life beneficiary. However, the only way to avoid the tax is to distribute the entire gain to the charity. This is even more likely to make it impossible for the trust to generate the required income. In this circumstance this provision of the House Bill would appear to be clearly unreasonable since it will tend to force the retention of an investment which ought otherwise to be sold. The real interest of both the life beneficiary and the charity having the remainder interest will thus be jeopardized. If, as in this example, the value of the remainder interest is deductible, there would appear to be no reason for imposing a capital gain tax since it is certain that the charity will receive the entire corpus.

It should be pointed out that this provision of Section 201 (f) may well lead to an absurd result. If the settlor of a trust provides for a distribution out of income of a fixed amount to a life beneficiary with a remainder to charity, he may still lose the deduction if the corpus of the trust is composed of assets which if sold will require payment of a capital gain tax in an amount which may make it uncertain as to whether the trust will earn enough income to meet the required payment. Similarly, if the trust instrument provides for the immediate distribution of the entire gain to charity in order to avoid the capital gain tax, the charitable deduction may similarly be lost because the amount of remaining corpus would be insufficient to provide the guaranteed income.

The foregoing discussion touches only on some of the problems raised by H.R. 13270. A number of general comments concerning the House Bill as it deals with charities and charitable contributions should also be made.

These provisions of the Bill are enormously complex. They are so complex that it is difficult to determine now whether or not they will create more inequities and more problems than they solve. Long experience with the Internal Revenue Code indicates that in general and over the long run, simplicity is not only a goal in and of itself, but is also a test for judging the efficacy of any specific provision. The charitable provisions of the House Bill (like the rest of its provisions) are tremendously complicated and are therefore presumptively bad legislation. It can confidently be predicted that these provisions of the House Bill will lead to a tremendous amount of litigation and will involve the Internal

Revenue Service in administrative time and expense significantly out of proportion to the amount of tax revenue involved. It can also be confidently predicted by the experienced practitioner that tax practitioners will realize substantial additional profits if H.R. 13270 is adopted in anything like its present form. The tax practitioner who is also interested in social policy as it relates to the tax law is aware that it is presumptively correct that the social utility of a provision of the tax law varies inversely with the size of his fees relating to that provision. Looking at all of the provisions of H.R. 13270 as they apply to charities, it must be concluded that socially useful charitable activity would be restricted by these provisions to a much greater extent than either tax equity or tax revenues would be improved.

MILES JAFFE.

STATEMENT OF POSITION OF AMERICAN GEOGRAPHICAL SOCIETY, SUBMITTED BY MYER FELDMAN, ATTORNEY

The American Geographical Society is a tax-exempt organization. The Society maintains a substantial library with particular excellence in its geographical subjects, and the best map collection outside the Library of Congress. It sponsors research, and publishes maps and journals. It operates at a substantial deficit, deriving income from membership dues, and also from gifts from corporations, individuals and foundations.

Many of the maps made by the Society are purchased by the Government, and in some cases the Government has purchased the plates. The price has in general been well below the cost of production to the Society. If the Society is forced by financial stringency to discontinue operations, many of its functions will either have to be taken over directly by the Government, or the Government will have to obtain less good maps from other sources. In either event, the cost will be passed on to the Government in various ways. For many years the Society has been doing research and carrying on publishing, which benefits the Government, at the expense of its income derived from gifts and contributions.

The Society feels that changes in the tax structure which would cut down on gifts and thus cut down on the Society's income would directly be contrary to the interests of all the services it performs, including that for the Government, and would be undesirable public policy. We have found the statement by the American Council on Education to be a good one in this regard, and wish to adopt this same view.

Owing to the wide nature of its support, the Society understands that it would probably not be deemed a "private foundation" subject to the stringest restrictions applicable to such foundations under the proposed law. However as a recipient of grants from private foundations, the Society would inevitably suffer from the curtailment of their activities as well as from the restrictions which the law would impose on the tax deductibility of contributions and bequests from individuals.

BOARD OF CHRISTIAN SOCIAL CONCERNS
OF THE UNITED METHODIST CHURCH,
Washington, D.C., October 31, 1969.

Hon. RUSSELL B. LONG,
Chairman, U.S. Senate Committee on Finance,
U.S. Senate, Washington, D.C.

DEAR SENATOR: The United Methodist Church has a natural interest in the question of public policy as it relates to tax-exempt institutions. First, we sponsor and operate thousands of churches, hospitals, colleges, universities, social centers, homes and other organizations which depend for their existence upon charitable giving. Also, we are sensitive to the need for the work of secular institutions in research and education that depend upon gifts.

In fact, it is difficult to imagine the kind of nation state in which we would live if such acts of charity were made burdensome because of precipitate changes in public policy concerning the status of tax-exempt institutions. At the same time, we are aware of some practices which have served narrow self-interest and that need correction. We know that you share these concerns.

I am enclosing for the record of your hearings and for your consideration a policy statement which was passed by the General Board of Christian Social Concerns of The United Methodist Church on October 9, 1969. The General

Board of Christian Social Concerns does not purport to speak for all United Methodists. It is an official agency of The United Methodist Church elected on a regional representative basis and speaks to the church and society on important social issues.

Thank you for your consideration of this matter.

Sincerely yours,

LUTHER E. TYSON,
Director, Department of Economic Life.

POLICY STATEMENT ON TAX REFORM AS RELATED TO CHARITABLE GIVING

Whereas the services provided by research, health, educational, welfare, cultural, religious, and charitable organizations are vital to the well-being of society;

And, whereas these continued services are dependent upon the gifts and donations of both citizens and institutions:

And, whereas proposed legislation at the federal level unduly restricts the likelihood and possibility of creating and furthering the growth and activities of the above mentioned organizations; be it

Resolved, That the tax policies of the nation be so designed that the incentive to give and to support the above organizations be enhanced;

That, while tax reform is needed, such legislation should make adequate distinction between those who receive tax windfalls and those who receive legitimate tax deductions because of their gifts to worthy causes;

That we oppose taxation of truly charitable foundations;

That tax policies be so designed that the activities of organizations in educating the public concerning issues of vital social significance and in seeking the registration of voters should not be limited through punitive policies.

We call the attention of all to the resolution of the 1968 General Conference of The United Methodist Church that states: "It is our conviction that the special treatment accorded to 'churches and conventions or associations of churches' with respect to exclusion of their unrelated business income from income taxation ought to be discontinued."

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